

Export Subsidies and the World Trade Organization

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I. INTRODUCTION

A basic approach is to recognize that there is a vast universe of governmental activity that can be called “subsidy” under broad definitions, but to recognize that the international system should not be concerned about all the contents of this vast universe.

- John H. Jackson¹

The mere utterance of the word “subsidies” sounds alarm bells in the minds of some international trade policy pundits and politicians. The term “export subsidies” intensifies the ringing of these bells to a deafening level. One learned trade law academic has gone so far as to wonder if an importing country should have an obligation to counter export subsidies by imposing countervailing duties on the products concerned.² And yet the use of subsidies, and more specifically of export subsidies, is rampant and pervasive worldwide, particularly in certain sectors, one of which is agriculture. One of the primary functions of modern governments is to redistribute income. Taxation and subsidization are major instruments used by governments to achieve their redistribution objectives. Thus, governments closely guard the right to subsidize. Subsidies, the argument goes, run so contrary to the spirit of free trade that they are by definition trade distorting and are consequently to be identified and progressively eliminated. However, it seems the operation of modern democratic and authoritarian governments alike requires the provision of subsidies to all kinds of sectors for all kinds of purposes. The true challenge thus becomes to determine which subsidies are trade distorting to an unacceptable degree—unacceptable that is, according to some mutually agreed upon standard of review. A further question,

¹ John H. Jackson, *The World Trading System* (Cambridge, Mass. and London: MIT Press, 1997) (2ed) at 293.

² Jackson, *Ibid.* at 280.

and ultimately one which requires a political response, is whether states are prepared to allow an international organization such as the WTO to intrude into domestic policy so as to prohibit the granting of subsidies, particularly export subsidies, for whatever sovereign purposes states see fit.

One of the mandates of the World Trade Organization (WTO), and of its predecessor, the General Agreement on Tariffs and Trade (GATT), was to discipline the national use of subsidies, especially export subsidies. Export subsidies for most industrial products have been banned for some time now.³ However, disciplines on export subsidies in other sectors have been slow and difficult to conclude and implement. The aircraft⁴ and agriculture⁵ sectors are notable cases. With the completion of the Uruguay Round of Multilateral Trade Negotiations, new disciplines were introduced through the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)*⁶ and the *Agreement on Agriculture (AOA)*⁷ for all sectors. These new rules were the subject of great controversy, and as a result the final texts are not without ambiguity. Thus, the rules have been subjected to close scrutiny by states through the WTO's dispute resolution mechanism.

³ Article XVI of the GATT 1947, as amended in 1955. The prohibition of export subsidies did not apply to primary products however. See Jackson, *Ibid.* at 285-286. See also, N. Chalifour and D. Buckingham, "Counting Our Chickens Before They Hatch: New Hope or No Hope for Discipline in Agricultural Trade under the new GATT and the NAFTA?", (1994) 32 Canadian Yearbook of International Law 111 at 118-119; and Gail Pearson, "Business Incentives and the GATT Subsidies Agreement", (October 1995) 23(5) Australian Business Law Review 368 at 373-375.

⁴ Oliver Stehmann, "Export Subsidies in the Regional Aircraft Sector – The Impact of Two Panel Rulings Against Canada and Brazil" (December 1999) V. 33 No. 6 JWT 97.

⁵ Dale McNeil, *Farthering the Reforms of Agricultural Policies in the Millennium Round*, Winter 2000 9(1), Minnesota Journal of Global Trade at 41.

⁶ *The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* (Geneva: GATT Secretariat 1994) at 264 [hereinafter the *SCM Agreement*].

⁷ *The Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts* (Geneva: GATT Secretariat 1994) at 39 [hereinafter the *AOA*].

This paper seeks to examine the increasingly important and contentious issue of the permissible use of export subsidies under WTO rules. The paper is divided into five major sections. The first section reviews the last ten years (1990-2000) of legal literature on WTO rules that affect the interpretation and legitimacy of export subsidies. The second part of the paper explores the interpretive approach the WTO's Dispute Settlement Body (DSB) has taken in addressing disputes. The third and fourth parts of the paper provide a detailed interpretation of the term "export subsidies" and the ambit of the prohibition of such subsidies under the WTO's *SCM Agreement* and *AOA* respectively. The jurisprudence of the DSB's panel and appellate reports amplifies these interpretation issues. The third and fourth sections of the paper both end with proposed legal tests for export subsidies under their respective agreements. The final section provides an economic perspective on the export subsidy tests.

**A. LEGAL LITERATURE EXPLORING THE SUBJECT OF SUBSIDIES
(1990-2000)**

1. Legal Literature

A fairly limited legal literature that examines the specific subject of subsidies under the WTO has developed over the past decade. The scant state of the literature is somewhat surprising considering the continued widespread use of subsidies and the relative frequency with which subsidy cases have already been before the DSB. A brief review of the literature that does exist will suffice to demonstrate the lacunae that this paper is attempting to fill.

The literature can be grouped roughly into four major streams. The first is the general analysis of WTO provisions on subsidies. Treatment of this subject often appears in general treatises on trade law such as John Jackson's *The World Trading System* and his most recent compilation of his essays, *The Jurisprudence of GATT and the WTO*.⁸ There are several Canadian trade law texts⁹ that, like Jackson's work, dedicate at least one chapter to the treatment of subsidies under the WTO. While this academic treatment of the subject of subsidies is a welcome addition to the legal literature, there is a noticeable dearth of academic texts or articles penned with a specific focus on subsidies under WTO law.¹⁰

A second stream of legal literature looks at the effects of the WTO agreements on the policies and legislation of particular countries in the formulation of national subsidy programs and the administration of countervailing duty law.¹¹ Several articles document the effects of WTO subsidies law on the United States,¹² the European Union,¹³ China,¹⁴

⁸ See Jackson, *supra* at note 1, particularly chapter 11 "*The Perplexities of Subsidies in International Trade*" at 279 (Cambridge: Cambridge University Press 2000), particularly Chapter 7 "*Perspectives on Countervailing Duties*" at 87.

⁹ Jon R. Johnson, *International Trade Law*, (Concord, ON: Irwin 1998) at chapter 6 "Antidumping and Countervailing Duties, Subsidies, and Safeguards"; Lawrence L. Herman, *Canadian Trade Remedy Law and Practice* (Toronto: Emond Montgomery 1997) at chapter 7; J.G.Castel et al., *The Canadian Law and Practice of International Trade*, (2ed.), (Toronto: Emond Montgomery 1997) at chapter 15.

¹⁰ Lara Friedlander, "*Lamenting the Disappearance of Pragmatism: Subsidies Law After the Uruguay Round*", (1994-95) 25 R.D.U.S. 287 is a notable exception to the trend partly because of its singular focus on subsidies and partly because of its counter-current conclusions that the WTO subsidies law may be less effective in the long run than the subsidies law that existed under the GATT; Pierre Didier, *WTO Trade Instruments in EU Law* (London: Cameron May, 1999), at 208-291.

¹¹ A recent contribution that bridges the first and the second stream of subsidies legal literature is William K. Wilcox's "GATT-Based Protectionism and the Definition of a Subsidy", (1998) 16 Boston University International Law Journal 129.

¹² Paul C. Rosenthal and Robert T.C. Vermylen, "*The WTO Antidumping and Subsidies Agreements: Did the United States Achieve its Objectives During the Uruguay Round?*", (Spring 2000) 31 Law and Policy in International Business 871; Richard O. Cunningham, "*Commentary On the First Five Years of the WTO Antidumping Agreement and the Agreement on Subsidies and Countervailing Measures*",

and Australia.¹⁵ As well, some very specific pieces have been written on certain aspects of WTO treatment of subsidies.¹⁶

A third stream focuses on analysis of specific WTO decisions and pays attention to cases that involve an examination of countervail measures or specific subsidies.¹⁷ A final stream of literature centres on the impact of WTO subsidies law in specific sectors,¹⁸ particularly agriculture.¹⁹ One interesting piece of scholarship which does not fit easily into any of these

(Spring 2000) 31 *Law and Policy in International Business* 897; Gary N. Horlick and Kristy L. Balsanek, "U.S.-GATT Antidumping and Countervailing Duty Implementing Legislation: Reflecting the Spirit of the Uruguay Round Agreement?", (Summer 1994) 15(2) *Can. Compet. Rec.* 33; David Rushford, "Subsidies and Privatization: Protectionism's Integral Role in United States Trade Law" (Winter 1999), 32(2) *U.C. Davis Law Review* 485.

¹³ Pierre Didier, *Les principaux Accords de l'OMC et leur transportation dans la Communauté Européenne*, (Brussels: Bruylant, 1997). In translation as *WTO Trade Instruments in EU Law: Commercial Policy Instruments: Dumping, Subsidies, Safeguards, and Public Procurement* (London: Cameron May, 1999); Paul Waer and Edwin Vermulst, "EC Anti-Subsidy Law and Practice After the Uruguay Round: A Wolf in Sheep's Clothing" (June 1999) *Journal of World Trade* at 19-43.

¹⁴ Jianming Shen, "A Critical Analysis of China's First Regulation on Foreign Dumping and Subsidies and its Consistency with WTO Agreements" (Fall 1997) 15(2) *Berkeley Journal of International Law* 295.

¹⁵ Gail Pearson, *supra* at note 3.

¹⁶ Terence P. Stewart and Amy S. Dwyer, *WTO Antidumping and Subsidy Agreements: A Practitioner's Guide to 'Sunset' Reviews in Australia, Canada, the European Union, and the United States* (The Hague, Boston: Kluwer Law International 1998).

¹⁷ Terence P. Stewart and Mara M. Burr, "The WTO's First Two and a Half Years of Dispute Resolution" (1998) *North Carolina International Law and Commercial Regulation* 481; Miguel Montana-Mora, "International Law and International Relations Cheek to Cheek: An International Law/International Relations Perspective On the U.S./E.C. Agricultural Export Subsidies Dispute" (Fall 1993) 19(1) *North Carolina Journal of International Law and Commercial Regulation* 1.

¹⁸ Such as Aircraft Construction, see *supra* at note 4, and Lawrence L. Herman, "Aircraft Subsidies Decision Has Major Implications" (Oct. 1999) 18 *Legal Alert* 49.

¹⁹ N. Chalifour and D. Buckingham, *supra* at note 3; Jim Dixon, "Nature Conservation and Trade Distortion: Green Box and Blue Box Farming Subsidies in Europe", (Spring 1999) 29(3) *Golden Gate University Law Review* 415; Larry Martin and Al Mussell, "Canadian Dairy Export Subsidies and the WTO Appellate Decision: Dairy Market Expansion In Limbo: A Special Report" (Guelph: George Morris Centre, 2000); Randy Green, "The Uruguay Round Agreement on Agriculture", (Spring 2000) 31 *Law and Policy in International Business* 819; Miguel Antonio Figueroa, "The GATT and Agriculture: Past, Present and Future", (Fall 1995) 5(1) *Kansas Journal of Law & Public Policy* 93; Louis Lorvellec, "Back to the Fields After the Storm: Agriculture in the European Union After the Uruguay Round Agreements", (Winter 1997) 2(2) *Drake Journal of Agricultural Law* 411; Joseph A. McMahon, "The Uruguay Round and Agriculture: Charting a New Direction?", (Summer 1995) 29(2)

streams looks at the treatment of subsidies in regional trade agreements around the world.²⁰

a. Analysis of subsidies issues primarily within the context of the WTO

i) Treatment of subsidies issues by trade law texts

Given that trade law texts attempt to cover all the major issues in international trade law, often in less than 500 pages, the treatment of subsidies issues is necessarily superficial. The texts generally begin by situating subsidies and countervail law within the arsenal of national trade remedies to combat unfair foreign competition. Thus the discussion of subsidies and dumping finds its way into the general discussion of countervailing duties (CVDs), antidumping duties, safeguard remedies and emergency actions.²¹ Usually, authors will trace the development of subsidies law from its infancy in the 1947 GATT Article VI, through the 1955 amendments which prohibited export subsidies for all but primary products, to the limited success of the 1979 Tokyo Subsidies Code, and conclude with an examination of the WTO's *SCM Agreement* (and sometimes the *AOA*) provisions.²² While

International Lawyer 411; Clayton Yeutter, *"International Trade Agreements: Implications for Agriculture"* (Spring 1995) 18(3) Hamline Law Review 319; Jimmye S. Hillman, *"Agriculture in the Uruguay Round: A United States Perspective,"* (Summer 1993) 28(4) Tulsa Law Journal 761.

²⁰ Jean-Francois Bellis, *"The Treatment of Dumping, Subsidies and Anti-competitive Practices in Regional Trade Agreements"* in Paul Demaret, Jean-Francois Bellis and Gonzalo Garcia Jimenez, *Regionalism and Multilateralism After the Uruguay Round* (Brussels: European Interuniversity Press; 1997) at 363.

²¹ Johnson, *supra* at note 9, at 146-147; Herman, *supra* at note 18, at 1-9; Castel et al., *supra* at note 9, at 497-498.

²² See Jackson, *supra* at note 1, at 285-293; Herman, *supra* at note 18, at 1-4 and 40-41; and Castel et al. *supra* at note 9, at 499-500.

the texts may give a brief definition of what constitutes a subsidy, there is usually very little, if any, examination of the ambiguities that the WTO agreements create.²³

The WTO's *SCM Agreement* outlines a two-pronged definition of a subsidy. A subsidy is deemed to exist if there is "financial contribution by government or any public body" and "a benefit is thereby conferred".²⁴ The general texts often quote the specific provisions from Article 1.1²⁵ but rarely is either prong analyzed in sufficient detail. Jackson²⁶ does, however, provide a very helpful explanation of the origin of the two prongs of the definition and how the U.S. and European positions differ on the interpretation of the meaning of financial contribution.

The specificity rule, set out in Article 2 of the *SCM Agreement*, is canvassed next, albeit briefly, in most of the texts.²⁷ Subsidies subject to discipline under the *SCM Agreement* (and able to be countervailed) must be specific. Specific subsidies are those to which *de jure* or *de facto* access is limited to certain enterprises,²⁸ subsidies to which access is limited to certain enterprises in a designated geographic region,²⁹ and subsidies that are prohibited.³⁰

²³ Here, Jackson is the exception in that he provides a clear and systematic examination of the structure of the *SCM* and some of the difficulties and ambiguities that it contains. See Jackson, *supra* at note 1, at 290-300.

²⁴ *SCM Agreement*, Article 1.1.

²⁵ See for example, Castel et al., *supra* at note 9, at 509-511.

²⁶ Jackson, *supra* at note 1, at 295-296.

²⁷ Herman, *supra* at note 18, at 44-47; Castel et al., *supra* at note 9, at 508. Jackson, *supra* at note 1, does a better job than the other texts at examining the rationale and some of the limitations of the "specificity test" at 296-298.

²⁸ *SCM Agreement*, Article 2.1.

²⁹ *SCM Agreement*, Article 2.2.

³⁰ *SCM Agreement*, Article 2.3. Prohibited subsidies are set out in Article 3 and include subsidies contingent on export performance and those contingent upon the use of domestic over imported goods.

In the three Canadian general trade texts, the balance of the coverage of subsidies outlines the WTO framework for countervailing duty actions³¹ as well as the procedure Canada follows to determine if a subsidy exists and whether it is causing or threatens to cause material injury to domestic industries.³² All of the texts make some attempt to comment on the congruency of current national countervail legislation and international obligations assumed under the WTO.

The Jackson text is less oriented to a step-by-step analysis of U.S. practice but often refers to specific aspects of U.S. practice as examples. Jackson concludes his examination of subsidies with an “inventory” of the remaining problems that must be sorted out with subsidies.³³ They include:

- (1) Governments, especially strong ones like the United States, need to exercise restraint in the use of CVDs, for if they apply a CVD to a particular practice other states are likely to follow suit.
- (2) A new prerequisite for an actionable subsidy should be a finding of “substantial cross-border effects”.
- (3) Further elaboration and definition are needed for prohibited and non-actionable subsidies.
- (4) The “injury test” for actionable subsidies should be preserved and should be better implemented.

³¹ Johnson, *supra* at note 9, at 151-152.

³² The national coverage is done in significant detail in Castel et al., *supra* at note 9, at 512-576; and in Herman, *supra* at note 18, at chapters 3-6 and 10-18.

- (5) Provision of a more explicit and higher *de minimus* cutoff is needed for the percentage of subsidization required for CVDs to be established.
- (6) Procedural costs must be reduced for parties involved in a CVD case.
- (7) CVD procedures ought not to be based on practices that have occurred far in the past. Instead, WTO rules should permit states to look more into the future, using the “threat of material injury” as a means to prevent some unfairly subsidized imports from entering an importing country’s market.

The interaction between the *SCM Agreement* and the *AOA* in the treatment of agricultural subsidies is rarely canvassed under the coverage of subsidies in the general texts.³⁴ Agricultural export subsidies have been quantified for each WTO member state under the *AOA* and are subject to reduction commitments that will be fully implemented by 2001. An agricultural export subsidy within a country’s reduction commitment level³⁵ is a non-actionable subsidy under both the *SCM Agreement* and the *AOA*.³⁶ Even Jackson does not specifically examine the connection between the two but instead only states parenthetically that “agricultural subsidies are handled by a different agreement” from the *SCM Agreement*.³⁷ Furthermore, in his brief section on agriculture under the Uruguay Round agreements, Jackson provides only one paragraph on the *AOA*’s treatment of export

³³ Jackson, *supra* at note 1, at 301-302.

³⁴ Johnson, *supra* at note 9, at 152-154 is the exception, with Herman, *supra* at note 18, not mentioning the connection and Castel et al., *supra* at note 9, briefly noting the connection at 37 and at note 27 at 501.

³⁵ As set out in Part V of the *AOA* and members Schedule 5 to the *AOA*.

³⁶ However, such measures may be countervailable under the NAFTA as between Canada and the United States under Article 701(2).

³⁷ Jackson, *supra* at note 1, at 292.

subsidies for agricultural products.³⁸ Thus, with regard to subsidies extended to agricultural products, much work is still needed to develop a clearer understanding of the relationship between the *SCM Agreement* and the *AOA* and the obligations flowing to member states from the interface of these agreements.

ii) Treatment of subsidies issues in trade law articles focusing on the WTO

During the period leading up to and immediately after the conclusion of the Uruguay Round there was much speculation as to how the new, comprehensive World Trade Organization Agreement (WTOA) would come to grips with disciplining subsidies. One interesting piece from this period which provides a good analysis of subsidy treatment under the WTOA is Friedlander's "Lamenting the Disappearance of Pragmatism: Subsidies Law after the Uruguay Round".³⁹ After conducting a thorough historical review of the development of subsidies disciplines under the GATT before the conclusion of the Uruguay Round, Friedlander points out that the pre-WTO disciplines for subsidies consisted of a two-track approach—the right of states to impose CVDs if the country could prove the existence of a subsidy, material injury, and a causal connection between the two; and the right to request consultations with another member of GATT when an export or any subsidy was causing harm to a domestic industry.⁴⁰

Friedlander argues that the WTO's *SCM Agreement* has introduced a rigidity and legalism that might do a disservice to the WTO as an institution and to the members of WTO. With

³⁸ Jackson, *supra* at note 1, at 316.

³⁹ Friedlander, *supra* at note 10.

the categorization of subsidies into “prohibited”, “actionable”, and “non-actionable” groups, specific rules apply as to how countries can defend against or attack export subsidies. It is the introduction of these rules that reduces the flexibility of GATT’s consensus-based approach to working out difficulties amongst members. While Friedlander acknowledges that the definition of subsidies has been clarified, members must now argue for or against legal interpretations rather than deal with broader pragmatic concerns. Furthermore, the classification system proposed in the *SCM Agreement* does not “clearly address the underlying, more complex issue in subsidies law: the determination of the ‘legitimacy’ of a domestic subsidy by an international tribunal”.⁴¹

Friedlander concludes that the WTO’s well-crafted rules will lead to legalistic decisions from WTO panels that may well be ignored by governments.⁴² They will also foreclose the pragmatic responses that were available under the pre-WTO regime, increasing the probability that the “excessively legalistic GATT will eventually lose its effectiveness”.⁴³ The injury and prejudice rules that circumscribe the limits of subsidies are punitive and legalistic. These rules need, rather, to be tempered by a revitalization of interstate dialogue that recognizes nonviolation nullification and impairment as a legitimate basis of WTO dispute resolution. Such a dialogue would assist the WTO in maintaining reciprocity within limits set by states themselves.⁴⁴ “By rejecting the pragmatic approach, the GATT has

⁴⁰ Friedlander, *supra* at note 10, at 293.

⁴¹ Friedlander, *supra* at note 10, at 298.

⁴² This has been the case in some high-profile disputes such as the *Beef Hormones* case, the *Banana* case and the *Aircraft* case.

⁴³ Friedlander, *supra* at note 10, at 301.

⁴⁴ Friedlander, *supra* at note 10, at 313.

chosen a new set of problematic questions which will only escalate in complexity and difficulty.”⁴⁵

b. Academic articles focusing on the impact of WTO subsidies law on national trade remedy regimes

The effect of WTO subsidies law on the United States has been a particular focus of several authors.⁴⁶ Wilcox’s article “GATT-Based Protectionism and the Definition of Subsidy” perhaps best explores both the legal literature that examines WTO commitments that limit the trade-distorting use of subsidies and CVDs and the actual national legislation that permits their use. Wilcox studies recent developments in U.S. subsidy law and the effect the WTO agreements have had and will have upon that law. However, Wilcox goes further. In his final section,⁴⁷ Wilcox provides a detailed analysis of what the Uruguay Round adds to the definitional and operational aspects of subsidies law under the WTO. Wilcox maintains that the important changes arising from the 1994 text of the WTO are “two mechanisms to limit the use of CVDs (the specificity and financial contributions requirements) and the traffic-light framework”.⁴⁸

While his discussion of the traffic-light framework is primarily descriptive (red light equals prohibited subsidies; yellow light equals actionable subsidies; and green light equals non-actionable subsidies), Wilcox’s work on the WTO requirements for specificity and financial

⁴⁵ Friedlander, *supra* at note 10, at 316.

⁴⁶ Wilcox, *supra* at note 11; Rosenthal and Vermeylen, *supra* at note 12; Richard O. Cunningham, *supra* at note 12; Horlick and Balsanek, *supra* at note 12; and Rushford, *supra* at note 12.

⁴⁷ Wilcox, *supra* at note 11, at 151-163.

⁴⁸ Wilcox, *supra* at note 11, at 151.

contribution is more analytical and hence more helpful to the objectives of this study. Under the WTO's *SCM Agreement*, "specificity" has been adopted as one of the elements that must be proved before a subsidy is actionable. Wilcox maintains that the specificity element, now applicable to all the WTO members' national trade law and originating in U.S. law,⁴⁹ is difficult to articulate. However, the specificity requirement is a useful and manageable tool that can be used to separate good subsidies from bad ones, i.e., "those that distort markets for the sole purpose of helping domestic producers".⁵⁰ Wilcox reviews the pertinent American case law that fleshes out and limits the concept of specificity.⁵¹

Wilcox concludes with an important observation. The contracting parties of the WTO and the past policies of the United States remain at odds with respect to the starting point for the assessment of subsidies and their countervailability. The contracting parties of the WTO see domestic subsidies as not countervailable unless it is reasonably clear that their purpose is to benefit domestic producers and to give them an unfair advantage over foreign suppliers. On the other hand, the American position is that any specific subsidy, whatever its intent, is presumed to be market distorting and countervailable.⁵² Wilcox concludes that this difference of perspective, along with the probable abuse of green-light subsidies, will give rise to ongoing conflict over the use of CVDs by WTO member states.

Articles by Rosenthal and Vermylen and by Cunningham both spend a good deal of time examining whether U.S. negotiators achieved their objectives for subsidy law reform during

⁴⁹ Wilcox, *supra* at note 11, at 153-154.

⁵⁰ Wilcox, *supra* at note 11, at 155.

⁵¹ Wilcox, *supra* at note 11, at 157-158.

the Uruguay Round. Rosenthal and Vermylen maintain that the U.S. agenda during the Round, at least as far as subsidy issues were concerned, was threefold: to prevent the WTO rules from weakening U.S. ADD and CVD law; to ensure that WTO panels would accord adequate deference to decisions of the U.S. Department of Commerce and the International Trade Commission; and to increase transparency in the application of ADD and CVD law in the trading partners of the United States. Their conclusion is that U.S. negotiators were successful in achieving their objective of greater transparency, ambiguous in achieving their deference goal, and less than successful in their attempt to preserve U.S. CVD law. While U.S. negotiators prevented a wholesale dismantling of U.S. CVD law, it was weakened nonetheless.⁵³

Cunningham is more positive in his appraisal of the overall success of U.S. negotiators in achieving their objectives for subsidies law reform under the Uruguay Round. He maintains, however, that it is inaccurate to state that the primary U.S. objective was to protect U.S. CVD law from erosion by the WTOA. Rather he argues that the “United States was successful in its effort to transform a GATT discipline that was deficient both in its substance and enforcement mechanism into a WTO regime that would provide a meaningful remedy for U.S. companies encountering subsidized competition in markets outside the United States”.⁵⁴ Cunningham argues that three recent WTO panel cases (*Indonesia–Certain Measures Affecting the Automobile Industry*, *Australia–Subsidies Provided to Producers and Exporters of Automotive Leather*, and *Canada–Measures*

⁵² Wilcox, *supra* at note 11, at 160.

⁵³ Rosenthal and Vermylen, *supra* at note 12, at 873.

⁵⁴ Cunningham, *supra* at note 12, at 897.

Affecting the Export of Civilian Aircraft) all point to the WTO as getting tough on trade-distorting subsidization.⁵⁵

Academics from outside the United States have also engaged in the kind of analysis completed by U.S. commentators. Pearson suggests in her 1995 article,⁵⁶ that a number of Australian programs are likely to be in violation of the new WTO subsidies rules. She contends that part of the problem stems from Australian policy objectives that tend to be inherently self-contradictory. The Australian government's attempts to turn the nation into a dynamic trading nation tug in two different directions. On the one hand, the government is promoting policies which will open the country's markets to world competition. On the other hand, it is eager to listen to producers' and exporters' requests for assistance in the movement of Australian products into foreign markets. Pearson states that there has been "intense lobbying for government to provide incentives to business in the context of economic downturn and the longer-term need to develop a broader export economy".⁵⁷ This intense lobby has been largely successful, Pearson suggests, in that it has brought about a number of programs to assist export promotion. However, Pearson concludes her article with a detailed examination⁵⁸ of just how many of these initiatives would not be considered acceptable export subsidies according to the Illustrative List of Export Subsidies found in Annex 1 of the Uruguay Round Agreement.

⁵⁵ Cunningham, *supra* at note 12, at 903.

⁵⁶ Pearson, *supra* at note 3.

⁵⁷ Pearson, *supra* at note 3, at 371.

⁵⁸ Pearson, *supra* at note 3, at 382-395.

c. Literature reviewing WTO panel decisions grappling with subsidy and CVD issues

While many recent articles⁵⁹ chronicle the WTO's jurisprudential developments, there is currently no academic piece that systematically reviews decisions that have dealt with the subsidies issues before the WTO.

Cunningham, in his article on U.S. perspectives on WTO subsidies law, does examine some of the WTO cases, especially those in which the United States was a party (*Indonesia–Certain Measures Affecting the Automobile Industry*, *Australia–Subsidies Provided to Producers and Exporters of Automotive Leather*) and where American interests would be substantially affected by the outcome (*Canada–Measures Affecting the Export of Civilian Aircraft*). Rosenthal and Vermylen do likewise with an examination of three cases: *United States–Imposition of Countervailing Duties on Certain Hot-rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*; *Canada–Aircraft*; and *Brazil–Export Financing Program for Aircraft*.

d. Literature focusing on WTO subsidies law as it affects agriculture

Several academic pieces⁶⁰ set out the general parameters of WTO disciplines for agriculture resulting from the conclusion of the Uruguay Round. Many of the articles, besides describing the historical development of new obligations, emphasize the unique position of

⁵⁹ See, for example, five new articles in *Part I: Review of the Dispute Settlement Understanding of* (Spring 2000) 31 *Law and Policy in International Business* 565-781.

⁶⁰ See *supra* at note 17. For a very recent contribution which updates some of the earlier pieces, see Randy Green, “*The Uruguay Round Agreement on Agriculture*” (Spring 2000) 31 *Law and Policy in International Business* 819.

agricultural products under the WTOA, in that they are subject to obligations under both the AOA and SCM Agreement.

Some authors focus on the historical development of the Uruguay Round disciplines on subsidies⁶¹ while others document the modesty of new disciplines in agricultural subsidization under the Uruguay Round.⁶² Dixon's piece⁶³ provides a window on the compatibility of European agricultural and environmental policy with disciplines set out in the WTO's AOA. His overview of European agricultural programs and possible areas of incompatibility with the Common Agricultural Policy is interesting but, for the purposes of this report, offers little analysis of the WTO compatibility of present and potential EU agricultural programs which provide export incentives. This is the case with many of the articles.⁶⁴

Thus, very little of the academic literature has focused on a detailed analysis of the ambit of WTO disciplines for agricultural export subsidies. One reason for this may be that the importance of the export subsidies issue has diminished. While export subsidies remain important, states, including the United States, have restricted their use because of changes in market conditions without any collapse of export competitiveness. Other issues, like

⁶¹ See particularly, Hillman, *supra* at note 19, at 766-786 for an American perspective and see Eva Rook Basile, "The General Agreement on Tariffs and Trade (GATT), the European Economic Community (EC), and Agriculture" (Summer 1993) 28(4) *Tulsa Law Journal* 741 for a European perspective.

⁶² Yeutter, *supra* at note 19, at 321, 323; Green, *supra* at note 19, at 823-825.

⁶³ Dixon, *supra* at note 19. For a pre-WTO look at EU policies and compatibility with subsidies law, see Basile, *supra* at note ____.

those surrounding GMOs, have attained a higher profile and pushed the subsidies issue out of the limelight,⁶⁵ if only for the present.

e. Legal analysis relating to agricultural export subsidies requiring further examination

The legal literature explored above demonstrates that the subject of export subsidies has not gone unnoticed by legal academics, practitioners and policy makers. Two important themes run through the literature: (1) the new WTO subsidy rules are a product of a half-century evolution, and (2) an important paradigm shift has occurred within the world trading system away from a pragmatic, consensual approach to a rules-based approach. In the field of trade in agricultural products, the transition has been stark and abrupt. While industrial products have been subject to disciplines increasingly over the life of the GATT/WTO, agricultural products became subject to them in any real sense only in 1995.

This novel development for agricultural trade rules necessitates that a new importance be attributed to the interpretation of the WTO rules and the words used in them. The tasks of understanding and applying the WTO rules to situations brought before WTO panels, and of anticipating what future panels may decide with respect to national programs, become serious fields of academic inquiry.

⁶⁴ See for example, McMahon, *supra* at note 19, where the section on export subsidies simply describes the WTO commitments contained in the AOA with none of the definitional difficulties relating to agricultural subsidies being addressed.

⁶⁵ Green, *supra* at note 19, at 829.

With respect to rules permitting export subsidization found in the *SCM Agreement*, three areas of concern need further elaboration. First, the meaning of “financial contribution” and the meaning of “receipt of a benefit” need to be clarified. Second, with respect to permitted export subsidization of agricultural production, additional areas of inquiry surface—the meaning of the definition of “subsidies” in Article 9.1 of the *AOA* and the exact ambit of subsidies included in the Illustrative List of Export Subsidies in Annex 1 of the *AOA*. Finally the relationship between the *SCM Agreement* and the *AOA* requires clarification. This clarification should include examination and articulation of the extent to which the two agreements share common definitional aspects.

It is to an analysis of some of these questions that this study now turns. By using rules of legal interpretation and by examining WTO panel jurisprudence, this study will provide a fuller understanding of the difficult questions surrounding the content and application of the WTO’s subsidy rules, particularly those pertaining to export subsidies for agricultural products.

The *SCM Agreement* and the *AOA*⁶⁶ provide basic rules for the regulation of export subsidies. These rules have now been interpreted and applied in a number of Dispute Settlement Body reports from the WTO. These reports are an important body of jurisprudence in determining the legality of export subsidy programs. This study synthesizes the rules applied in these cases and develops legal tests for export subsidies, as well as an economic analysis of the legal tests.

⁶⁶ *Supra* at note 6 and 7 and GATT 1994, Art. XVI:3.

A brief chronology shows how quickly the export subsidy concept has evolved in WTO law. On August 2, 1999 the Appellate Body in *Canada–Aircraft* found that a “subsidy”, within the meaning of Article 1.1 of the *SCM Agreement*, arises where the grantor makes a “financial contribution” which confers a “benefit” on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.⁶⁷ On October 13, 1999, the Appellate Body applied this definition to an agricultural product under Article 9.1 of the *AOA* in the case of *Canada–Measures Affecting the Importation of Milk and the Exportation of Dairy Products (Canada–Milk)*⁶⁸. On February 24, 2000, the Appellate Body applied both of these decisions in a case under Article 8 and Article 10.1 of the *AOA* in *US–FSC*.⁶⁹ The result has been the rapid application of a consistent definition of subsidy in WTO jurisprudence, for both agricultural and non-agricultural products.

⁶⁷ Appellate Body Report, *Canada–Measures Affecting the Export of Civilian Aircraft (Canada–Aircraft)*, WT/DS70/AB/R, adopted 20 August 1999, para. 156 and 157.

⁶⁸ Panel Report, *Canada–Measures Affecting the Importation of Milk and the Exportation of Dairy Products (Canada–Milk)*, WT/DS103/R, WT/DS113/R, adopted 27 October 1999.

⁶⁹ Appellate Body Report, *United States–Tax Treatment for “Foreign Sales Corporations” (US–FSC)*, WT/DS108/AB/R, adopted 20 March 2000, para. 146 and 147.

TABLE 1

EXPORT SUBSIDY CASES IN THE WTO

ALL BY DATE:		
DATE	CASE NAME	AB OR PANEL
4/14/99	CANADA-AIRCRAFT	PANEL
4/14/99	BRAZIL-AIRCRAFT	PANEL
5/17/99	CANADA-MILK	PANEL
5/25/99	AUSTRALIA-LEATHER	PANEL
8/2/99	CANADA-AIRCRAFT	AB
8/2/99	BRAZIL-AIRCRAFT	AB
10/8/99	US-FSC	PANEL
10/13/99	CANADA-MILK	AB
2/11/00	CANADA-AUTOS	PANEL
2/24/00	US-FSC	AB
5/31/00	CANADA-AUTOS	AB
PANEL & AB:		
DATE	CASE NAME	AB OR PANEL
4/14/99	CANADA-AIRCRAFT	PANEL
4/14/99	BRAZIL-AIRCRAFT	PANEL
5/17/99	CANADA-MILK	PANEL
5/25/99	AUSTRALIA-LEATHER	PANEL
10/8/99	US-FSC	PANEL
2/11/00	CANADA-AUTOS	PANEL
8/2/99	CANADA-AIRCRAFT	AB
8/2/99	BRAZIL-AIRCRAFT	AB
10/13/99	CANADA-MILK	AB
2/24/00	US-FSC	AB
5/31/00	CANADA-AUTOS	AB
CANADA ONLY:		
DATE	CASE NAME	AB OR PANEL
4/14/99	CANADA-AIRCRAFT	PANEL
8/2/99	CANADA-AIRCRAFT	AB
2/11/00	CANADA-AUTOS	PANEL
5/31/00	CANADA-AUTOS	AB
5/17/99	CANADA-MILK	PANEL
10/13/99	CANADA-MILK	AB

Table 1 shows the chronological history of the main cases considered in this paper. The approach in this study is to follow the structure of the *SCM Agreement* and the *AOA* regarding export subsidies. The more general provisions of the *SCM Agreement* are described first. Then the more specific provisions of the *AOA* are examined. This follows the approach taken by the DSB. The DSB cases are examined as they relate to each topic. Before looking at the specific agreements it is necessary to explore the general interpretive approach used by the DSB.

II. GENERAL INTERPRETIVE APPROACH

The Dispute Settlement Body of the WTO has adopted a general interpretive approach to the issue of subsidies. This approach has been outlined in DSB panel decisions and confirmed in DSB appellate body reports. Any analysis of subsidies will have to recognize this approach.

The interpretive approach begins with recognition that the WTO agreements are part of public international law and as such are subject to normal rules of treaty interpretation. The interpretation rules set out in the *Vienna Convention* apply.⁷⁰ The most important rule is that words should be given their ordinary meaning:

Article 31.1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.⁷¹

⁷⁰ *Vienna Convention on the Law of Treaties*, 23 May 1969, 1155 U.N.T.S. 221; 8 I.L.M. 679.

⁷¹*Ibid.* at Art. 31.

A. THE ORDINARY MEANING

The ordinary meaning of a words is found in its dictionary definition. The most frequent references are *The New Shorter Oxford English Dictionary* and *Black's Law Dictionary*.⁷² The dictionary meaning of words that appear in WTO terms is a necessary starting point for understanding the legal requirements.

B. THE TEXTUAL APPROACH

The DSB has then considered the immediate text of the agreement at issue to give added meaning to words being considered. This approach arises when the dictionary definitions may leave interpretive questions open.⁷³ It requires consideration of whether the surrounding phrase, sentence or paragraph can further define the meaning of words. An example is in the *Canada–Aircraft* case where the Appellate Body looked for the meaning of “benefit” in the phrase “a benefit is thereby conferred” in Article 1.1(b) of the *SCM Agreement*.⁷⁴ The Appellate Body found that “benefit” means an advantage to a recipient, because “confer” means “give, grant or bestow”.

So each provision should be examined for meaning in the text involved.

⁷² *The New Shorter Oxford English Dictionary*, (Clarendon Press, 1993). *Black's Law Dictionary*, (West Publishing Co., 1990); *The Concise Oxford Dictionary*, (Clarendon Press, 1995), p. 120; *Webster's Third New International Dictionary* (unabridged), (William Benton, 1966), Vol. I, p. 204.

⁷³ Appellate Body Report, *Canada–Aircraft*, supra at note 67, para. 153.

⁷⁴ Ibid. at para. 156.

C. THE CONTEXTUAL APPROACH

The DSB has used the interpretive concept of considering the context of the provision to add meaning to words. The context has included other parts of the same article,⁷⁵ the same agreement,⁷⁶ illustrative lists,⁷⁷ the preambles,⁷⁸ footnotes,⁷⁹ and other WTO agreements.⁸⁰ Each of these applications has built on the concept that the WTO agreements represent a single undertaking with interconnected parts.⁸¹ Any future attempt to interpret subsidy provisions will have to be aware of these possible contextual approaches to interpretation.

D. OBJECTS AND PURPOSE

The DSB has relied on statements about the object and purpose of the various WTO agreements as interpretive aids. The object and purpose of the *AOA* has been found to be:⁸²

As enunciated in the preamble to the *Agreement on Agriculture*, the main purpose of the Agreement is to “establish a basis for initiating a process of reform of trade in agriculture” in line with, *inter alia*, the long-term objective of establishing “a fair and market-oriented agricultural trading system”. This objective is pursued in order “to provide for substantial progressive reductions in agricultural support and protection sustained over an agreed period of time, resulting in correcting and preventing restrictions and distortions in world agricultural markets.

The object and purpose of the *SCM Agreement* as been described as:⁸³

⁷⁵ Appellate Body Report, *US–FSC*, supra at note 69, para. 146 and 147.

⁷⁶ Ibid. at para. 97.

⁷⁷ Panel Report, *Canada–Milk*, supra at note 68, para. 7.25.

⁷⁸ Appellate Body Report, *Canada–Measures Affecting the Importation of Milk and the Exportation of Dairy Products (Canada–Milk)*, WT/DS103/AB/R, WT/DS113/AB/R, adopted 27 October 1999, para. 87 and Appellate Body Report, *Canada–Aircraft*, supra at note 67, para. 168.

⁷⁹ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 87.

⁸⁰ Appellate Body Report, *Brazil–Measures Affecting Desiccated Coconut (“Brazil–Coconut”)*, WT/DS22/AB/R, adopted 20 March 1997, at 11.

⁸¹ This is an important part of the interpretive approach as will frequently be seen in the interpretive work of the DSB.

⁸² Panel Report, *Canada–Milk*, supra at note 68, para. 7.25.

the establishment of multilateral disciplines on the premise that some forms of government intervention distort international trade, [or] have the potential to distort [international trade].

III. THE *SCM* DEFINITION

A. THE DEFINITION OF SUBSIDY

The definition of subsidy in the *SCM Agreement* is found in Article 1.1:

For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (hereinafter referred to as “government”), i.e., where:

- (i) government practice involves a direct transfer of funds (e.g., grants, loans and equity infusion), potential direct transfers of funds or liabilities (e.g., loan guarantees);
- (ii) government revenue that is otherwise due, is foregone or not collected (e.g., fiscal incentives such as tax credits);
- (iii) a government provides goods or services other than general infrastructure, or purchases goods;
- (iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments; or

(a)(2) there is any form of income or price support in the sense of Article XVI of the GATT 1994; and

(b) a benefit is thereby conferred.

The prohibition of export “subsidies” is contained in Article 3.1 of the *SCM Agreement*:

Except as provided in the *Agreement on Agriculture*, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;

⁸³ Panel Report, *Canada–Measures Affecting the Export of Civilian Aircraft* (“*Canada–Aircraft*”), WT/DS70/R, adopted 20 August 1999, para. 178.

- (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

These definitions form the basic legal background for disputes about export subsidies generally. Additional terms from the *SCM Agreement* will be described as they arise.

B. THE ELEMENTS OF A SUBSIDY

Two elements are necessary for the finding of a subsidy in the *SCM Agreement*. They are:

1. a financial contribution by government; and
2. a benefit thereby conferred.

Each of these elements will be examined to define a legal test for the existence of a subsidy. Then, the following section will explore the idea of contingency on export performance in order to define an illegal export subsidy.

1. A Financial Contribution

The idea of a financial contribution as part of the subsidy definition arises from the beginning of Article 1.1(a)(1) of the *SCM Agreement*:

- ... a subsidy shall be deemed to exist if:
 - (a)(1) there is a financial contribution by a government... .

There is no direct parallel to this language in the *AOA*. The closest parallel is in Article 9.1(c):

Payments on the export of an agricultural product that are financed by virtue of governmental action,

However, since the AOA relies on the general *SCM Agreement* definition of subsidy, the requirement of a “financial contribution by a government” will be highly relevant to agriculture.

The idea of a financial contribution by a government is further defined in Article 1.1(a)(1) to include:

1. a direct transfer of funds or potential direct transfer of funds or liabilities;
2. government revenue that is not otherwise due is foregone;
3. government provides goods or services or purchases goods;
4. government makes a payment to a funding mechanism.⁸⁴

This is not an exhaustive list of possible government financial contributions, and arguably other types of measures might be found to be a financial contribution under this definition. Of this list of four types of financial contributions, only the first two have received consideration in the DSB. The direct transfer of funds was considered in *Australia–Leather*, *Canada–Aircraft* and *Brazil–Aircraft*.⁸⁵ In *Australia–Leather* and *Brazil–Aircraft* transfers of funds by way of grants were admitted to be subsidies. Government revenue foregone was

⁸⁴ *SCM Agreement*, Art. 1.1(a)(1).

⁸⁵ Panel Report, *Australia–Subsidies Provided to Producers and Exporters of Automotive Leather (Australia–Leather)*, WT/DS126/R, adopted 16 June 1999; Appellate Body Report, *Canada–Aircraft*, supra at note 67; Panel Report, *Brazil–Export Financing Program for Aircraft (Brazil–Aircraft)*, WT/DS46/AB/R, adopted 20 August 1999.

considered in *Canada–Automobiles* and *US–FSC*.⁸⁶ These two types of financial contribution can be examined in more detail.

a. Direct transfers of funds

Canada–Aircraft: Panel Report

The idea of a financial contribution by a government first received some comment from the Dispute Settlement Body in the *Canada–Aircraft* case.⁸⁷ The dispute concerned various Canadian measures which were alleged to be export subsidies under the *SCM Agreement*. The measures included a debt financing program involving a potentially below-market interest rate. The Panel applied the part of the subsidy definition from the *SCM Agreement* dealing with financial contribution. It refers specifically to Article 1.1(a)(1)(i):

a government practice involves a direct transfer of funds (e.g., grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g., loan guarantees).

The Panel found that there was a financial contribution in two of the alleged subsidy programs, the Canada Account Debt Financing program, and the Technology Partnerships Canada program (TPC).

Regarding the Canada Account program, the complainant (Brazil) satisfied the Panel that interest-free or low-interest loans were granted to exporters. The Panel accepted the evidence from Brazil as a *prima facie* case of “subsidy” within the meaning of Article 1 of the *SCM Agreement*. The Panel commented:

⁸⁶ Panel Report, *Canada–Automobiles*, WT/DS139/R, WT/DS142/R, adopted 19 June 2000 and Panel Report, *US–FSC*, WT/DS108/R, adopted 20 March 2000.

We are in no doubt that the Canada Account debt financing in issue constitutes a “financial contribution” by a public body, since Brazil has demonstrated that such assistance debt financing constitutes a “direct transfer of funds” by a public body, within the meaning of Article 1.1(a)(I) of the *SCM Agreement*.⁸⁸

Canada refused to respond to a request for further information and clarification by the Panel, citing the information as sensitive, confidential business information. Canada asserted that it had not put in a defence regarding whether these contributions were subsidies within the meaning of Article 1 of the *SCM Agreement*. However, the Panel proceeded to rely on the *prima facie* case established by Brazil and ruled that the Canada Account Debt Financing program constituted a subsidy within the meaning of Article 1 of the *SCM Agreement*.

Regarding the Technology Partnerships Canada program, the program consisted of conditionally repayable loans or investments, depending on profitability. Again, Canada declined to put in a defence regarding whether these contributions were subsidies within the meaning of Article 1 of the *SCM Agreement*. The Panel found that the TPC contributions were “financial contributions”, stating:

We are in no doubt that TPC contributions constitute “financial contributions” by a public body within the meaning of Article 1.1 of the *SCM Agreement*, as they are direct transfers of funds by the government of Canada, in the sense of Article 1.1(a)(1)(i). Canada has not disputed this fact.⁸⁹

The Panel relied on this finding to hold that the TPC program was a financial contribution.

⁸⁷ Panel Report, *Canada–Aircraft*, supra at note 83.

⁸⁸ Ibid. at para. 9.221.

⁸⁹ Ibid. at para. 9.306.

The *Canada–Aircraft* case therefore did not provide any detailed legal analysis of what was required for a financial contribution by way of the direct transfer of funds.

At the same time it released the *Canada–Aircraft* Panel Report, the DSB released the *Brazil–Aircraft* Panel Report.⁹⁰ It also dealt with alleged export subsidies by way of interest rate subsidies for the export of regional aircraft. Canada claimed, and Brazil conceded, that there was an export subsidy within the meaning of Article 1 and that it was contingent on exports within the meaning of Article 3 of the *SCM Agreement*. The Panel agreed with these positions. The argument revolved around whether the export subsidy was prohibited by the *SCM*. Brazil argued that it was a permitted subsidy. The Panel disagreed and found the subsidy illegal. The lack of dispute about the existence of the subsidy meant there was little discussion by the Panel about the meaning of export “subsidy”. The existence of the export subsidy was not the subject of appeal.

Canada–Aircraft: Appellate Body Report

The definition of “subsidy” in the context of export programs received its first comment by the Appellate Body in *Canada–Aircraft*. The comments came from the Appellate Body with respect to Article 1.1(b) of the *SCM Agreement* and the meaning of the term “benefit” not the term “subsidy”. However, the comments set the framework for the consideration of subsidy issues in future cases.

⁹⁰ Panel Report, *Brazil–Aircraft*, supra at note 85.

At the panel hearing, Canada had not specifically disputed that the Canada Account and the TPC programs involved a financial contribution by way of the direct transfer of funds. Therefore, it is not surprising that the Appellate Body did not give detailed consideration of this requirement. The Appellate Body did point out that the definition of “subsidy” in Article 1.1 has two discreet elements:

1. “a financial contribution by a government or any public body”, and
2. “a benefit is thereby conferred”.⁹¹

The Appellate Body pointed out that the focus of the first element is on the action of the government in making the “financial contribution”.⁹² Therefore, it is the action of the granting authority which is to be considered in Article 1.1(a). This is distinguished from the focus in Article 1.1(b), regarding “benefit ... conferred” being on the recipient of that governmental action.

This overall two-part structure of Article 1.1 must continually be remembered. The structure separates the concept of who is making a financial contribution from consideration of who is receiving a benefit from the contribution. This brief analysis provides the starting point for future consideration of the term “subsidies” in the DSB.

Canada–Milk: Appellate Body Report

⁹¹ Appellate Body Report, *Canada–Aircraft*, supra at note 67, para. 156.

⁹² Ibid. at para. 156.

The separation of the ideas of “financial contribution” and “benefit” in *Canada–Aircraft* was soon expanded upon in *Canada–Milk*. The Appellate Body referred to its decision in *Canada–Aircraft* and then, for the first time, substituted the phrase “transfer of economic resources” for “financial contribution”.⁹³ This phrase would become part of the standard legal test language when looking for the existence of a subsidy.

The definition in *Canada–Milk* of a subsidy as “**a transfer of economic resources from the grantor to the recipient for less than full consideration**” was applied by the Appellate Body in *US–FSC*.⁹⁴ So the idea of a transfer of economic resources is now firmly established as the legal test for a financial “contribution”. Is it any clearer? None of the cases have discussed what an economic resource is. Is it something that only has value in the marketplace? What if it has no value when given, but turns out to have value later? These will be questions that arise in the future about what an economic resource is.

Sub-paragraphs (i), (iii) and (iv) of Article 1.1(a)(1) involve different types of government payments. They have not yet had detailed analysis by the DSB. Perhaps these most obvious of financial contributions will not attract disputes about whether a financial contribution has been made. The more subtle foregoing of government revenue will more likely remain the most hotly contested type of export subsidy. The following section on “government revenue foregone” contains the DSB analysis of sub-paragraph (ii) of Article 1.1(a)(1) of the *SCM Agreement* dealing with “government revenue foregone”.

⁹³ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 87 and 89.

b. Government revenue foregone

“Government revenue foregone” is the second category of financial contribution in Article 1.1(a)(1). It has drawn attention in two cases in the DSB: *US–FSC* and *Canada–Automobiles*.⁹⁵ They may be relevant to the treatment of agricultural products because they involved tax and duty exemptions that could potentially be agricultural policy tools.

i) Otherwise due and the “but for” test

US–Foreign Sales Corporations (FSC): Panel Report

In the *US–FSC* Panel Report the issue was when revenue should be considered “otherwise due”. The issue arose because the United States granted a special tax exemption for the export profits for certain foreign sales corporations. The Panel decided that they should determine whether, as a general rule, the tax regime of a member represents the proper benchmark for assessing whether foregone revenue is “otherwise due”. The Panel looked at the dictionary definition of the word “due” and found that it meant “that is owing or payable, as a debt”. The Panel recognized that the financial contribution must be by a *government* and arises only where *government revenue* is not collected. Thus the question becomes “whether taxes are owing or payable to a government within the territory of a member”. So the Panel found that whether tax or government revenue is otherwise owing or payable must be determined by reference to that government’s tax regime.

⁹⁴ Appellate Body Report, *US–FSC*, supra at note 69, para. 136.

⁹⁵ Panel Report, *US–FSC*, supra at note 86.

The Panel cited the case of *Indonesia–Certain Measures Affecting the Automobile Industry*⁹⁶ as precedent that the proper benchmark for determining whether revenue foregone was “otherwise due” involves a comparison with the tax regime otherwise applied by the member.

The Panel then stated that they considered the actual text of the *SCM Agreement* called for the application of the “but for” test with respect to the tax measure in question. In other words, what would the tax situation be, **but for** the FSC exemption? This is then used as the legal test of when government revenue is otherwise due in Article 1.1(a)1(ii).⁹⁷

The Panel applied the “but for” test by examining the tax treatment of the income in question that would be applicable but for the FSC measures. The Panel confirmed that the application of this test required panels to apply their best judgment on a case by case basis. In applying the test, the Panel found that, in the absence of the FSC scheme, income which is shielded from taxation by that scheme would be subject to taxation.⁹⁸ Based on this conclusion, the Panel found that there was a foregoing of revenue which was otherwise due

⁹⁶ Panel Report, *Indonesia–Certain Measures Affecting the Automobile Industry (Indonesia–Automobiles)*, WT/DS54/R, WT/DS55/R, WT/DS59/R, WT/DS64/R, adopted 23 July 1998.

⁹⁷ In arriving at a conclusion on the relevant test, the Panel noted that Article 3.1(a) of the *SCM Agreement* contains a precise definition of the concept of “export subsidy”. Article XVI: 4 of GATT 1947 deals with some types of subsidies. However, it never uses the term “export subsidy”, much less defines it. So the Panel recognizes that the language in Article 3.1(a) of the *SCM Agreement* has no counterpart in Article XVI:4 of GATT 1947. Therefore, the Panel dismisses the relevance of Article XVI:4 of GATT 1947 when it states “that legal principles derived from Article XVI:4 of GATT 1947, read in isolation and without the benefit of the detailed provisions of the *SCM Agreement* regarding the concepts of “subsidy” and “export subsidy”, can be of little, if any, interpretative guidance in understanding the scope of a Member’s obligations regarding export subsidies under the *SCM Agreement*.”

⁹⁸ Panel Report, *US–FSC*, supra at note 86, para. 7.98.

and thus gave rise to a financial contribution within the meaning of Article 1.1(a)(1)(ii) of the *SCM Agreement*.⁹⁹

The United States urged the DSB in *US–FSC* to consider Footnote 59 to Item (e) of the Illustrative List of Export Subsidies as the starting point for the interpretation of Article 1.1(a)(1)(ii). Item (e) reads:

The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises¹⁰⁰.

Footnote 59 reads:

The Members recognize that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The Members reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any Member may draw the attention of another Member to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the Members shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of Members under GATT 1994, including the right of consultation created in the preceding sentence.

Paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member.

The United States suggested that Footnote 59 allowed them to give the special tax exemption. The Panel rejected this argument. Footnote 59 does not authorize a member to exempt only certain limited categories of export income from taxation. Therefore Item (e)

⁹⁹ *Ibid.* at para. 7.10.

¹⁰⁰ *SCM Agreement*, Illustrated List of Export Subsidies.

supports the application of Article 1.1 of the *SCM Agreement* to the FSC tax exemption scheme.

The Appellate Body also rejected the U. S. argument that Footnote 59 qualifies the general interpretation of the term “otherwise due”.

US–FSC: Appellate Body Report

The Appellate Body then made its pronouncement on the application of Article 1.1(a)(1)(ii) in *US–FSC*. It supported the Panel’s decision that revenue otherwise due had been foregone in the tax exemption scheme.

The Appellate Body began its interpretation of Article 1.1 of the *SCM Agreement* by examining Article 1.1(a)(1)(ii). The Appellate Body moved immediately to a consideration of the phrase “*foregoing*” of “revenue *otherwise due*”. The Appellate Body determined that what is otherwise due depends on the rules of taxation that each member establishes for itself. In establishing its tax regime, the Appellate Body pointed out that a member must respect its WTO obligations. It cited as authority for this proposition the cases of *Japan–Taxes on Alcoholic Beverages* and *Chile–Taxes on Alcoholic Beverages*.¹⁰¹

In examining this language the Appellate Body stated:

In our view, the “*foregoing*” of revenue “*otherwise due*” implies that less revenue has been raised by the government than would have been raised in a different situation, or, that is, “otherwise”. Moreover, the word “foregone” suggests that the government has given up an entitlement to raise revenue that it could “otherwise” have raised.

¹⁰¹ Appellate Body Report, *US–FSC*, supra at note 69, para. 90.

This cannot, however, be an entitlement in the abstract, because governments, in theory, could tax *all* revenues. There must, therefore, be some **defined, normative benchmark against which a comparison can be made** between the revenue actually raised and the revenue that would have been raised “otherwise” [emphasis added].¹⁰²

This language, “defined normative benchmark”, would be used in later cases to describe the comparative test.

The Appellate Body then accepted the Panel’s conclusion that the basis of comparison must be the domestic tax rules applied by the member in question.

The Appellate Body then commented on the “but for” test. The Panel felt this was the appropriate legal standard to provide a sound basis for comparison in this particular case. However, the Appellate Body had reservations about applying this test in place of the actual treaty language. The Appellate Body felt that the “but for” test would be applicable where there was an alternative measure under which the revenues in question would be taxed, absent the contested measure. However, the Appellate Body felt the test would not be applicable in every case. It felt the treaty language was actually wider than the “but for” test and the wider test might be reserved for other cases in the future.

The Appellate Body therefore concluded that the FSC measure allows the government of the United States to forego revenue that is otherwise due under Article 1.1(a)(1)(ii) of the *SCM Agreement*. The United States had acknowledged at the appeal that the FSC measure represented a departure from the rules of taxation that would “otherwise” apply to FSCs.

The United States also acknowledged that the tax liability of the FSCs would be higher without the FSC measure involved here. The result was that the Appellate Body upheld the Panel's decision and found a financial contribution under Article 1.1(a)(1)(ii) of the *SCM Agreement*.

The important Appellate Body case of *US–FSC* dealt only briefly with the issue of financial contribution, but the context is significant. The issue arose under the *AOA*, but not under Article 9.1. It arose under the meaning of “export subsidies” in Article 8 and Article 10.1.

In its analysis of Article 10.1, the Appellate Body recognized that the *AOA* does not contain the definition of the term “subsidy” or “subsidies”.¹⁰³ The Appellate Body pointed out that in its report in *Canada–Milk*, it stated that “a subsidy involves a transfer of economic resources from the grantor to the recipient for less than full consideration”.¹⁰⁴ It referred to the definition of subsidy in Article 1.1 of the *SCM Agreement* as context for arriving at that conclusion. It therefore set out the test that it would follow in this case as being:

1. whether the FSC measure involves a transfer of economic resources by the grantor; and
2. whether any transfer of economic resources involves a benefit to the recipient.

¹⁰² Ibid. at para. 90.

¹⁰³ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 136.

¹⁰⁴ Ibid. at para. 136.

The Appellate Body referred again to the *Canada–Milk* case where export subsidies under the *AOA* may involve not only direct payments, but also revenue foregone.¹⁰⁵ However, the Appellate Body pointed out that it is only where a government foregoes revenue that is *otherwise due* that a subsidy may arise. This is the same test for disputes under both the *AOA* and under Article 1.1(a)(1)(ii) of the *SCM Agreement*.¹⁰⁶

The Appellate Body then noted that, under its examination of the Panel’s findings in this case, it concluded that the FSC measure involved the foregoing of revenues that are otherwise due under Article 1.1 of the *SCM Agreement*. The Appellate Body reasoned that there was no reason to reach any different conclusion under the *AOA*. Therefore, the FSC measure involved government revenue foregone. This is a transfer of economic resources, so this element of the subsidy test was satisfied. The result was a finding that the FSC measure was a subsidy under both the *SCM Agreement* and the *AOA*.

The *US–FSC* case demonstrates the interplay and parallels between the *AOA* and the *SCM Agreement*. The Appellate Body looked for the meaning of “export subsidy” in Article 10 of the *AOA*. It turned immediately to the “subsidy” definition in Article 1.1 of the *SCM Agreement*. It found that the “transfer of economic resources” element of that subsidy definition could be accomplished by the foregoing of revenue. This idea is supported by Article 1(c) of the *AOA*, where the limitations on subsidies are defined as “budgetary outlays” which include “revenue foregone”. In both agreements, “revenue foregone” is only a

¹⁰⁵ *Ibid.* at para. 138.

“subsidy” if it is “otherwise due”. Thus, all parts of both agreements must be considered for context in cases involving subsidies of agricultural products.

Canada–Automobiles: Panel Report

A further panel report on government revenue foregone came in *Canada–Automobiles*.¹⁰⁷ This case involved an import duty exemption granted by Canada to companies that imported autos into Canada, provided the companies also exported a certain number of autos. The issue was whether this duty exemption was a subsidy. The Panel determined that it should first decide whether the exemption was a subsidy within the meaning of Article 1 of the *SCM Agreement*. Then, it would consider whether that subsidy was contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.

The Panel first identified that there was a financial contribution in Article 1 where “government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits)”. The Panel then defined three of these terms:

1. “revenue” as “the annual income of a government or state from all sources, out of which public expenses are met”;
2. “otherwise” as “in other circumstances”; and
3. “due” as “that is owing or payable as an obligation or debt”.

¹⁰⁶ Ibid. at para. 139.

The Panel stated that these were the ordinary meanings of all of these terms and cited the dictionary definitions.

The Panel immediately concluded that customs duties represent “government revenue”. The Panel then moved to consider whether the customs duties at issue in this case represented government revenue *otherwise due*. The Panel applied a “but for” test in analyzing this question. The Panel identified a number of circumstances where a duty would be payable by an importer to Canada under domestic customs law. Except for the existence of the customs duty exemption being challenged here, the duty was otherwise due.¹⁰⁸ Therefore the Panel found that the import duty exemption constituted the “foregoing” of government revenue which was “otherwise due”.¹⁰⁹ The domestic benchmark test was applied.

Canada–Automobiles: Appellate Body Report

Canada appealed the finding of a subsidy in *Canada–Automobiles*. Canada argued that the import duties in issue were not *otherwise due* since the exemption from duties was not *in excess* of duties that would otherwise have “accrued”.¹¹⁰ The Appellate Body rejected that argument and found a subsidy.

The Appellate Body looked at the language of Article 1.1(a)(1)(ii) of the *SCM Agreement*. It then relied on its decision in *US–FSC* to look for a “defined, normative benchmark” rate of

¹⁰⁷ Panel Report, *Canada–Automobiles*, supra at note 86.

¹⁰⁸ Ibid.

¹⁰⁹ Ibid. at para. 10.160.

import duty.¹¹¹ It found this to be Canada's Most Favoured Nation rate of 6.1 percent. Since the government gave up this rate with the impugned duty exemption program, this amounted to “*foregoing*” of revenue “otherwise due”. It did not matter to the Appellate Body that some of the automobiles would have come into Canada duty free under NAFTA. It was the defined, normative benchmark of the *general* duty law that was most relevant. The variation from this benchmark resulted in the finding of a subsidy.

The Appellate Body in *Canada–Automobiles* went on to consider other issues which will be referred to later.

ii) The domestic benchmark in financial contribution

The significance of these cases, particularly the Appellate Body Report in *US–FSC*, is that once again a broad interpretation has been given to words in the WTO agreements. The words “financial contribution” and “revenue that is otherwise due” caught both of the tax and duty remission schemes at issue in these cases. The Appellate Body specifically reserved a wider test than the “but for” test for possible future use. The Appellate Body recognized that members might try inventive measures to circumvent the subsidy disciplines in the future. It appears ready to stop such attempts.

The other significant aspect of these cases is the idea of a defined, normative benchmark against which programs would be measured to find out if revenue is foregone. The accepted

¹¹⁰ Canada's Appellant's Submission, para. 72.

¹¹¹ Appellate Body Report, *Canada–Certain Measures Affecting the Automotive Industry (Canada–Automobiles)*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 91.

benchmark is the domestic legislative scheme which otherwise exists. Thus it is a domestic framework which provides the comparative benchmark. It is not some international norm, or the legislative framework of another country. This concept of domestic comparison finds expression in other areas, such as the benchmark price in the *Canada–Milk* case and the domestic interest rate in *Brazil–Aircraft*. The effect of this is to cause countries to make their domestic tax and their fiscal and trade policies as a whole align with world standards or norms, so that they do not have to attempt illegal subsidies to compete internationally with their exports.

2. A Benefit Is Thereby Conferred

The second branch of the subsidy definition under Article 1.1(b) of the *SCM Agreement* is the issue of “benefit”.

a. An advantage in the marketplace—commercial benchmarks

Canada–Aircraft: Panel Report

The evolution of the meaning of “benefit” in subsidy law began with the *Canada–Aircraft* Panel Report in April 1999. Canada argued that a benefit would exist if:

1. a public financial contribution by a public body imposes a cost on the government; and
2. it results in an advantage above and beyond what the market could provide.

Canada claimed that this interpretation of “benefit” is based on three things:

1. the ordinary meaning of “benefit”;
2. the context in which the word occurs; and
3. the object and purpose of the *SCM Agreement* as a whole.

The Panel’s interpretation of “benefit” began with applying the ordinary meaning of the word. The ordinary meaning of “benefit” includes some form of advantage.¹¹² The Panel stated that it is necessary to determine whether the financial contribution places the recipient in a more advantageous position than would have been the case but for the financial contribution. The Panel then stated that the market is the only logical basis for determining the position the recipient would have been in without the financial contribution. Therefore the Panel found that a financial contribution would only confer a “benefit” or an advantage if the “benefit” is provided on terms that are more advantageous than those that would have been available to the recipient in the market.

This interpretation of “benefit” rejects Canada’s argument that a net cost to the government must be involved. The focus of the Panel was on the position of the recipient, and not on the position of the government granting the financial contribution. This reasoning clearly rejects the idea that a financial contribution or a subsidy must involve a cost to the government initiating the program.¹¹³ Government programs that have no net cost to the government might still be considered subsidies because of this interpretation of “benefit” in Article 1.1 of the *SCM Agreement*.

¹¹² Panel Report, *Canada–Aircraft*, supra at note 83, para. 9.112.

Having arrived at this conclusion about the ordinary meaning of “benefit”, the Panel then turned to look for support for this interpretation.

The Panel found support for its interpretation of “benefit” in the context of the term. The first context referred to was Article 14 of the *SCM Agreement* which provides:

For the purpose of Part V, any method used by the investigating authority to calculate the benefit to the recipient conferred pursuant to paragraph 1 of Article 1 shall be provided for in the national legislation or implementing regulations of the Member concerned and its application to each particular case shall be transparent and adequately explained. Furthermore, any such method shall be consistent with the following guidelines:

- (a) government provision of equity capital shall not be considered as conferring a benefit, unless the investment decision can be regarded as inconsistent with the usual investment practice (including for the provision of risk capital) of private investors in the territory of that Member;
- (b) a loan by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market. In this case the benefit shall be the difference between these two amounts;
- (c) a loan guarantee by a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the guarantee pays on a loan guaranteed by the government and the amount that the firm would pay on a comparable commercial loan absent the government guarantee. In this case the benefit shall be the difference between these two amounts adjusted for any differences in fees;
- (d) the provision of goods or services or purchase of goods by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration. The adequacy of remuneration shall be determined in relation to prevailing market conditions for the good or service in question in the

¹¹³ Ibid. at para. 9.120.

country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale).¹¹⁴

The guideline in Article 14 uses the commercial yardstick for determining when a financial contribution shall be considered a benefit. Even though Article 14 expressly applies for the purposes of Part V of the *SCM Agreement* dealing with countervailing measures, the Panel found that the reference in Article 14 to “benefit” in Article 1.1 was enough to make it a relevant context for defining the term “benefit”.

Of particular note are the Panel’s comments about the object and purpose of the *SCM Agreement*. The Panel noted that the *SCM Agreement* does not contain any express statement of its object and purpose. However, the Panel did offer the view that the object and purpose of the *SCM Agreement* is the establishment of multilateral disciplines on the premise that some forms of government intervention distort international trade or have the potential to distort international trade. The Panel rejected the view that the avoidance of net cost to government is the object and purpose of the *SCM Agreement*.

The Panel’s very broad statement of the *SCM Agreement*’s object and purpose does not do much to advance the interpretation of the agreement’s individual provisions. At most, it appears to indicate that the focus of panel inquiries should be whether some forms of government intervention which distort trade or have the potential to distort trade should be subject to the disciplines set out in the *SCM Agreement*.

¹¹⁴ *SCM Agreement*, Art. 14.

The Panel therefore concluded:

we consider that a “financial contribution” by a government or public body confers a “benefit”, and constitutes a “subsidy” within the meaning of Article 1 of the *SCM Agreement* when it confers an advantage on the recipient relative to applicable commercial benchmarks, i.e., when it is provided on terms that are more advantageous than those that would be available to the recipient in the market.¹¹⁵

Canada–Aircraft: Appellate Body Report

Canada appealed the Panel’s decision that the notion of “cost to government” is not relevant to the interpretation of “benefit” in Article 1.1(b). Canada argued that the Panel erred in two respects:

1. by focusing on the commercial benchmarks in Article 14 to the exclusion of cost to government and
2. by rejecting Annex IV as relevant context.

The Appellate Body Report in *Canada–Aircraft*¹¹⁶ was released in August, 1999. It dealt directly with the interpretation of “benefit” in Article 1.1(b). The Appellate Body started with the ordinary meaning of “benefit”, referring to three dictionary definitions and confirming the Panel’s statement that “benefit” clearly encompasses some form of advantage. However, the Appellate Body recognized that these meanings still left some interpretive questions open.

¹¹⁵ Panel Report, *Canada–Aircraft*, supra at note 83, para. 9.120.

¹¹⁶ Appellate Body Report, *Canada–Aircraft*, supra at note 67.

The Appellate Body found that the term “benefit” implies there must be a recipient. It found that this implication provides textual support for the view that the focus of the inquiry under Article 1.1(b) should be on the recipient and not on the granting authority.¹¹⁷

The Appellate Body then considered the meaning of the word “confer” in Article 1.1(b). It found that Article 1.1(b) calls for an inquiry into what was conferred on the recipient. Therefore, the Appellate Body rejected Canada’s argument about the importance of “cost to government”.

This case therefore establishes that the focus in Article 1.1(b) must be on the recipient and not on the government providing the financial contribution. The Appellate Body interpreted “benefit” as conferring an advantage for the recipient over what is available in the marketplace.

In support of this interpretation the Appellate Body referred to Article 14 of the *SCM Agreement* as context. The Appellate Body found that the explicit textual reference in Article 14 to Article 1.1 indicated that “benefit” is used in the same sense in Article 14 as it is in Article 1.1.¹¹⁸

The Appellate Body also found contextual support for its interpretation by examining Article 1.1 as a whole. It found that there were two discrete elements:

1. a financial contribution by a government or by any public body; and

¹¹⁷ Ibid. at para. 154.

2. a “benefit” is thereby conferred.

It found that these elements define a subsidy by reference to:

1. the action of the granting authority; and
2. what is conferred on the recipient.

The Appellate Body also pointed to contextual support for its interpretation of benefit by noting that “benefit” implies some kind of comparison. It stated:

there can be no “benefit” to the recipient unless the “financial contribution” makes the recipient “better off” than it would otherwise have been, absent that contribution.¹¹⁹

The Appellate Body then developed this idea of “benefit” and comparison by specifying the marketplace as the yardstick for determining whether a “benefit” has been conferred. The Appellate Body stated that the trade-distorting potential of a financial contribution can be identified by determining whether the recipient has received a financial contribution on terms more favourable than those available to the recipient in the market.¹²⁰ It is highly debatable whether it is a correct conclusion that trade-distorting potential can be determined by asking whether someone has received something on terms more favourable than those available in the market. This requires some economic analysis. Particularly, it requires an analysis of whether the market itself is competitive or not, and whether it is operating without trade distortion in the first instance. It also requires analysis of whether input costs affected by financial contribution will have a trade-distorting potential in every

¹¹⁸ Ibid. at para. 155.

¹¹⁹ Ibid. at para. 157.

market. It may be the output or sale market that is the relevant area of inquiry with respect to trade distortion.

The Appellate Body also pointed to Article 14 as support for the view that the marketplace is an appropriate basis for comparison in arriving at a determination of “benefit”.

The Appellate Body rejected Canada’s argument that paragraph 1 of Annex IV is part of the relevant context of the term “benefit”. Paragraph 1 reads:

Any calculation of the amount of a subsidy for the purpose of paragraph 1(a) of Article 6 shall be done in terms of the cost to the granting government.

The Appellate Body found that the language in Annex IV is restricted to the interpretation of provisions in Article 6 of the *SCM Agreement* regarding countervailing measures, and is not relevant to interpreting Article 1.

Finally, the Appellate Body rejected the notion that cost to government is relevant to the interpretation of “benefit”, because this would exclude from Article 1(b) benefits that are conferred by a private body under the direction of government. Since contributions by private bodies are specifically included in the definition of “financial contribution” in Article 1.1(a), they cannot be excluded from the definition of “benefit” in Article 1.1(b) by implying a requirement of cost to government.

¹²⁰ Ibid. at para. 157.

The Appellate Body therefore concluded that the Panel was correct in its interpretation of the word “benefit” in 1.1(b) of the *SCM Agreement*. So “benefit” now means a **financial contribution which confers an advantage on the recipient relative to applicable commercial benchmarks, i.e., when it is provided on terms that are more advantageous than those that would be available to the recipient in the market.**

Brazil–Aircraft: Appellate Body Report

The Appellate Body Report in *Brazil–Aircraft* arrived at the same time as *Canada–Aircraft*. Again, there was little direct discussion of the meaning of “export subsidy” because of the concession by Brazil about its existence. But the Appellate Body did offer some language that fits into the development of the definition as it relates to the second element, “benefit”.

The question of “benefit” was not directly before the Appellate Body, as Brazil had conceded that the definition of export subsidy had been met. But Brazil advanced an argument under Item (k) of the Illustrated List of Export Subsidies.¹²¹ The argument was that if the interest subsidy program was not prohibited for falling within Item (k), then it must be permitted. The Appellate Body rejected the argument by saying that the program was in fact prohibited by Item (k).

¹²¹ *SCM Agreement*, Illustrated List of Export Subsidies, Item (k): “The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.”

The argument required the Appellate Body to comment on the meaning of “material advantage” in Item (k). The Appellate Body appeared to adopt the idea of a marketplace benchmark by its statement:

For the purposes of our analysis, we will assume that the Panel meant to use the “marketplace” as the benchmark for determining whether the PROEX subsidies were “used to secure a material advantage”.¹²²

The Appellate Body took pains to say that “material advantage” means something different from “benefit”. But it did not attempt to say what this difference might mean, if anything, in considering the market benchmark comparison.

The Appellate Body went on to note that the OECD has Commercial Interest Reference Rates (CIRR) for export credit rates. It suggested that, for the purposes of Item (k), the appropriate comparison to be made in determining whether an interest rate subsidy is prohibited, is between the actual net interest rate and the CIRR. This raises the possibility that the appropriate benchmark might be some international standard, not the domestic market rate. Could this logic apply to the idea of “benefit” in other contexts? Future cases would deal with this concept of an international benchmark. It appears to be rejected by the Appellate Body in *Canada–Milk* and *US–FSC* in favour of a domestic benchmark for comparisons.

¹²² Appellate Body Report, *Brazil–Export Financing Program for Aircraft (Brazil–Aircraft)*, WT/DS46/AB/R, adopted 20 August 1999, para. 178.

US–FSC: Panel Report

The *Canada–Aircraft* Appellate Body Report was quickly followed by the *US–FSC* Panel Report in October 1999. The Panel dealt with the question of benefit in one paragraph, finding that the financial contribution clearly confers a benefit since both FSCs and their parents need not pay certain taxes which would otherwise be due. The United States apparently did not raise any contrary argument with respect to the issue of benefit either with the Panel or the Appellate Body. Consequently, there was no comment regarding benefit in the Appellate Body Report.¹²³

Canada–Milk: Appellate Body Report

The next Appellate Body decision was *Canada–Milk* in October 1999. The report makes it clear that any inquiry under Article 9.1 of the *AOA* requires, as a starting point, an examination of the subsidy concept from the *SCM Agreement*. The concepts of “financial contribution” and “benefit” help define the terms “direct subsidies” and “payment” in Article 9.1. A benefit is determined if there is a transfer of economic resources from the grantor to the recipient for less than full consideration. The report points to two inquiries that must be made:

- (a) examine the economic value of what has transferred, and
- (b) determine if there has been something less than full consideration.

These two steps now have to be part of any legal test for a subsidy. Note how these steps parallel the “benefit” test in *Canada–Aircraft*, but use different language.

Canada–Automobiles: Panel Report

The next case dealing with “benefit” was *Canada–Automobiles*. The Panel referred to the Appellate Body Report in *Canada–Aircraft* and found that “benefit” has been defined as “an advantage”. It referred again to the dictionary definition referred to in the Appellate Body Report. Without any further analysis, the Panel found that the import duty exemption amounted to a financial contribution and that it therefore conferred a benefit within the meaning of Article 1.1(a) of the *SCM Agreement*.¹²⁴

Canada–Automobiles: Appellate Body Report

The Appellate Body did not deal specifically with the issue of benefit. It merely accepted the Panel’s finding that there was a financial contribution from revenue foregone and that a subsidy resulted.¹²⁵

The result of these reports is the consistent application of a “benefit” test for alleged export subsidies. The test is to determine if a financial contribution confers an advantage on the recipient relative to applicable commercial benchmarks, i.e., when it is provided on terms that are more advantageous than those that would be available to the recipient in the market.

The subsidy definition can now be stated generally as:

¹²³ Panel Report, *US–FSC*, supra at note 86 , para. 7.103 and Appellate Body Report, *US–FSC*, supra at note 69, para. 140.

¹²⁴ Panel Report, *Canada–Automobiles*, supra at note 86, para. 10.165.

A transfer of economic resources from the grantor to the recipient for less than full consideration that confers an advantage on the recipient relative to applicable commercial benchmarks.

3. A Legal Test for a Subsidy

A systematic legal test can now be detailed for determining the existence of a subsidy as defined by the *SCM Agreement*:

1. A subsidy is where a grantor makes a financial contribution that confers a benefit on the recipient as compared with what would have been otherwise available to the recipient in the marketplace, where:
 - a. a financial contribution is a transfer of economic resources, including a payment-in-kind which denotes a transfer of economic resources other than money, from the grantor to the recipient, and
 - b. a benefit occurs if there is a transfer of economic resources from the grantor to the recipient for less than full consideration. This analysis requires the following considerations:
 - an examination of the economic value of what has transferred;
 - a determination if something has been transferred for less than full consideration;
 - the use of the marketplace to determine economic value and full consideration.
2. Is the financial contribution offered by a government or its agency? A government agency is an entity which exercises powers vested in it by a government for the purpose of performing functions of a governmental character, that is, to regulate,

¹²⁵ Appellate Body Report, *Canada–Automobiles*, supra at note 111, para. 94.

restrain, supervise or control the conduct of private citizens. The source of the agency's powers must be a government. The functions the agency performs must be governmental in the sense that those functions are enforceable in courts of law.

C. THE PROHIBITION OF EXPORT SUBSIDIES

Now that we have a test for a subsidy, we can examine what an *export* subsidy is, and why it is illegal. Export subsidies are defined and prohibited by the *SCM Agreement* in Article 3.1(a):

Except as provided in the *Agreement on Agriculture*, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex 1.

1. Contingent on Export Performance

The idea of contingency also arises under the *AOA* in Article 1(e):

“export subsidies” refer to subsidies **contingent upon export performance** including the export subsidies listed in Article 9 of this Agreement.

In both agreements, the requirement of contingency on export performance is an essential criterion before a subsidy may be a potentially illegal export subsidy.

This section will examine the evolution of the meaning of the phrase “contingent upon export performance” in the *SCM Agreement*.

a. Article 3.1(a) of the *SCM Agreement*

i) Contingent in law

Canada–Aircraft: Panel Report

The first panel examination of this provision came in April 1999 in *Canada–Aircraft*.¹²⁶

The issue became whether the Canada Account financing subsidy was contingent on export performance. From statements made by Canada in the evidence, the Panel concluded that the Canada Account financing took the form of export credits granted, according to program requirements, “for the export of goods”. The Panel concluded that export credits granted “for the purpose of supporting and developing directly or indirectly, Canada’s export trade” are expressly contingent in law on export performance. This was found to fall within the meaning of Article 3.1(a) of the *SCM Agreement*. Having reached this conclusion, the Panel found that Canada acted in violation of Article 3.2 of the *SCM Agreement*.

Canada–Aircraft: Appellate Body Report

The Panel’s finding in the *Canada–Aircraft* case that the Canada Account financing was “contingent in law” on export performance was not appealed by Canada.¹²⁷ Thus the Appellate Body Report in the case does not deal with the legal issues about “contingent in law”.

The Appellate Body Report does deal with “contingent in fact” regarding the TPC subsidy program. The comments of the Appellate Body regarding “in fact” are detailed below.

¹²⁶ Panel Report, *Canada–Aircraft*, supra at note 83.

¹²⁷ Appellate Body Report, *Canada–Aircraft*, supra at note 67.

US–FSC: Panel Report

The Panel Report in *Canada–Aircraft* was followed by two other panel reports dealing with export contingency. The first one to deal with contingency “in law” was the *US–FSC* Panel in October 1999. It did not provide much analysis, but did deal with the Illustrative List of Export Subsidies in the *SCM Agreement*. It dealt with a tax exemption scheme using the concept of “contingent in law”.

The Panel found contingency within the meaning of Article 3.1 on the following rationale:

1. The subsidy is only available with respect to “foreign trading income”.
2. Foreign trading income arises from the sale or lease of export property.
3. Export property is limited to goods produced in the United States which are used outside the United States.
4. Therefore, the existence of the subsidy depends upon the existence of income arising from the export of U.S. goods.
5. The existence of such income depends on the export of U.S. goods.¹²⁸

The Panel found support for this interpretation in Item (e) of the Illustrative List of Export Subsidies. Item (e) reads:

The full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises.¹²⁹

The Panel found that the taxes from which the FSC scheme provides exemptions are “direct taxes” within the meaning of Item (e).¹³⁰ The Panel concluded that the FSC exemptions

¹²⁸ Panel Report, *US–FSC*, supra at note 86, para. 7.108.

¹²⁹ *SCM Agreement Illustrative List of Export Subsidies*.

constituted a subsidy contingent upon export performance within Article 3.1(a) of the *SCM Agreement*.

Canada–Automobiles: Panel Report

The next decision was the Panel Report in *Canada–Automobiles* in February 2000. The case dealt with a dispute over what it means to be contingent “in law”. The European Communities argued that it is enough if the requirement to export is stated expressly in the law or implicitly in the law. Canada argued that a subsidy is only contingent in law upon export performance where the underlying legal instruments of that subsidy *expressly* provide that the subsidy is available to enterprises only on condition of export performance. Canada rejected the notion that the requirement to export could be implicit in the law. Canada suggested that the *implicit* requirement would mean that there was only contingency in fact. This argument would have required a much higher burden of proof on someone attempting to prove contingency in fact. The Panel rejected the Canadian argument. The Panel therefore accepted that a subsidy can be contingent in law if the requirement to export is stated either expressly or implicitly in the law. The Panel arrived at this conclusion by applying the *Black’s Law Dictionary* definition of “law” as “that which is laid down, ordained, or established”. The Panel stated:

Following from this definition, export contingency *in law*, in our view, must refer to the situation where one can ascertain, on the face of the law (or other relevant legal instrument), that export contingency exists. In other words, an examination of the terms of the underlying legal instruments of the subsidy in question would suffice to determine whether or not export contingency in law exists.¹³¹

¹³⁰ Panel Report, *US–FSC* at note 86, para. 7.110.

¹³¹ Panel Report, *Canada–Automobiles*, supra at note 86, para. 10.179.

The Panel further stated that “the existence of export contingency can be demonstrated on the basis of the law or other relevant legal instrument, without reference to external factual elements”.

The Panel in *Canada–Automobiles* then commented on the definition of “contingent” as “conditional, dependent”. The Panel relied on the Appellate Body’s decision in *Canada–Aircraft* for support for this definition and its interpretation of contingency in law.¹³²

The Panel then moved to a consideration of the legal instruments involved in the duty exemption. The regulations examined dealt with the issue of the ratio of cars sold at export to cars imported on which the duty exemption was claimed. The Panel found that it was the law (or other relevant legal instruments) that created the import duty exemption upon condition of meeting certain ratio requirements for exported vehicles. On the basis of this analysis, the Panel found that it was the *law* which established contingency upon export performance. Having arrived at this conclusion about contingency and law, the Panel did not need to examine the question of contingency and fact.

The Panel went on to confirm that the Illustrative List to the *SCM Agreement* is not an exhaustive or exclusive list. It does not circumscribe the types of practices which may be found to be subsidies contingent upon export performance.

¹³² Ibid. at para. 10.183.

The Panel also rejected Canada's argument that there was not a sufficient "nexus" between the subsidy and exportation to find contingency. The Panel stated that it is contingency which is the test, not the degree of connection or "nexus".

The Panel also dealt with Canada's submission that the purpose of the *SCM Agreement* is to discipline subsidies that distort trade and that the import duty exemption did not distort trade. Canada argued that the exemption only increased the volume of duty-free imports into Canada. In answering this argument, the Panel pointed out that the only legal test was whether the subsidy fell within the meaning of Article 3.1(a). The Panel recognized that a subsidy might have a dual character of facilitating imports as well as promoting exports. The Panel therefore rejected this argument and confirmed that the subsidy was contingent on exports. The legal test for contingency in law is therefore whether a subsidy is "conditional" or "dependent" for its existence upon export performance by the recipient.

Canada–Automobiles: Appellate Body Report

The Appellate Body in *Canada–Automobiles* also dealt with the issue of "contingent in law".

It stated the legal test:

In our view a subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure.¹³³

The Appellate Body also pointed out that the conditionality on export performance does not need to be expressly stated in the law. It ...

¹³³ Appellate Body Report, *Canada–Automobiles*, supra at note 111, para. 100.

can also be derived by necessary implication from the words actually used in the measure.¹³⁴

Thus contingency “in law” can be found either expressly or implicitly in the legal instruments creating the measure. This will cast wide a net on what subsidies are contingent on export performance.

The Appellate Body found contingency in the legal instruments, stating:

the import duty exemption is tied to the exportation of motor vehicles by the manufacturer beneficiaries. By the very operation of the measure, the more motor vehicles that a manufacturer exports, the more motor vehicles it can import duty free. In other words, a clear relationship of dependency or conditionality exists between the granting of the import duty exemption and the exportation of motor vehicles by manufacturer beneficiaries.

ii) Contingent in fact

Australia–Leather: Panel Report

The first panel report on the issue of contingency “in fact” came in May 1999 in *Australia–Leather*.¹³⁵ The issue of “contingent in law” was not argued. In a succinct analysis the Panel dealt with the meaning of “contingent ... in fact”:

9.55 An inquiry into the meaning of the term “contingent–in fact” in Article 3.1(a) of the *SCM Agreement* must, therefore, begin with an examination of the ordinary meaning of the word “contingent”. The ordinary meaning of “contingent” is “dependent for its existence on something else”, “conditional; dependent on, upon”. The text of Article 3.1(a) also includes footnote 4, which states that the standard of “in fact” contingency is met if the facts demonstrate that the subsidy is “in fact tied to actual or anticipated exportation or export earnings”. The ordinary meaning of “tied to” is “restrain or constrain to or from an action; limit or restrict as to behavior, location, conditions, etc.” Both of the terms used—“contingent–in fact” and “in fact tied to” suggest an interpretation that requires a close connection between the grant or maintenance of a subsidy and export performance.

¹³⁴ Ibid. at para. 100.

¹³⁵ Panel Report, *Australia–Leather*, supra at note 85.

9.56 In our view, the concept of “contingent ... in fact ... upon export performance”, and the language of footnote 4 of the *SCM Agreement*, require us to examine all of the facts that actually surround the granting or maintenance of the subsidy in question, including the terms and structure of the subsidy, and the circumstances under which it was granted or maintained. A determination whether a subsidy is in fact contingent upon export performance cannot, in our view, be limited to an examination of the terms of the legal instruments or the administrative arrangements providing for the granting or maintenance of the subsidy in question. Such a determination would leave wide open the possibility of evasion of the prohibition of Article 3.1(a), and render meaningless the distinction between “in fact” and “in law” contingency. Moreover, while the second sentence of footnote 4 makes clear that the mere fact that a subsidy is granted to enterprises which export cannot be the sole basis for concluding that a subsidy is “in fact” contingent upon export performance, it does not preclude the consideration of that fact in a panel’s analysis. Nor does it preclude consideration of the level of a particular company’s exports. This suggests to us that factors other than the specific legal or administrative arrangements governing the granting or maintenance of the subsidy in question must be considered in determining whether a subsidy is “in fact” contingent upon export performance.

9.57 Based on the explicit language of Article 3.1(a) and footnote 4 of the *SCM Agreement*, in our view the determination of whether a subsidy is “contingent ... in fact” upon export performance requires us to examine all the facts concerning the grant or maintenance of the challenged subsidy, including the nature of the subsidy, its structure and operation, and the circumstances in which it was provided. In this context, Article 11 of the DSU requires a panel to make an objective assessment of the facts of the case. Obviously, the facts to be considered will depend on the specific circumstances of the subsidy in question, and will vary from case to case. In our view, all facts surrounding the grant and/or maintenance of the subsidy in question may be taken into consideration in the analysis. However, taken together, the facts considered must demonstrate that the grant or maintenance of the subsidy is conditioned upon actual or anticipated exportation or export earnings. The outcome of this analysis will obviously turn on the specific facts relating to each subsidy examined.

The Panel then made a detailed analysis of the facts and concluded that the subsidies were “contingent ... in fact”:

All of the facts, weighted together, lead us to conclude that the three subsidy payments, under the grant contract are in fact tied to Howe’s actual or anticipated exportation or export earnings. These payments are conditioned on Howe’s agreement to satisfy, on the basis of best endeavors, the aggregate performance targets. The second and third grant payments are, in addition, explicitly conditioned on satisfaction, on a best endeavors basis, of interim sales performance targets. Given the export-dependent nature of Howe’s business, and the size of the Australian market, these sales performance targets are, in our view, effectively,

export performance targets. The sales performance targets set out in the grant contract, in conjunction with the other facts enumerated above, therefore lead us to the conclusion that the grant of the subsidies was conditioned on anticipated exportation.¹³⁶

Canada–Aircraft: Panel Report

The Panel in *Canada–Aircraft* considered whether the TPC program was “contingent upon export performance” within the meaning of Article 3.1(a) of the *SCM Agreement*.

There was no argument in this case that the TPC program was contingent in law on export performance. It was accepted that it was not contingent in law. The argument revolved around whether the program was contingent in fact upon export performance. The argument turned on the meaning of footnote 4 to the *SCM Agreement* which sets the standard for contingency in fact. Footnote 4 reads as follows:

This *standard is met* when the *facts demonstrate* that the *granting* of a subsidy, without having been made legally contingent upon export performance, *is in fact tied to actual or anticipated exportation or export earnings*. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy, within the meaning of this provision [emphasis added].

The Panel began its interpretation of Article 3.1(a) by looking at the ordinary meaning of “contingent”.¹³⁷ It found the meaning to be “dependent for its existence on something else” “conditional; dependent upon”. The Panel then referred to the meaning of “tied to” in footnote 4 as “restrain or constrain to or from actions; limit or restrict as to behavior, location, conditions, etc.” The Panel stated “the phrase ‘tied to’ requires a special connection between the grant of the subsidy and the actual or anticipated exportation or export

¹³⁶ Ibid.

¹³⁷ Panel Report, *Canada–Aircraft*, supra at note 83, para. 9.331.

earnings”. The Panel considered that the connection between the grant of the subsidy and the anticipated exportation or export earnings required by “tied to” is conditionality. The parties agreed with this interpretation.

The parties also agreed on a “but for” test for determining whether a subsidy is tied to anticipated exportation or export earnings. The Panel stated that they could most effectively determine whether the requisite conditionality existed between the program and exports by determining whether the facts demonstrated that the financial contribution would not have been granted but for anticipated exports.

The disagreement between the parties arose over the question of what facts are relevant in determining the application of the “but for” test. The Panel first determined that one of the relevant factors is the export orientation of the industry involved. This is one factor, but it is not necessarily determinative. The Panel then pointed out that any fact could be relevant, provided it demonstrates (either individually or in conjunction with other facts) whether or not a subsidy would have been granted but for anticipated exportation or export earnings.¹³⁸ The Panel also noted that the relative importance of each fact can only be determined in the context of a given case, and not on the basis of generalities.

The Panel went on to say that the factual evidence adduced must demonstrate that:

1. if there had been no expectation of export sales ensuing from the subsidy,

¹³⁸ Ibid. at para. 9.337.

2. then the subsidy would not have been granted.

This appears to clearly state the “but for” test was involved. This also injects new language into the test by the use of the word “sales”. The Panel stated that the “but for” test is “concerned principally with anticipated export sales”.¹³⁹

In what could become a controversial part of the test in the future, the Panel went on to state:

thus the closer a subsidy brings a product to sale on the export market, the greater the possibility that the facts may demonstrate that the subsidy would not have been granted but for anticipated exportation or export earnings. Conversely, the further removed a subsidy is from sales on the export market, the less the possibility that the facts may demonstrate that the subsidy would not have been granted but for anticipated exportation or export earnings.¹⁴⁰

The Panel then applied the “but for” test to the TPC program. The Panel found sixteen different items in the documents provided in evidence referring to exports and the growth of export sales. The Panel stated:

In our view, these facts demonstrate that TPC funding to the regional aircraft sector is expressly designed and structured to generate sales of particular products, and that the Canadian Government expressly takes into account, and attaches considerable importance to, the proportion of those sales that will be for export, when making TPC contributions in the regional aircraft sector.

¹³⁹ Ibid. at para. 9.339.

¹⁴⁰ Ibid. at para. 9.339.

The Panel found that the contributions were made for “near market projects with high export potential”. On this basis the Panel found that the TPC program fell within footnote 4 and Article 3.1(a) of the *SCM Agreement*.

Canada had argued that the TPC program was not conditional on exports actually taking place. There were no penalties if export sales were not realized. This argument was rejected by the Panel because it found that the test in footnote 4 refers to anticipated, not just actual, exportation or export earnings. The Panel found that the grants were conditional on an expectation that export sales would flow directly from the contributions.

The Panel therefore concluded that the TPC program was contingent in fact upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*.

Canada–Aircraft: Appellate Body Report

In August 1999 the Appellate Body released its report in *Canada–Aircraft*, giving the first appeal-level ruling on “contingent on export performance”. The Appellate Body gave a detailed examination of “contingent ... in fact”. The Appellate Body found that the Panel’s conclusion was that a subsidy is contingent in fact upon export performance if there is a relationship of conditionality or dependence between the grant of the subsidy and the anticipated exportation or export earnings.¹⁴¹

¹⁴¹ Appellate Body Report, *Canada–Aircraft*, supra at note 67, para. 162.

The Appellate Body found that the key word was “contingent”. The ordinary dictionary meaning of this term is “conditional” or “dependent for its existence on something else”.

For textual support, the Appellate Body referred to the fact that Article 3.1(a) makes an explicit link between “contingency” and “conditionality” in stating the export contingency can be the sole or one of several other “conditions”.¹⁴² The Appellate Body then went on to state that the legal standard expressed by the word “contingent” is the same for both *de jure* or *de facto* contingency. The Appellate Body recognized that the language “in law or in fact” resulted from the negotiators’ desire to prevent circumvention of the prohibition against subsidies contingent “in law” upon export performance.¹⁴³ Having pointed out that the legal standard for contingency is the same for “in law or in fact”, the Appellate Body pointed out that the difference is in what proof must be offered. The difference is expressed as:

de jure export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other instrument;

and *de facto* contingency

must be inferred from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.¹⁴⁴

¹⁴² Ibid. at para. 166.

¹⁴³ It is noteworthy that in this regard the Appellate Body made reference to the submission of the European Communities during the negotiations on the *SCM Agreement*. This appears to open up the submissions made in negotiations as appropriate contextual reference for determining the meaning of terms contained in the agreement.

¹⁴⁴ Appellate Body Report, *Canada–Aircraft*, supra at note 67, para. 167.

The Appellate Body noted that it is within the context of the difficulty of proving contingency in fact that the *SCM Agreement* provides footnote 4. The Appellate Body specified that the standard set out in footnote 4 requires proof of three different substantive elements:

1. the “*granting of subsidy*”;
2. “*is ... tied to ...*”; and
3. “actual or *anticipated* exportation or export earnings”.

Before applying the standard, the Appellate Body noted that export contingency must be demonstrated by the facts, but the facts which must be taken into account in a particular case will depend on the circumstances of that case. The Appellate Body declined to make any general rule as to what facts or what kind of facts *must* be taken into account.

The three elements of the contingency test in footnote 4 were then further described by the Appellate Body.

Footnote 4: “granting of a subsidy”

The first question to ask is whether, in providing the subsidy, the granting authority imposed a condition based on export performance. The focus is on the granting member and not on the recipient. The Appellate Body used this description of the test to reject Canada’s argument that the concept of contingency should focus on the reasonable knowledge of the recipient. It appears therefore that the knowledge of the recipient about the expectation or requirement of exports is irrelevant.

Footnote 4: “tied to”

The Appellate Body found that the ordinary meaning of “tied to” is “to limit or restrict as to conditions”. This second element of footnote 4 therefore emphasizes that a relationship of conditionality or dependence must be demonstrated.¹⁴⁵ The Appellate Body required that the facts must demonstrate that the granting of the subsidy is tied to or contingent upon actual or anticipated exports. In a footnote, the Appellate Body appeared to reject the adoption of the “but for” test by the Panel. It appears that the Appellate Body felt that the Panel was substituting language for the language actually found in the agreement and the footnote. The Appellate Body did not explicitly reject the use of the “but for” test, but its footnote appears to indicate that the Panel did not need to go to the extent of formalizing a separate and distinct legal standard or legal test to arrive at its conclusion.

Footnote 4: “actual or anticipated exportation or export earnings”

The Appellate Body found that the dictionary definition of the word “anticipated” is “expected”.¹⁴⁶ However, the Appellate Body took pains to attempt to state that there is something more required than a mere expectation of exports on the part of the granting authority. The Appellate Body suggested that the anticipation or expectation of exports is to be gleaned from an examination of objective evidence. This appears to mean that the anticipation or expectation might be held on the part of some person other than the granting authority. For example, a private company exporter may have an anticipation or expectation of export earnings. This appears to be enough to satisfy this standard. The Appellate Body further suggested that subsidies may be granted with the anticipation on

¹⁴⁵ Ibid. at para. 171.

the part of the granting authority that exports will result. This also may satisfy this third element of the test regarding anticipated exportation. However, the Appellate Body did state that this is a totally separate element of the test from the second element of “tied to”.

The Appellate Body then looked at the structure of footnote 4 to give meaning to its description of the three-element test set out above. It pointed out that mere knowledge on the part of a granting authority that a recipient’s sales are export oriented does not demonstrate, *without more*, that the granting of a subsidy is tied to actual or anticipated exports. The Appellate Body saw the second sentence of footnote 4 as a specific expression of the requirement in the first sentence to demonstrate the “tied to” requirement. The Appellate Body confirmed that the export orientation of a recipient may be taken into account as one relevant fact in establishing “tied to”, provided that it is one of several facts which are considered and is not the only fact supporting such a finding.¹⁴⁷

The Appellate Body dealt with the Panel’s discussion about “closeness to market”. They did so in the context of this three-step test. The Appellate Body stated that the closeness to market did not amount to a legal presumption which satisfied the test. It ruled that the Panel had taken the closeness-to-market fact regarding the program as one of the factors to be considered in the application of the test. Unfortunately, the Appellate Body did not make the assessment of this closeness-to-market argument in the context of either the second or third element of the test. It appears that it would properly be considered as the application of the third element of the test.

¹⁴⁶ Ibid. at para. 172.

Having set out this three-step legal test, the Appellate Body then reviewed the Panel's application of the legal standard to the facts relating to the TPC program. The Appellate Body appeared to be impressed with the Panel's review of the sixteen different facts which led it to conclude that *de facto* export contingency was established. It is noteworthy that the Appellate Body drew special attention to the eligibility criteria used by a granting authority, and their application in practice, in determining export contingency.¹⁴⁸ These will become important considerations in any future case involving the *de facto* argument for contingency of government programs.

The Appellate Body supported the Panel's review of all of the facts and rejected Canada's argument that the Panel had used export orientation as the effective test. The Appellate Body also again supported the Panel's application of all of the facts, including nearness to market.

In an interesting comment near the end of the decision, the Appellate Body referred with approval to the fact that the Panel took into account a number of facts related to the TPC program as a whole. The Appellate Body found that some of TPC's contributions in some industry sectors were not contingent upon export performance. However, this did not necessarily mean that the same was true for all of TPC's contributions. The Appellate Body therefore concluded that

¹⁴⁷ Ibid. at para. 173.

¹⁴⁸ Ibid. at para. 178.

it is enough to show that one or some of TPC's contributions do constitute subsidies "contingent in fact upon export performance".¹⁴⁹

The conclusion from this is that if any of the parts of the program that have been challenged amount to a contingent subsidy, the program will contravene the *SCM Agreement*.

These cases have established that contingency upon export performance exists when there is a state of conditionality or dependence between the subsidy and export performance. Contingency "in law" exists when the conditionality can be demonstrated on the express words of the legal instrument creating the measure, or by necessary implication from those words. Contingency "in fact" exists when the conditionality can be inferred from the total configuration of the facts constituting and surrounding the granting of the subsidy.

2. The Prohibition of Export Subsidies

Article 3.1(a) of the *SCM Agreement* contains the prohibition of export subsidies. It is an absolute prohibition if the conditions of subsidy and contingency upon export performance are met. Any offending subsidy is termed inconsistent with a member's obligations under the *SCM Agreement*. The member is then requested to bring its program into conformity with its obligations.

IV. THE AGREEMENT ON AGRICULTURE

A. THE AOA DEFINITION OF EXPORT SUBSIDIES

¹⁴⁹ Ibid. at para. 179.

The definition of “export subsidies” for the purposes of the AOA is found in Article 1(e) of the AOA;

1(e) “export subsidies” refer to subsidies contingent upon export performance including the export subsidies listed in Article 9 of this Agreement.

“Subsidies” is not a defined term in the AOA.

Article 9.1 of the agreement provides:

1. The following export subsidies are subject to reduction commitments under this Agreement:
 - (a) the provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such producers, or to a marketing board, contingent on export performance;
 - (b) the sale or disposal for export by governments or their agencies of non-commercial stocks of agricultural products at a price lower than the comparable price charged for the like product to buyers in the domestic market;
 - (c) payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived;
 - (d) the provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight;
 - (e) internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments;
 - (f) subsidies on agricultural products contingent on their incorporation in exported products.

Canada–Milk was the first AOA case to be reported by the DSB. The reports of the Panel and the Appellate Body¹⁵⁰ provide insight and analysis into the application of the AOA and the *SCM Agreement*. The Panel and Appellate Body reports for *United States–Foreign Sales*

Corporations have followed.¹⁵¹ They further describe and explain the WTO rules which will apply to export subsidies in agriculture. These are the only cases to date dealing specifically with the definition of export subsidies in agriculture.

B. AN AGRICULTURAL PRODUCT

1. Product Classifications

In any export subsidy issue, the first question is whether the product at issue is an *agricultural product* which is covered by the *AOA*.¹⁵² This will determine whether the *AOA* provisions apply. The question is answered by Article 2 of the *AOA*:

This Agreement applies to the products listed in Annex 1 to this Agreement, hereinafter referred to as agricultural products.¹⁵³

Annex 1 describes agricultural products by reference to portions of the Harmonized System of Tariff Classifications. So product coverage will be obvious unless there are disputes about the tariff classification of the product.

If the product is not covered by the *AOA*, then the general rules of the *SCM Agreement* will apply.

¹⁵⁰ Panel Report, *Canada–Milk*, supra at note 68 and Appellate Body Report, *Canada–Milk*, supra at note 78.

¹⁵¹ Panel Report, *US–FSC*, supra at note 86 and Appellate Body Report, *US–FSC*, supra at note 69.

¹⁵² Panel Report, *Canada–Milk*, supra at note 68, para. 7.18 and Panel Report, *US–FSC*, supra at note 86.

¹⁵³ *Agreement on Agriculture*, Art. 2.

2. Priority of Agreements

Once it has been determined that the issue involves an agricultural product, the next step is to determine if the *AOA* answers the claim. The *SCM Agreement* accedes to the priority of the *AOA* by virtue of two provisions:

Article 3.1 of the *SCM Agreement*:

Except as provided in the *Agreement on Agriculture*, the following subsidies, within the meaning of Article 1, shall be prohibited:

- (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;
- (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.¹⁵⁴

Article 21 of the *Agreement on Agriculture*:

1. The provisions of GATT 1994 and of other Multilateral Trade Agreements in Annex 1A to the WTO Agreement shall apply **subject to the provisions of this Agreement**.
2. The Annexes to this Agreement are hereby made an integral part of this Agreement.¹⁵⁵

So if a subsidy scheme complies with the *AOA*, there can be no breach of the *SCM Agreement*. If the scheme does not fully comply with the *AOA*, then it could be examined for non-compliance with the *SCM Agreement* as well as breach of the *AOA*.¹⁵⁶

¹⁵⁴ *SCM Agreement*, Art. 3.

¹⁵⁵ *Agreement on Agriculture*, Art. 21.

¹⁵⁶ Panel Report, *Canada–Milk*, supra at note 68, para. 7.22.

3. Burden of Proof

One of the next steps after determining if a good is an agricultural product is to determine if it is a “scheduled” product in Section II, Part IV of a member’s schedule. If it is not, then it is an “unscheduled” agricultural product. The relevance of this is that Article 10.3 of the AOA provides that, for any scheduled product, the burden of proof is on the exporting party to show that any amounts exported in excess of the quantities listed in the schedule are not subject to subsidies.¹⁵⁷ This highlights the importance of identifying the product that is involved as a first step in any of these disputes and determining whether the product is listed in the member’s schedule or not. If it is an unscheduled product, it cannot be supported by any export subsidy. If it is a scheduled product, then only the export subsidies allowed by the member’s schedule are allowed. Any subsidy granted in excess of the reduced export subsidy levels contained in the schedule will be illegal.

C. WHAT IS AN EXPORT SUBSIDY IN THE AOA?

1. THE INTERPRETIVE APPROACH

a. Article 1(e) definition of “export subsidy”

The AOA defines export subsidies in Article 1(e):

“export subsidies” refers to subsidies contingent upon export performance, including the export subsidies listed in Article 9 of this Agreement.¹⁵⁸

The meaning of Article 1(e) is considered in the DSB Panel and Appellate Body reports in both *Canada–Milk* and *US–FSC*. These reports deal with the export subsidy rules in the AOA. The DSB started its examination in each case with the specific subsidy language in

¹⁵⁷ *Agreement on Agriculture*, Art. 10.3 and Panel Report, *US–FSC*, WT/DS108/R, adopted 20 March 2000.

Article 9. In *Canada–Milk*, the Panel found a subsidy under Article 9.1(a) and (c), while the Appellate Body found a subsidy only under 9.1(c). In *US–FSC*, the Panel found a 9.1(d) subsidy, but the finding was reversed on appeal. The language regarding these 9.1 subsidies will be examined later. The significant point is that in both of these cases the Appellate Body felt the need to define the term “subsidy” as the first step in its inquiry into the AOA and Article 1(e).

The interpretive approach taken in both cases was to move immediately to consider whether the programs at issue were subsidies as defined in Article 9.1. The reason for this is that the only possible *legal* export subsidy for an agricultural product in these cases is a subsidy of a scheduled product which falls within the member’s reduction commitment levels. Thus, once it is determined that you are dealing with an export subsidy of an agricultural product, it must be determined if the subsidy is of a type set out in Article 9.1. If it is, then it might be legal if it falls within the reduction commitments. If it is not in Article 9.1, then it must be illegal.¹⁵⁹

In *Canada–Milk*, the Appellate Body stated “a subsidy involves a transfer of economic resources from the grantor to the recipient for less than full consideration”. The Appellate Body made reference to Article 1.1 of the *SCM Agreement* as context for this interpretation of “subsidy”:

¹⁵⁸ *Agreement on Agriculture*, Art. 1(e).

¹⁵⁹ This general approach is described in the Panel Report, *Canada–Milk*, WT/DS103/R, WT/DS113/R, adopted 27 October 1999, para. 7.18 – 7.23. There are some other possible legal subsidies for agricultural products as described in *Agriculture: Explanation, Export Competition/Subsidies* at http://www.wto.org/english/tratop_e/agric_e/ag_intro04_export.htm.

As we said in our Report in *Canada–Aircraft*, a “subsidy”, within the meaning of Article 1.1 of the *SCM Agreement*, arises where the grantor makes a “financial contribution” which confers a “benefit” on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.¹⁶⁰

This definition was offered in the context of considering an issue in *AOA*, Article 9.1. Therefore, the *SCM Agreement* language and the meaning of “subsidy” must always be considered in any *AOA* export subsidy issue.

In *US–FSC*, the Appellate Body again approved the *SCM Agreement* concept of subsidy for use in the *AOA*.¹⁶¹ It then relied on its statement in *Canada–Milk*, and on the subsidy definition of Article 1.1 of the *SCM Agreement* to define “subsidy” for the *AOA*. The Appellate Body noted that the *AOA* does not contain a definition of the terms “subsidy” or “subsidies” and relied on the *SCM Agreement* to fill this hole. As a result of this case the definition of “subsidy” for both the *SCM Agreement* and the *AOA* has clearly become the same.

The second part of the legal test for an export subsidy in the *AOA* is once again the element of contingency upon export performance. This element will be examined below. However, the development of the meaning of “subsidy” in the *AOA* will be examined first.

b. The *Canada–Milk* case

i) The arguments in the *Canada–Milk* case

¹⁶⁰ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 87.

¹⁶¹ Appellate Body Report, *US–FSC* supra at note 69, para. 87.

The factual aspects of the Canadian dairy regime are set out in the Panel and Appellate Body reports in *Canada–Milk*.¹⁶² The principal aspects are summarized here.

1. Institutions

“Regulatory jurisdiction over trade in dairy products in Canada is divided between the federal and the provincial governments. The Canadian federal government has the power to regulate inter-provincial and international trade generally, including trade in milk, while the provincial governments have jurisdiction over aspects of the production and sale of milk within the provinces. Three entities have decision-making roles with respect to the production and sale of milk in Canada: the Canadian Dairy Commission (the ‘CDC’), the provincial milk marketing boards and the Canadian Milk Supply Management Committee (the ‘CMSMC’).”¹⁶³

2. The Special Milk Class Scheme

“Industrial milk in Canada is subject to a national common classification system, under which the pricing of milk is based on the end use to which the milk is put. The classification system establishes five different ‘classes’ of milk, the first four of which cover milk used exclusively in the domestic market. The ‘Special Milk Classes’ are the five subclasses of Class 5 milk. Special Classes 5(a) to 5(c) cover milk used for the preparation of certain dairy products that are either sold in the domestic market or exported. Special Class 5(e) is for the removal of surplus milk from the domestic market.”¹⁶⁴

3. Price of milk to the processor

“The price of Special Classes 5(d) and 5(e) milk is negotiated by the CDC and the processors/exporters on a transaction-by-transaction basis. The price at which industrial milk is made available under Special Classes 5(d) and 5(e) is ‘significantly lower’ than the price of industrial milk destined for domestic use.”¹⁶⁵

4. Returns to the producer—pooling

¹⁶² Panel Report, *Canada–Milk*, supra at note 68, para. 2.1–2.16 and Appellate Body Report, *Canada–Milk*, supra at note 78, para. 6–16.

¹⁶³ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 7.

¹⁶⁴ Ibid. at para. 14.

¹⁶⁵ Ibid. at para. 15.

“Returns to producers from the sale of milk are calculated on the basis of a system of pooling. Two separate pooling mechanisms are used to pool returns from sales of in-quota and over-quota milk. Revenues from all in-quota sales are pooled on a regional basis, whether the milk sold was destined for domestic use or for export. Over-quota sales are subject to a much more limited pooling of returns that covers only over-quota sales. The pooling is conducted on a national basis.”¹⁶⁶

The Special Milk Classes 5(d) and 5(e) were challenged by New Zealand and the United States as illegal export subsidies under Article 9.1 of the *AOA*.

Canada argued that the Article 1(e) definition in the *AOA* contains two components:

- (a) the first component is “subsidies contingent on export performance”;
- (b) the second component includes as export subsidies, for the purposes of the definition, the export subsidies specifically listed in Article 9 of the agreement.¹⁶⁷

Canada further divided the first component “subsidies contingent on export performance”, into two components:

- (i) “subsidies” and
- (ii) “contingent on export performance”.

Canada viewed the term “subsidy” as not defined in the *AOA*. Canada therefore suggested that the “prime contextual interpretive source” for the meaning of the term “subsidy” is the definition found in the *SCM Agreement*. Canada argued that the definition of “subsidy” in the *SCM Agreement* applies for the purposes of all WTO agreements. It argued that the

¹⁶⁶ Ibid. at para. 16.

¹⁶⁷ Panel Report, *Canada–Milk*, supra at note 68.

definition is exclusive, in the sense that any measure or practice that does not fall within the terms of the definition cannot be considered a subsidy for WTO purposes.¹⁶⁸

The rationale for Canada's argument in this regard was that the *SCM Agreement* definition of "subsidy" is restrictive, since it seems to include a requirement of a financial contribution by a government. Since there was no financial contribution by a government in the Special Milk Class Schemes, they could not be considered subsidies.

New Zealand argued that the meaning of the term "subsidy" should be determined first by reference to the *AOA*. New Zealand argued that the *SCM Agreement* does not provide an overriding definition for the purposes of all of the WTO agreements, including the *AOA*. Rather, reference could also be made to the Illustrated List of Exports Subsidies in Annex 1 to the *SCM Agreement* and to the broader question of what constituted a subsidy under GATT 1947 and GATT practice.

New Zealand suggested that it was not necessary for the Panel to make broad pronouncements on the scope of the *SCM Agreement* definition of subsidy as it was not necessary for this dispute.

New Zealand argued that the wording of Article 1 of the *SCM Agreement* necessarily limits the definition of subsidy to that agreement. Reference was made to the words "for the purposes of this agreement" and "a subsidy shall be deemed to exist if".

¹⁶⁸ Ibid. at para 4.128.

New Zealand further argued that there is nothing in the *AOA* that incorporates the *SCM Agreement* definition. In fact provisions like Article 21 of the *AOA* make all the other WTO agreements subject to the provisions of the *AOA*.

New Zealand also argued that the export subsidies listed in Article 9.1 of the *AOA* were export subsidies by definition. They do not need to be tested against the subsidy definition in the *SCM Agreement*. Further, not only are the Article 9 subsidies export subsidies by definition, they are also indicative or illustrative of the broader category of export subsidies referred to elsewhere in the *AOA* (in Article 9 and Article 10).

The United States. also argued that the term “subsidy” is not governed either exclusively or primarily by Article 1 of the *SCM Agreement*. The *SCM Agreement* is only one part of the interpretive context of the Article 1(e) definition. The United States referred to the *Brazil–Desiccated Coconut* case as authority.¹⁶⁹

ii) The Panel Report

The Panel was confronted with the choice of how it would approach the question of whether an export subsidy existed under Article 9.1 of the *AOA*. Would it look for a subsidy as defined in the *SCM Agreement*, or would it turn first to the language in Article 9.1? The Panel concluded that “what needs to be examined here in the first place is whether an ‘export subsidy’ is provided for quantities of exports of agricultural products in excess of the

¹⁶⁹ Ibid. at para. 4.139.

reduction commitments made by Canada under the *AOA*".¹⁷⁰ The Panel determined that it would first examine whether the Milk Class Scheme involved an export subsidy listed in Article 9.1. They chose to do this because Article 9.1 contains the most specific and appropriate language provided to make this determination. The Panel preferred this specific approach to Canada's argument about first examining whether the scheme was a subsidy more generally with particular reference to the *SCM Agreement*. The Panel did not specifically reject Canada's argument about finding a "subsidy" first, but the practical effect was to reject the argument.

The Panel dealt with Canada's argument about giving prime importance to the *SCM Agreement* in just one brief paragraph. They did this after just a general outline of the arguments and no critical analysis. The Panel did not make specific reference to any of the particular arguments raised by the parties on which interpretive approach should apply. So the description of the connection between the two agreements would wait for further reports.

iii) The appeal argument

At the appeal level Canada again argued that the term "export subsidies" in the *AOA* must take into account the definition of "subsidy" in the *SCM Agreement*. Canada argued that the *SCM Agreement* is the latest statement of WTO members as to their rights and obligations

¹⁷⁰ Ibid. at para. 7.31.

concerning agricultural subsidies. Canada argued that there should be consistency between the two agreements with respect to the notions of “subsidies” and “export subsidies”.¹⁷¹

Specifically, Canada argued that determination of direct subsidies in Article 9.1(a) of the AOA should begin with the interpretation of the word “subsidies”. The elements of the definition of “subsidy” in Article 1.1 of the *SCM Agreement* must be present before something can be a subsidy in Article 9.1 in the AOA. Then, if the subsidy definition is satisfied, a further inquiry must be made into whether the subsidy is direct. Canada suggested that “direct” means paid or funded directly from government funds paid directly to the beneficiary by the government itself.

iv) The Appellate Body Report

The Appellate Body did not comment on this interpretive approach suggested by Canada. Instead, the Appellate Body turned immediately to the question of whether a payment-in-kind is a direct subsidy within the meaning of Article 9.1. The only clue offered by the Appellate Body regarding the application of the *SCM Agreement* was in its reference to its decision in *Canada–Aircraft*.¹⁷² The reference was to the definition of “subsidy” offered in that case, where a subsidy was described as arising “where the grantor makes a financial contribution which confers a benefit on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace”. This seems to be a clue from the Appellate Body that the first determination to make is whether there was a subsidy

¹⁷¹ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 18.

¹⁷² Ibid. at para. 87.

within the meaning of the *SCM Agreement*. This is supported by the Appellate Body's statement:

We, therefore, conclude that the Panel erred in finding that “a determination in the instant matter that ‘payments-in-kind’ exist would also be a determination of the existence of a direct subsidy.” The Panel should have considered whether the particular “payment-in-kind” that it found existed was a “direct subsidy”. Instead, because the Panel assumed that a “payment-in-kind” is necessarily a “direct subsidy”, it did not address specifically either the meaning of the term “direct subsidies” or the question whether the provision of milk to processors for export under Special Classes 5(d) and 5(e) constitutes “direct subsidies”.¹⁷³

Further support is found in the Appellate Body's decision in *Canada–Milk* for the concept of applying the definition of “subsidy” in the *SCM Agreement* to Article 9 of the *AOA*.¹⁷⁴ The Appellate Body stated:

Thus, on our reading of the Panel Report, the Panel equated a “payment-in-kind” with a “direct subsidy”, and then equated a “payment-in-kind” with a “benefit”. For the Panel, it followed logically from the existence of a “benefit” that a “direct subsidy” also existed. If the “benefit” was provided by “governments or their agencies”, it followed, furthermore, that there was an export subsidy as listed in Article 9.1(a) are granted through Special Classes 5(d) and 5(e). Since we have held that the interpretive approach which underlies the finding in paragraph 7.87 of the Panel Report is wrong, it follows that that finding is itself tainted by the same errors of law. The conferral of a “benefit” does not necessarily constitute a “payment-in-kind”, and a “payment-in-kind” is not necessarily a “direct subsidy”. Thus, the Panel's assessment that a “benefit”, and hence a “payment-in-kind”, are provided by “governments or their agencies” does not, in our view, warrant the conclusion that export subsidies are conferred.¹⁷⁵

The Appellate Body criticized the Panel for its inconsistent reliance on the *SCM Agreement* in interpreting Article 9.1(a). The Appellate Body referred with approval to the fact that the Panel used the concept of “benefit” from the definition of subsidy in the *SCM Agreement* to help define the word “payment”. It appears the Appellate Body felt that the concept of “benefit” should also have been used by the Panel to assist in defining the term “direct

¹⁷³ Ibid. at para. 88.

¹⁷⁴ Ibid. at para. 90.

subsidies”. The Appellate Body also seemed to suggest that the Panel should have used the concept of “financial contribution” from Article 1.1 of the *SCM Agreement* to help define the terms “direct subsidies” and “payment” in Article 9.1.

The Appellate Body went on to set out the test for determining the proper application of 9.1(a). The test is:

1. A subsidy is where a grantor makes a financial contribution which confers a benefit on the recipient as compared with what would have been otherwise available to the recipient in the marketplace.
2. A financial contribution is a transfer of economic resources.
3. The financial contribution can be a payment-in-kind, which denotes a transfer of economic resources other than money, from the grantor to the recipient.
4. A benefit is determined if there is a transfer of economic resources from the grantor to the recipient for less than full consideration.
 - (a) Examine the economic value of what has transferred.
 - (b) Determine if there has been something less than full consideration.

v) Points to ponder

In analyzing these *Canada–Milk* reports, it is disappointing that the Appellate Body did not directly address the arguments presented about whether a subsidy in Article 9.1 of the AOA must be a subsidy as defined in the *SCM Agreement*. Despite the lack of a clear statement,

¹⁷⁵ Ibid. at para. 91.

the Appellate Body leaves the impression that the types of programs described in Article 9.1 must be subsidies in the *SCM Agreement* before they are subsidies in the *AOA*. It is also disappointing that the Appellate Body did not comment on the meaning of “direct” subsidies in Article 9.1(a). Perhaps the meaning is so straightforward that it needs no definition. The Appellate Body again left the impression that a program would be subject to limitations from Article 9.1 and Article 3 only if the program was found to be a “direct” subsidy.

In comparing the language in the reports, it appears that the Appellate Body and the Panel were really talking about the same thing in several respects, only using different terminology. First, the Panel was looking for the transfer of a “benefit” from the Dairy Commission to the exporter. However, the Appellate Body was looking for the transfer of economic resources for “less than full consideration”. These really are the same concepts, and, although they are worded differently, amount to looking for some financial gain on the part of the exporter. Alternatively, both bodies were looking for some unfair reduction in cost to the exporter that would give the exporter a trade advantage and therefore contravene the *AOA*. If the Appellate Body had recognized this use of language by the Panel, it might not have so quickly rejected the Panel’s interpretive approach.

The Appellate Body made a number of comments about the need to examine the question of whether there was a “direct subsidy”, or any “subsidy” at all. The Appellate Body felt that the Panel did not do this examination. However, the Panel made a number of references to “*payment-in-kind in the sense of Article 9.1(a)*” [emphasis added]. This reference is quite clearly to a payment-in-kind in the sense of a “direct subsidy”. It is obvious that Article

9.1(a) is about direct subsidies. It appears that if the Panel had simply substituted the words “direct subsidies” for the phrase “payments-in-kind in the sense of Article 9.1(a)” the Appellate Body may have been satisfied with the result.

c. The *US-FSC* case

i) The Panel Report

In the *US-FSC* case, the products at issue fell under both the *AOA* and the *SCM Agreement*. The European Communities claimed that the United States had acted inconsistently with the *AOA* by providing FSC subsidies in excess of their reduction commitments. The Panel turned immediately to Article 9.1(d):

The provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs, and the costs of international transport and freight.

The key term for interpretation in 9.1(d) is “the provision of subsidies”. The Panel took the contextual approach, referring to Article 1.1 of the *SCM Agreement*, but leaving the door open that a subsidy under the *AOA* might not be a subsidy under the *SCM Agreement*:

With respect to whether the FSC scheme is a subsidy within the meaning of the *Agreement on Agriculture*, we note that, although the term “export subsidy” is defined in Article 1(e) of the *Agreement on Agriculture*, the term “subsidy” is nowhere defined in that Agreement. Accordingly, the parties have referred to the term “subsidy” as defined in the *SCM Agreement*—and, in the case of the United States, to the concept of subsidy as used in Article XVI of GATT 1994—as relevant context for the interpretation of that term as used in the *Agreement on Agriculture*. In effect, the parties have relied upon the arguments they presented in the context of the European Communities’ claims under the *SCM Agreement* as the basis for their views regarding whether a “subsidy” exists within the meaning of the *Agreement on Agriculture*.

We agree with the parties that Article 1 of the *SCM Agreement*, which defines the term “subsidy” for the purposes of the *SCM Agreement*, represents highly relevant context for the interpretation of the word “subsidy” within the meaning of the *Agreement on Agriculture*, as it is the only article in the WTO Agreement that provides a definition of that term. This is not of course to say that the definition of “subsidy” in the *SCM Agreement*, which applies “[f]or the purpose of this [i.e., the *SCM*] *Agreement*”, is directly applicable to the *Agreement on Agriculture*. In particular, we cannot preclude *a priori* that there could be cases where relevant provisions of the *Agreement on Agriculture* might lead a panel to conclude that the term “subsidy” as used in the *Agreement on Agriculture* has a different meaning in a particular context from that ascribed to it by Article 1 of the *SCM Agreement*. As a general matter, however, and subject to any provision of the *Agreement on Agriculture* under which the contrary is to be inferred, we consider that a measure which represents a subsidy within the meaning of the *SCM Agreement* will also be a subsidy within the meaning of the *Agreement on Agriculture*.¹⁷⁶

The Panel had already found that the FSC scheme was a subsidy in the *SCM Agreement*. The parties did not argue that any provision of the *AOA* suggested a different interpretation. So the Panel concluded that the FSC scheme conferred a subsidy within the meaning of the *AOA*.¹⁷⁷ It also concluded that the subsidy was made “to reduce the costs of marketing exports of agricultural products” in Article 9.1(d).

ii) The Appellate Body Report

The Appellate Body did not disturb the approach taken by the Panel in interpreting Article 9.1. The Appellate Body first confirmed the Panel’s finding that the FSC scheme was a subsidy in the *SCM Agreement*.¹⁷⁸ Then in considering the *AOA*, the Appellate Body moved directly to interpreting the word “marketing” in Article 9.1(d). It did not comment on the interpretation of the word “subsidies”, thereby implicitly approving the Panel’s interpretive

¹⁷⁶ Panel Report, *US–FSC*, supra at note 86, para. 7.149–7.150.

¹⁷⁷ Ibid. at para. 7.151.

¹⁷⁸ Appellate Body Report, *US–FSC*, supra at note 69, para. 121.

approach of first examining whether a subsidy existed. The result of these decisions is the following procedure:

1. Consider the exact wording of the Article 9.1 provision involved.
2. Where the term “subsidy” is used in the parts of 9.1, use the *SCM Agreement* definition.
3. If the term “subsidy” is *not* used, then consider the exact words of the Article 9.1 provision to see if the program fits the meaning of the words.

2. The Relationship to the *SCM Agreement*

The Appellate Body’s decision in *Canada–Milk* can now be placed in the context of other subsidy cases in the WTO. The Appellate Body Report in October 1999 was the first appeal report dealing with subsidies in agriculture. But it followed the August 1999 Appellate Body Report in the *Canada–Aircraft* case dealing with subsidies in the *SCM Agreement*. The *Canada–Milk* case followed the interpretive concepts and the definition of subsidy used in *Canada–Aircraft*. So, in some sense, Canada’s argument in the *Milk* case was successful in urging that “subsidy” as defined in the *SCM Agreement* should define “subsidy” in the *AOA*.

What Canada did not succeed in was arguing for a narrow definition of “subsidy” in the *SCM Agreement*. The result of the *Canada–Aircraft* and *Canada–Milk* appellate body decisions has been a very broad definition of “subsidy”. The breadth of the definition of “subsidy” as a “transfer of economic resources for less than full consideration” is demonstrated by the fact that it caught both a government loan program in the *Aircraft*

case and a producer-financed two-price system in the *Milk* case. This wide definition of “subsidy” is now part of WTO jurisprudence.

The evolving subsidy definition was applied in February 2000 by the Appellate Body in *United States–Foreign Sales Corporations*.¹⁷⁹ In dealing with the question of subsidy under the *SCM Agreement* for non-agricultural products, the Appellate Body approved the idea of beginning the examination of a specific measure by examining the general definition of a “subsidy” in Article 1.1 of the *SCM Agreement*.¹⁸⁰ This definition applies throughout the *SCM Agreement* to all the different types of “subsidies” covered by that agreement. By extension it applies to all WTO agreements.

The applicability of the *SCM Agreement* “subsidy” definition to the *AOA* was confirmed by the Appellate Body in the *US–FSC* case. This is an important crossover case as it deals with both agricultural and non-agricultural products. In dealing with agricultural products, the Appellate Body noted the absence of a “subsidy” definition in the *AOA*. It then relied on its Report in *Canada–Milk* to apply the concepts of “financial contribution” and “benefit” from Article 1.1 of the *SCM Agreement* to the *AOA*. This led the Appellate Body to the standard test of a transfer of economic resources for the benefit of the recipient. This case marks an important milestone in the development of a broad and universal test for a subsidy in the WTO.

3. Specific Provisions of Article 9.1

¹⁷⁹ Appellate Body Report, *US–FSC*, supra at note 69.

The language of each specific provision in Article 9.1 of the *AOA* needs to be examined closely. It should be noted that Article 9.1(a), (d) and (f) each contain the term “subsidy”. The case analysis of (a) and (d) suggests that this requires a finding that the program is a “subsidy” as defined by the *SCM Agreement*. But (b), (c) and (e) do not use the term “subsidy”. The case analysis of 9.1(c) suggests that a determination does **not** need to be made that the program is a “subsidy” as defined by the *SCM Agreement*. So different analyses need to be made depending on which subparagraph is involved. The specific language of each subparagraph will always have to be considered.

a. Article 9.1(a)

Article 9.1(a) reads:

The provision by governments or their agencies of direct subsidies, including payments-in-kind, to a firm, to an industry, to producers of an agricultural product, to a co-operative or other association of such producers, or to a marketing board, contingent on export performance.

This provision will be examined in its three component parts.

i) Provision

US-FSC

The meaning of the word “provision” in Article 9.1(a) has not been considered directly.

However, the word “provide” in Article 3.3 of the *AOA* was interpreted in the *US-FSC* case.

Article 3.3 states:

Subject to the provisions of paragraphs 2(b) and 4 of Article 9, a Member shall not **provide** export subsidies listed in paragraph 1 of Article 9 in respect of the

¹⁸⁰ Ibid. at para. 89.

agricultural products or groups of products specified in Section II of Part IV of its Schedule in excess of the budgetary outlay and quantity commitment levels specified therein and shall not **provide** such subsidies in respect of any agricultural product not specified in that Section of its Schedule.

The Panel found that “provide” meant “make available” and not “actual granting”. The Appellate Body did not support this definition, but offered nothing as an alternative.¹⁸¹

Thus, this meaning of “make available” will be relevant to future Article 9.1(a) disputes.

ii) By governments or their agencies

Canada–Milk

The *Canada–Milk* case allowed the Appellate Body to comment on the meaning of “governments or their agencies” in Article 9.1(a). The Appellate Body turned to *Black’s Law*

Dictionary for the meaning of “government”:

the regulation, restraint, supervision, or control which is exercised upon the individual members of an organized jural society by those invested with authority.¹⁸²

The Appellate Body went on to state:

The essence of “government” is, therefore, that it enjoys the effective power to “regulate”, “control” or “supervise” individuals, or otherwise “restrain” their conduct, through the exercise of lawful authority. This meaning is derived, in part, from the *functions* performed by a government and, in part, from the government having the powers and *authority* to perform those functions.

By using this definition of “government”, the Appellate Body arrived at a definition of “government agency”:

A “government agency” is, in our view, an entity which exercises powers vested in it by a “government” for the purpose of performing functions of a “governmental” character, that is, to “regulate”, “restrain”, “supervise” or “control” the conduct of private citizens.

¹⁸¹ See Section IV. C. 3. c. i) below

¹⁸² Appellate Body Report, *Canada–Milk*, supra at note 78, para. 97.

The Appellate Body then used this definition of “government agency” to confirm the Panel’s finding that the provincial milk marketing boards were government agencies. The Appellate Body set out two parts for applying this test:

1. the *source* of the agencies’ powers;
2. the *functions* of the agencies.

The Appellate Body was satisfied that the fact that the marketing boards “operate within a legal framework set up by federal and provincial legislation” was enough to satisfy the requirement that the source of the boards’ powers was governmental in nature.¹⁸³ This test seems to be a very broad test of the source of an agency’s powers, as the concept of a legislative legal framework might apply to many organizations. A distinction might have to be drawn in the future between a legal framework that is permissive in its legislation and one that is mandatory. Presumably, only mandatory creative legislation would be found to be a *source* of an agency’s powers. The fact that there is something more than a permissive legal framework is identified in the Panel’s comment “these boards act under the *explicit authority delegated to them by either the federal or a provincial government*”.¹⁸⁴

The second part of the test of government agency is to examine the *functions* of the relevant agency. Both the Panel and the Appellate Body found that the function of the marketing boards was to regulate a particular sector of the economy. The Appellate Body made particular note of the fact that a board’s functions, including its regulatory control, are

¹⁸³ Panel Report, *Canada–Milk*, supra at note 68, para. 7.76 and Appellate Body Report, *Canada–Milk*, supra at note 78, para. 99.

¹⁸⁴ Panel Report, *Canada–Milk*, supra at note 68, para. 7.77.

executed through orders and regulations which are enforceable in courts of law.¹⁸⁵ The Appellate Body commented:

Thus, the powers of the provincial boards are augmented by the machinery of the State itself, and the boards have at their disposal the public force to ensure that their regulatory functions and decisions are carried out.

Thus this seems to be a clear test to apply in other cases whether the agency has a regulatory function which is enforceable in law.

It is interesting that both the Panel and the Appellate Body commented that governments retain “ultimate control” over provincial milk marketing boards, even though the boards enjoy a high degree of discretion in the exercise of their powers.¹⁸⁶ They offered no discussion as to what the meaning of “ultimate control” really is. Neither did they suggest that “ultimate control” is a necessary requirement to find the existence of a “government agency”. The concept of ultimate control does not fit in with the two-part test described above of the source of powers and function of the agencies involved. Therefore, “ultimate control” should not form part of the legal test for the existence of a government agency.

iii) Direct subsidies, including payments-in-kind.

Canada–Milk

The term “payments-in-kind” was central to the *Canada–Milk* case and received detailed attention. The Appellate Body confirmed the obvious when it stated that:

¹⁸⁵ Ibid. at para. 100.

¹⁸⁶ Ibid. at para. 7.78 and Appellate Body Report, *Canada–Milk*, supra at note 78, para. 100.

the term “payments-in-kind” describes one of the forms in which “direct subsidies” may be granted.¹⁸⁷

Thus the broad reach of Article 9.1(a) will cover direct subsidies of any kind. But if an allegation of subsidy by a “payment-in-kind” is involved, that term should be considered first.

The Panel in the *Canada–Milk* case determined that the word “payments” in the term “payments-in-kind”, “connotes a gratuitous act, a bounty or benefit provided, for example, in pursuit of a policy objective”.¹⁸⁸ The Appellate Body disagreed. They stated that “payments” in “payments-in-kind” denotes “a transfer of economic resources, in a form other than money, from the grantor of the payment to the recipient”.¹⁸⁹

The Appellate Body stated that the Panel erred in finding that “payment” means a gratuitous act or benefit. The Appellate Body pointed out that a “payment” provides no indication of the economic value of the transfer, either to the grantor or the recipient. A “payment” can be made for full or partial consideration, or it may be made gratuitously. The Panel had erroneously mixed the issue of “benefit” to a recipient with the simple definition for “payment”. So we are left with the bare Appellate Body definition of “payment”. Unfortunately, there was no discussion of what an economic resource is.

¹⁸⁷ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 87.

¹⁸⁸ Ibid. at para. 7.44.

¹⁸⁹ Ibid. at para. 87.

There was little discussion of what “in kind” means. The Panel stated that “ ‘payment-in-kind’ in Article 9.1(a) must ordinarily be construed to include payment in goods or labour as opposed to payment in money”.¹⁹⁰ This may be a narrow definition, but it covers the facts dealt with in the *Milk* case. Further, if a program does not fit within the meaning of “payments-in-kind”, it could still be a direct subsidy.

As noted above, a payment-in-kind may be a direct subsidy. If a payment-in-kind is found according to the above definition, a further determination must be made of whether it is a direct subsidy, before Article 9.1(a) applies. If a payment-in-kind is *not* found, it must still be determined if the program is a direct subsidy. So the meaning of “direct subsidy” is relevant in either case.

The Appellate Body in the *Canada–Milk* case provided a specific definition of “subsidy”.

... a “subsidy” involves a transfer of economic resources from the grantor to the recipient for less than full consideration.¹⁹¹

The Appellate Body made specific reference to its definition of “subsidy” in its report in the *Canada–Aircraft* case, where it considered Article 1.1 of the *SCM Agreement*. Therefore, the “subsidy” definition in the *SCM Agreement* and the cases decided under it are now clearly applicable to the *AOA*, including Article 9.1.

The “subsidy” definition in *Canada–Aircraft* is:

¹⁹⁰ Panel Report, *Canada–Milk*, supra at note 68, para. 7.45 citing the *New Shorter Oxford English Dictionary*.

¹⁹¹ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 87.

the grantor makes a “financial contribution” which confers a “benefit” on the recipient, as compared with what would have been otherwise available to the recipient in the marketplace.¹⁹²

The parallels to note in the definitions are:

“a transfer of economic resources” is a “financial contribution”;

“for less than full consideration” is a “benefit” as compared to what would otherwise be available to the recipient in the marketplace.

After finding the Panel had erred in law in a flawed interpretive approach, the Appellate Body did not apply its own definitions and approach to Article 9.1(a) in *Canada–Milk*. It did not need to do so as it found the Canadian programs were illegal export subsidies under Article 9.1(c). Thus we are left without the benefit of analysis on this point.

This lack of analysis leaves unanswered a key point about Canada’s programs. Clearly there was a transfer of economic resources in the provision of milk to the processors. Was it for less than full consideration? Was the price less than the market price that the processor would have paid otherwise? This leaves only the Panel’s analysis of what the appropriate benchmark price is.

The Panel used the phrase “payment-in-kind in the sense of Article 9.1(a)” to mean a direct subsidy. The Panel also concluded that a benefit to the recipient has to be found for there to be a subsidy. The question then becomes what the appropriate benchmark is for determining whether the provision of a good at a certain price confers a benefit. The Panel concluded that the benchmark price **is the price at which the recipient can obtain the**

¹⁹² Ibid. at para. 87.

good from any other source.¹⁹³ This is consistent with the Appellate Body's test of **benefit as compared to what would otherwise be available to the recipient in the marketplace.**

The argument Canada presented to the Panel was that processors could import milk on equally favourable terms and conditions, including price, as those available to the processors under the impugned programs. Specifically, Canada had an import for re-export program.¹⁹⁴ The Panel rejected this argument for two reasons:

1. The import program was discretionary for the government and did not depend on commercial considerations.
2. No milk had recently been imported under the program.

The result was that the Panel found the Canadian Special Milk Classes 5(d) and 5(e) provided milk to processors for export on terms and conditions which were more favourable than those under any other alternative source.¹⁹⁵ This amounted to saying that the domestic price was the appropriate benchmark.

This reasoning leads to the conclusion that an import for re-export program might satisfy the legal requirements of setting a low benchmark price if:

1. it is not discretionary, but available as a matter of right on application; or

¹⁹³ Panel Report, *Canada–Milk*, supra at note 68, para. 7.47.

¹⁹⁴ Ibid. at para. 7.52.

2. it is shown to be commercially viable by actual imports.

In either case, these requirements would make the benchmark price equal to the world price, as imports could flow into the country at world price. A two-price system would not then be illegal, as long as the export price was no lower than what processors would pay in the marketplace for products for re-export.¹⁹⁶ This makes sense in that it would not distort the world price in the case of a small-country exporter. It would still cause problems with a price impact by a large-country exporter.

The end result was that Article 9.1(a) was interpreted by the Appellate Body, but not applied. However, we are left with the inescapable conclusion that Canada's Special Milk Class Scheme would be caught by Article 9.1(a).

b. Article 9.1(c)

Article 9.1(c) of the AOA reads:

¹⁹⁵ Panel Report, *Canada–Milk*, supra at note 68, para. 7.52.

¹⁹⁶ The Panel commented in *Canada–Milk* at para. 7.62: “We want to stress, however, that the existence of this “payment-in-kind” to processors does not in and of itself establish the existence of an export subsidy within the meaning of Article 9.1(a). In our view, in particular the existence of parallel markets for domestic use and for export with the different prices does not necessarily constitute an export subsidy. The price differential may, for example, be a consequence of high—but WTO consistent—import tariffs that can cause domestic prices to be higher than the world market price. In such scenario, efficient producers may take the decision—based on their own profitability—to also produce and sell milk for export, albeit at a lower price than the domestic price. If the decision to sell in either the domestic market or the export market is one made by the individual producer and based on commercial grounds only (e.g., on an allocation of sales to the two markets with a view to obtaining a maximized total revenue, taking into account the inherently limited domestic demand for milk and the lower price for export)—not a decision by the government or its agencies taken on behalf of the producers—such scenario would, in our view, not appear to be an export subsidy in the sense of Article 9.1.”

payments on the export of an agricultural product that are financed by virtue of governmental action, whether or not a charge on the public account is involved, including payments that are financed from the proceeds of a levy imposed on the agricultural product concerned or on an agricultural product from which the exported product is derived.

The Panel approached the interpretation of this provision by identifying two separate parts:

1. the presence of “payments on the export of an agricultural product”
2. which are “financed by virtue of governmental action”.¹⁹⁷

i) Payments on the export of an agricultural product

Canada–Milk: Appellate Body

The issue in the *Milk* case was whether the word “payments” in Article 9.1(c) includes “payments-in-kind”. The Panel referred to the *Oxford English Dictionary* definition of the word “payment” and found that:

the ordinary meaning of the word “payment” includes both the act of remunerating a person with money and the act of remunerating a person with its equivalent in kind, a so-called “payment-in-kind”.¹⁹⁸

The Appellate Body confirmed the Panel’s conclusion that payments in Article 9.1(c) include payments-in-kind. It re-examined the dictionary meanings of “payment”. It also found support for this meaning in the context of Article 9.1(c) in the other provisions of Article 9.1 and in other parts of the *AOA*. The Appellate Body rejected Canada’s suggested restrictive reading of the word “payments” in Article 9.1(c). It found that payments did not have to be monetary. It made special reference to Article 1(c) and its definition of “budgetary outlay” to include “revenue foregone”. The Appellate Body clearly wanted payments to include

¹⁹⁷ Panel Report, *Canada–Milk*, supra at note 68, para. 7.89.

¹⁹⁸ Ibid. at para. 7.92.

payments-in-kind, which would include revenue foregone. It used this concept to comment on the broad view that it takes of the subsidy disciplines in the *AOA*:

The contrary view would, in our opinion, elevate form over substance and permit Members to circumvent the subsidy disciplines set forth in Article 9 of the *Agreement on Agriculture*.

Before completing its analysis of the question of payments, the Appellate Body reverted to its use of the idea of the transfer of economic resources and the market price benchmark:

In our view, the provision of milk at discounted prices to processors for export under Special Classes 5(d) and 5(e) constitutes “payments”, in a form other than money, within the meaning of Article 9.1(c). If goods or services are supplied to an enterprise, or a group of enterprises, at reduced rates (that is, at below-market rates), “payments” are, in effect, made to the recipient of the portion of the price that is not charged. Instead of receiving a monetary payment equal to the revenue foregone, the recipient is paid in the form of goods or services. But, as far as the recipient is concerned, the economic value of the transfer is precisely the same.

This re-emphasizes the importance of determining a benchmark price and using it to determine if a transfer of economic resources for the benefit of the recipient is involved.

ii) Financed by virtue of governmental action

Canada–Milk

This is the second element of the test in Article 9.1(c) for the existence of a subsidy. The Panel noted that the test is still “financed by virtue of governmental action”, and that “payments that are financed from the process of a levy” are only one example of payments that would be caught by Article 9.1(c). There are other types of programs that would satisfy the test of “financed by virtue of governmental action”, and that are not product levies. Therefore, the Panel examined what was required for a program to be “financed by virtue of governmental action”.

In their analyses of this part of Article 9.1(c), both the Panel and the Appellate Body relied on their finding that the organizations involved in the alleged subsidy schemes were “government agencies”. This had been determined in their findings under Article 9.1(a). The Appellate Body felt that a strong presumption therefore arose that the conduct of these agencies in managing the subsidy programs would appropriately be regarded as “governmental action”. However, the Appellate Body did not appear to rely on this presumption to reach its conclusion under this test. Rather, it proceeded to assess the meaning of “by virtue of”.

The Appellate Body directed that “governmental” involvement as a whole should be examined to see if the payments were financed by virtue of governmental action. Particularly, the Appellate Body was interested in the “action” of the agencies concerned.¹⁹⁹ In examining the action, the following facts were considered by the Panel:

- a) the supply of milk under Special Classes 5(d) and 5(e) is managed by “agencies” of the Canadian federal or provincial governments, within the meaning of Article 9.1(a);
- b) these “agencies” determine when and what quantity of milk may be processed for export under those Special Classes;
- c) they negotiate the sale price of the milk with the processor or exporter;
- d) they enable the processor or exporter to take delivery of the milk;
- e) they collect the price paid for the milk by the processors or exporters;

¹⁹⁹ Appellate Body Report, *Canada–Milk*, supra at note 78, para. 119.

- f) they determine the rules for the pooling of returns to producers for in-quota milk, as well as the rules for the more limited pooling of returns for over-quota milk;
- g) in the implementation of these rules, they determine the effective selling price of milk for the producers;
- h) they pay out those returns to producers; and
- i) they monitor and supervise the operation of Special Classes 5(d) and 5(e).²⁰⁰

These facts could be generalized as the following questions for other subsidy programs:

1. Is the supply of goods or money managed by government agencies?
2. Do the agencies determine when and what quantity of goods may be processed or sold for export?
3. Do the agencies negotiate the sale price of the goods with the processor or the exporter?
4. Do the agencies enable the processor or exporter to take delivery of the goods?
5. Do the agencies collect the price paid for the goods by the processor or exporter?
6. Do the agencies determine the rules for pooling the returns to producers for the goods?
7. In implementing the pooling rules, do the agencies determine the effective selling price of the goods for the producers?

²⁰⁰Ibid. at para. 116.

8. Do the agencies pay the returns to the producers?
9. Do the agencies monitor and supervise the operation of the alleged subsidy programs?

The Appellate Body confirmed the conclusion of the Panel that the Special Milk Class Scheme involved governmental action at every stage. It went so far as to state that governmental action was indispensable for the transfer of economic resources to take place. This left the Appellate Body with no doubt that the transfer of resources took place “by virtue of governmental action”.²⁰¹

iii) The future of marketing boards

In a comment that may be relevant to many domestic marketing schemes involving pooling, the Appellate Body stated:

Nor does the fact that, under Special Class 5(e), in-quota returns to *producers* are pooled very differently from over-quota returns alter our conclusion. The price paid for the milk by the *processors* is not, in any way, dependent on whether milk is part of in-quota or over-quota production. Moreover, even though the two pooling mechanisms differ in significant respects, they both nevertheless involve “governmental action” that remains an essential aspect of the financing of the “payments” to processors or exporters.

This appears to mean that any pooling arrangement will necessarily be considered “governmental action”. Therefore, if any “payment” can be determined by a pooling scheme legislated by the government, then a pooling scheme will be considered a subsidy pursuant to Article 9.1(c). However, not every pooling scheme will necessarily amount to a subsidy. Pooling schemes will usually satisfy the second element of the Article 9.1(c) test of

²⁰¹ Ibid. at para. 121.

“financed by virtue of governmental action”. But *both* this test and the legal test of “payment” must be satisfied. It is possible that a pooling scheme could operate such that it did not produce a transfer of economic resources for the benefit of the recipient. As long as prices for sale for export did not fall below a defined normative benchmark price for such products from other sources, then there would be no “payment”. If the export price results in no “payment” then there is no subsidy, regardless of whether the price is then pooled with other prices for return to the producer.

The conclusion from the *Canada–Milk* case is that Canada might have saved its Special Milk Class Scheme from WTO illegibility if it had allowed exporters to access milk from other markets at competitive prices. This would have established a benchmark price for export milk that would have resulted in no “payment” in the Special Milk Class Scheme. The question of pooled returns would then have been irrelevant.

c. Article 9.1(d)

Article 9.1(d) of the AOA reads:

The provision of subsidies to reduce the costs of marketing exports of agricultural products (other than widely available export promotion and advisory services) including handling, upgrading and other processing costs of international transport and freight.

US-FSC

This provision has been interpreted in *United States–Foreign Sales Corporations*,²⁰² a dispute that involved the provision of special tax exemptions for the income of foreign sales corporations on products sold for export.

The Panel interpreted Article 9.1(d) as setting out two criteria:

1. There must be the provision of subsidies; and
2. The provision of those subsidies must be to reduce the cost of marketing exports of agricultural products.²⁰³

i) Provision of subsidies

In this part of its analysis, the Panel referred to the fact that it had already determined that the tax scheme involved was a subsidy under the *SCM Agreement*. In the absence of any argument to the contrary by the United States, the Panel applied the *SCM Agreement* definition of “subsidy” to this part of the *AOA*. The Panel therefore concluded that the FSC scheme conferred a subsidy within the meaning of Article 9.1(d) of the *AOA*.

The Appellate Body did not comment on this approach. However, the Appellate Body had likewise found that the FSC scheme was a subsidy within the meaning of the *SCM Agreement*. The Appellate Body moved immediately to a consideration of the second branch of the test in Article 9.1(b). It could therefore be inferred that the Appellate Body approved

²⁰² Appellate Body Report, *US–FSC*, supra at note 69, and Panel Report, *US–FSC*, supra at note 86.

²⁰³ Panel Report, *US–FSC*, supra at note 86, para. 7.148.

the reasoning of the Panel in the application of the *SCM Agreement* definition of subsidy to the *AOA*.

ii) Reduce the costs of marketing exports of agricultural products

In approaching this part of the test, the Panel stated:

In this respect, we note that, as a practical commercial matter and in ordinary parlance, income taxes are a cost of doing business. Because FSC subsidies reduce an exporter's income tax liability with respect to marketing activities, they effectively reduce the cost of marketing agricultural products.²⁰⁴

The Panel therefore concluded that the FSC subsidies were covered by Article 9.1(d). The Appellate Body disagreed with this broad interpretation of the "costs of marketing exports". The Appellate Body relied on the text of Article 9.1(d). They found that the types of costs described and intended by Article 9.1(d) are specific types of costs that are incurred as *part of* and *during* the process of selling a product.²⁰⁵ They distinguished these marketing costs from general business costs, such as administrative overhead and debt financing costs, which are not specific to the process of putting a product on the market. Thus, the legal test for costs in Article 9.1(d) is:

costs that are incurred as part of and during the process of selling the product.

The result was that the Appellate Body reversed the Panel's finding and ruled that the FSC measure was not a subsidy within the meaning of Article 9.1(d).

²⁰⁴ Ibid. at para. 7.155.

²⁰⁵ Appellate Body Report, *US-FSC*, supra at note 69, para. 130.

D. THE PROHIBITION OF EXPORT SUBSIDIES IN THE AOA

Now that we have examined the meaning of subsidies in the *AOA*, particularly in Article 9.1, we can explore the meaning of “contingent upon export performance” in the definition of an export subsidy. This exercise is necessary to determine what types of subsidies might be subject to limitation or prohibition in the *AOA*.

1. Contingent on Export Performance

Once again, Article 1(e) of the *AOA* provides:

(e) “export subsidies” refer to subsidies contingent upon export performance including the export subsidies listed in Article 9 of this Agreement.

What does “contingent” mean in this provision? The key issue is whether it includes “in law” and “in fact” as specifically stated in the *SCM Agreement*. The *Canada–Milk* case does not offer any clues, as contingency in law was acknowledged. But *Canada–Automobiles* offers some clues. The case deals with Article 3.1(b) of the *SCM Agreement*, which reads:

subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

Like Article 1(e) of the *AOA*, Article 3.1(b) of the *SCM Agreement* does **not** contain the phrase “in law or in fact”.

Canada–Automobiles: Panel Report

The Panel Report in *Canada–Automobiles* dealt with the question of whether the import duty exemption is contingent upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the *SCM Agreement*.

The Panel referred to its earlier definitions of the words “in law” and “contingent” and determined that there was nothing in the legal provisions which made the import duty exemptions contingent in law upon the use of domestic over imported goods. This raised the issue of whether it would be enough to challenge the subsidies under Article 3.1(b) if they could be proved to be contingent *in fact*. The Panel referred to the argument that Article 3.1(a) contains the words “in law or in fact” whereas Article 3.1(b) does not contain that phrase. The Panel recalled the Appellate Body finding in *Japan–Alcoholic Beverages* that “omissions must have some meaning”.²⁰⁶ The Panel therefore found that Article 3.1(b) extends only to contingency in law. It does not extend to contingency in fact. Therefore, the Panel did not have to address the question of contingency in fact in Article 3.1(b).

This finding by the Panel could be applied to the language in the AOA. Like Article 3.1(b) of the *SCM Agreement*, the AOA uses only the bare word “contingent”. Neither provision uses the phrase “contingent in law or in fact”. So arguably, at that time, “contingent” in the AOA meant only contingent in law and not contingent in fact. However, this impression was later reversed by the Appellate Body in *Canada–Automobiles*.

Canada–Automobiles: Appellate Body Report

The meaning of the bare phrase “contingent upon export performance” in Article 3.1(b) was considered in the Appellate Body Report for the *Canada–Automobiles* case.²⁰⁷ It was

²⁰⁶ Appellate Body Report, *Japan–Taxes on Alcoholic Beverages (Japan–Alcoholic Beverages)*, WT/DS8/AB/R, WT/DS10/AB/R, WT/DS11/AB/R, adopted 1 November 1996.

²⁰⁷ Appellate Body Report, *Canada–Automobiles*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 118.

considered in the context of the Article 3.1(b), *SCM Agreement* argument, but the comments are relevant to the *AOA*.

First, the Appellate Body set out the legal standard it applied to “contingent in law” in *Canada–Aircraft*.²⁰⁸ Contingency is demonstrated by conditionality, either express or implied, in the words of the relevant legislation, regulation or other legal instrument. The Appellate Body reviewed the Panel Report and reversed the Panel’s decision that there was contingency in law. The Appellate Body stated that the Panel did not fully examine the legal instruments at issue and the implications or operation of the legal requirements for individual manufacturers. The legal requirements might have amounted to “contingent in law”, but the Appellate Body could not determine the point from the information in the Panel Report. Therefore, the legal test for “contingent in law” remained the same; only its application was changed.

Second, the Appellate Body was asked by the European Communities and Japan to rule on the question of whether “contingent” in Article 3.1(b) means “in fact” as well as “in law”.²⁰⁹ As noted above, the Panel had found it applies only to “in law”. The Appellate Body reversed the Panel and found that “contingent upon export performance” in Article 3.1(b) means both “in law” and “in fact”. The Appellate Body stated:

In our view, the Panel’s analysis was incomplete. As we have said, and as the Panel recalled, “omission must have some meaning.” Yet omissions in different contexts may have different meanings, and omission, in and of itself, is not necessarily dispositive. Moreover, while the Panel rightly looked to Article 3.1 (a) as relevant context in the interpreting Article 3.1 (b), the Panel failed to examine other

²⁰⁸ Appellate Body Report, *Canada–Automobiles*, WT/DS139/AB/R, WT/DS142/AB/R, adopted 19 June 2000, para. 123.

²⁰⁹ *Ibid.* at para. 135.

contextual elements for Article 3.1 (b) and to consider the object and purpose of the *SCM Agreement*.

The Appellate Body analyzed these points as follows:

- i) The text of Article 3.1(b) has nothing to include contingent “in fact”, but it has nothing to *exclude* “in fact”. So the text is inconclusive.
- ii) Article 3.1(a) is relevant, but not the only context.
- iii) Article III: 4 of GATT 1994 is relevant context and it covers both *de jure* and *de facto* contingency. So it would be surprising if Article 3.1(b) was limited to *de jure* contingency.
- iv) Article II and Article XVII of GATS cover both contingencies regarding discriminatory treatment. The obligation in Article II, like Article 3.1(b) is unqualified and therefore its ordinary meaning includes both *de facto* and *de jure* standards.
- v) A restricted meaning of “contingent” in Article 3.1(b) would be contrary to the object and purpose of the *SCM Agreement* because it would make circumvention of obligations by members too easy.

Using this analysis, the Appellate Body concluded that the term “contingent” in Article 3.1(b) extends to “in fact” as well as “in law”. The Appellate Body then tried to apply the “in fact” standard, but was unable to do so because of lack of information in the Panel Report.

This analysis of Article 3.1(b) in the *Canada–Automobiles* case has application to Article 1(e) of the AOA because of the similar language about subsidies “contingent upon export

performance”. The interpretive approaches used by the Appellate Body in *Canada-Automobiles* would likely result in a similar ruling that “contingent upon export performance” in Article 1(c) means both “in law” and “in fact”.

US-FSC: Appellate Body Report

The finding by the Appellate Body in *Canada-Automobiles* regarding contingency in law must be compared to the language in the report of the Appellate Body in *US-FSC*. In the section of the report dealing with the *AOA*, the Appellate Body pointed out that there is no reason to read the requirement of “contingent upon export performance” in the *AOA* differently from the same requirement imposed by the *SCM Agreement*.²¹⁰ This is noteworthy because the language *is* different in the two agreements. In the *SCM Agreement* it refers to contingent “in law or in fact” while the *AOA* refers only to “contingent”. The Appellate Body suggested that the two agreements use precisely the same words to define “export subsidies”.²¹¹ The Appellate Body stated that although there are differences in the disciplines resulting under the two agreements, those differences do not affect the “common substantive requirement relating to export contingency”.²¹²

What is this “common substantive requirement”? It may be that the Appellate Body intended only to reinforce its point, made in *Canada-Aircraft*, that the legal test for contingency is the same whether it refers to law or fact. Contingency requires some element of conditionality or dependence. The legal test will be the same, but the evidence required

²¹⁰ Appellate Body Report, *US-FSC*, supra at note 69.

²¹¹ This is simply not a correct statement, as the *SCM Agreement* does not define “export subsidies” at all. The language regarding subsidies in the *SCM Agreement* is quite different from the language in the *Agreement on Agriculture*.

²¹² Appellate Body Report, *US-FSC*, supra at note 69, para. 141.

may be different, depending on whether proof is required of contingency in law, or contingency in fact.

However, it is arguable that the Appellate Body intended that its statement would eliminate the effect of the different language in the two agreements. It may be that the Appellate Body intended that “contingent upon export performance” means “contingent, in law or in fact” in both agreements. If this is the case, then the legal test of contingency in the AOA may be broader than it appears at first glance. The AOA may include contingency *in law or in fact*. This interpretation is supported by the apparent inclination of the Appellate Body to give broad interpretations of the treaty language in order to catch trade-distorting activity.

Having decided to use the same test of export contingency under both the *SCM Agreement* and the AOA, the Appellate Body in *US-FSC* then noted that it had already upheld the Panel’s finding that the FSC measure involved subsidies contingent upon export performance under Article 3.1(a) of the *SCM Agreement*. It should be remembered that this was a finding of contingency *in law*. So the language in the decision may not make the *ratio* of the case a finding that the AOA includes contingency *in fact*. The Appellate Body agreed with the Panel’s decision that the FSC measure was contingent in law upon export performance. The Appellate Body stated “the provision of subsidies under the FSC measure is dependent or conditional upon either the exportation of ‘export property’, or in the case of

services provided before exportation, at the very least, the anticipation of that expectation”.²¹³

2. The Prohibition of Export Subsidies

The language of dispute settlement in the WTO uses the description “acted inconsistently with its obligations” when a member has violated a term of an agreement. In the *AOA*, the key obligation of a member regarding export subsidies is in Article 8:

Each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member’s Schedule.²¹⁴

Article 8 means that there are two categories of export subsidies in the *AOA*. The first category of export subsidies comprises those which conform to the *AOA* and are generally allowed. The second category comprises those that do not conform to the *AOA*. The second category is prohibited.

The issue of the conformity of export subsidy programs with the *AOA* must be examined in light of two other provisions, Article 3 and Article 10. A detailed examination of the issues of conformity with the *AOA*, and the consequences of nonconformity, is beyond the scope of this paper. It is sufficient to say that the area of subsidy limitation and prohibition in the *AOA* is ripe for further study now that the DSB has made some pronouncements on the terms of the *AOA*.

²¹³ Ibid. at para. 142.

²¹⁴ *Agreement on Agriculture*, Art. 8.

V. LEGAL TESTS FOR EXPORT SUBSIDIES IN AGRICULTURE

Again, as under the *SCM Agreement*, it is possible to articulate a series of questions to determine if a measure will be classified as an export subsidy under the *AOA*.

1. Is the product at issue an agricultural product?
2. Is the agricultural product a scheduled or unscheduled product in the member's schedule?
3. Does the program at issue for a scheduled product fall within the definitions in Article 9.1? Consider the exact wording of the Article 9.1 provision involved.
 - a) Where the term "subsidy" is used in the parts of 9.1, use the *SCM Agreement* definition of "subsidy".
 - b) If the term "subsidy" is *not* used, then consider the exact words of the Article 9.1 provision to see if the program fits the meaning of the words.
4. The provisions of Article 9.1(a), (d) and (f), which refer to subsidies, require the subsidy definition in the *SCM Agreement* to be satisfied.
5. A subsidy occurs when a grantor makes a financial contribution which confers a benefit on the recipient as compared with what would have been otherwise available to the recipient in the marketplace, where:
 - a. a financial contribution is a transfer of economic resources, including a payment-in-kind which denotes a transfer of economic resources other than money, from the grantor to the recipient, and

b. a benefit occurs if there is a transfer of economic resources from the grantor to the recipient for less than full consideration. This analysis requires the following considerations:

- an examination of the economic value of what has transferred.
- a determination if there has been something transferred for less than full consideration.
- determination of economic value and full consideration according to the marketplace.

6. Regarding Article 9.1(a) programs:

- (a) Does the program provide a subsidy in the sense of “make available”? This may be sufficient, or “actual granting” of the subsidy may be required.
- (b) Is the program offered by a government or its agency? A government agency is an entity which exercises powers vested in it by a government for the purpose of performing functions of a governmental character, that is, to regulate, restrain, supervise or control the conduct of private citizens. The source of the agency’s powers must be a government. The functions the agency performs must be governmental in the sense that those functions are enforceable in courts of law.
- (c) Does the program offer a direct subsidy?
 - i) Is the subsidy direct from the government or its agency to the recipient, with no intermediary?
 - ii) Is there a subsidy within the meaning of the *SCM Agreement*?

- iii) Within the meaning of “subsidy” is the transfer of economic resources done by a payment-in-kind (as a transfer of economic resources in a form other than money)?
7. Regarding Article 9.1(d):
- (a) Does the program provide a subsidy in the sense of “make available”? This may be sufficient, or “actual granting” of the subsidy may be required.
 - (b) Does the program offer a subsidy within the meaning of the *SCM Agreement*?
 - (c) Does the program reduce the costs of marketing exports of agricultural products, which are costs that are incurred as part of and during the process of selling the product?
8. The provisions of Article 9.1(b), (c), and (e) require only that their specific language be satisfied for there to be a deemed subsidy. There is no requirement that the *SCM Agreement* definition of subsidy be satisfied.
9. Regarding Article 9.1(c):
- (a) Is there a payment in the nature of a transfer of economic resources for a consideration less than the full market price?
 - (b) The payment can be in money or a form other than money.
 - (c) Is the payment financed by virtue of governmental action, considering the following factors taken as a whole:
 - i) Is the supply of goods or money managed by government agencies?
 - ii) Do the agencies determine when and what quantity of goods may be processed or sold for export?

- iii) Do the agencies negotiate the sale price of the goods with the processor or the exporter?
 - iv) Do the agencies enable the processor or exporter to take delivery of the goods?
 - v) Do the agencies collect the price paid for the goods by the processor or exporter?
 - vi) Do the agencies determine the rules for pooling the returns to producers for the goods?
 - vii) In implementing the pooling rules, do the agencies determine the effective selling price of the goods for the producers?
 - viii) Do the agencies pay the returns to the producers?
 - ix) Do the agencies monitor and supervise the operation of the alleged subsidy programs?
10. Is the subsidy contingent upon export performance? Contingency can be either contingency in law or contingency in fact.
- a) Contingency in law is demonstrated by conditionality, either express or implied, in the words of the relevant legal instrument.
 - b) Contingency in fact is demonstrated by conditionality found by inference from all of the facts surrounding the granting of the subsidy.

Working through this series of questions will assist a WTO member state in determining if its measures are *AOA* compatible. This same series of questions is schematically shown in Figure 1 in Appendix A.

VI. THE ECONOMIC ANALYSIS OF EXPORT SUBSIDIES

A. INTRODUCTION

The economic questions brought forth by the evolving legal definition of an export subsidy under the WTO are complex and multifaceted. These questions must be approached both from the point of view of economic theory and the evolutionary development of the General Agreement on Tariffs and Trade (GATT), and subsequently the World Trade Organization (WTO). The answers to these questions are unlikely to satisfy economic theorists concerned with international trade. This is because the WTO is the result of a fifty-year negotiation process and the compromises that it entailed rather than a set of rules based on sound economic principles. It is well known that the economic rationale that underlies much of the WTO is flawed—for example, the provisions surrounding dumping do not reflect sound economic principles—and the result is a set of agreements based on the “art of the possible” rather than a logically consistent set of rules.

The WTO rules represent economic compromises that the countries of the WTO are collectively willing to live with. When countries learn through experience that what they previously agreed to is no longer palatable, they are free to propose changes in the next round of negotiations. As a result, the WTO is never *finished*, but rather represents an iterative process that may or may not be moving toward a set of rules that are consistent with economic theory. Legal interpretations of the compromises may act to increase or decrease the economic palatability of what has been agreed, but they cannot impose theoretically consistent economic logic where none exists. Renegotiation can always alter the rules regardless of the legal interpretation applied to that which was previously agreed.

Thus, the approach taken in the economic analysis section of this study will not be to take recourse in abstract propositions of economic theory or current legal interpretations but rather to start with some observations regarding the economic concerns of the WTO parties relating to export subsidies. When appropriate, however, if WTO practice is not logically consistent with economic theory in an important way, it will be pointed out.

Two major questions need to be dealt with in the economic analysis. The first relates to the question of what constitutes a transfer of economic resources. The WTO panels relating to export subsidies have accepted a very broad range of government activities that can be construed as being directly involved in or facilitating in other ways the transfer of economic resources. Can these activities directly or indirectly lead to a transfer of resources? Will they do so in all circumstances?

The second major question is whether the WTO legal test has set an economically defensible benchmark price. The economic environment is defined by many distortions. This question of the benchmark price is important because export subsidies may be attempts by governments to correct or offset already existing market distortions. Further, if domestic and international prices diverge, the divergence is only of interest if it arises as a result of a single policy initiative that distorts a market. The domestic price is not a true “market” price. If this is the case, is it appropriate to use such a price for the “market” benchmark that the WTO panels require as a reference point? This is important, because if the domestic price cannot be used as a reference point, the question of what would constitute an appropriate benchmark arises. This raises the spectre that some non-observable price is the

appropriate benchmark and implies that it must be a “constructed price” that approximates a “counterfactual” market solution (i.e., that would arise in the absence of policy distortion(s)).

The regulation of international trade is an economic matter. Trade is regulated by governments because they wish to alter the economic outcome produced by the international market²¹⁵ or to augment domestic policy initiatives. The motives for regulating international trade are many and include altering the competitive position of domestic producers, raising revenues, correcting market failures, gaining strategic advantage, offsetting “unfair” practices of foreign firms or governments, etc. In the agriculture sector, the regulation of international trade has often been undertaken as an adjunct to domestic policy initiatives—in other words, the primary motivation was to assist in the achievement of domestic policy goals rather than to directly achieve a trade objective. In almost all developed countries, the primary motivation for agricultural policy is to slow the technologically driven exit of farmers. Imports of agricultural commodities reduce the number of domestic farmers required and exports increase the number of farmers.²¹⁶ Largely at the behest of the United States, agricultural trade received waivers from many GATT disciplines, including those on export subsidies, until the Uruguay Round. As a result, a large number of domestic policy instruments were developed over the years which

²¹⁵ Governments may also wish to regulate trade for the purposes of inducing other countries to change their behaviour, as in the case of trade sanctions (see Kerr, W. A. and Gaisford, J. D. (1994) A Note on Increasing the Effectiveness of Sanctions, *Journal of World Trade*, 28 (6): 169-176.; Gordon, D. V., Hannesson, R. and Kerr, W. A. (2000) Of Fish and Whales—The Credibility of Threats in International Trade Disputes, *Journal of Policy Modeling* (forthcoming)). This aspect of trade regulation is ignored in this study.

had elements affecting trade in agricultural commodities. The stronger disciplines on export subsidies negotiated generally in the GATT largely prevented their implementation in other sectors. It was agreed in the Uruguay Round, however, that agriculture would be integrated into the general GATT disciplines, albeit with a transition phase.²¹⁷ The changes brought by the Uruguay Round agreements mean that a number of previously existing domestic policies with trade ramifications have to be judged as to whether they comply with WTO obligations as currently constituted.

Given that the reason to regulate international trade is to alter economic outcomes, economic principles have been central to the GATT since its inception. International trade agreements including the WTO (and before it the GATT), however, represent political compromises. The essence of the compromise is as follows. Economic theory suggests that free trade is welfare enhancing. However, changes in international competitiveness over time lead to economic forces that suggest a movement of resources out of relatively inefficient industries and into relatively efficient industries. The movement of resources among sectors is not costless and, hence, changing competitiveness creates losers. Domestic politicians may wish to extend protection from foreign competitors to prevent or slow the losses that would arise from deteriorating international competitiveness.²¹⁸ This protection may be in the form of border measures, subsidies, or a host of non-tariff barriers. On the

²¹⁶ See Gaisford, J. D. and Kerr, W. A. (2001) *Economic Analysis for Trade Negotiations*, Edward Elgar, Cheltenham (forthcoming).

²¹⁷ See Kerr, W. A. (2000) The Next Step Will Be Harder: Issues for the New Round of Agricultural Negotiations at the World Trade Organization, *Journal of World Trade*, 34 (1): 123-140

²¹⁸ See Leger, L. A., Gaisford, J. D. and Kerr, W. A. (1999) Labour Market Adjustments to International Trade Shocks, in Dahiya, S. B. (Ed) *The Current State of Economic Science*, Vol. 4, Spellbound, Rohtak: 2011-2034.

one hand, domestic politicians want to be unfettered in their ability to extend protection to their constituents. On the other hand, the ability to freely put trade barriers in place greatly increases the risks associated with investing in international commercial arrangements. This reduces those investments and leads to foregone economic opportunities. Firms wishing to engage in international commercial activities thus desire strong, transparent rules of trade. International trade agreements, hence, represent compromises between domestic politicians' desire for flexibility in being able to extend protection and their desire to facilitate international commercial opportunities. At any given time, trade arrangements such as the agreements that underlie the WTO represent the current state of that compromise. Given that part of the compromise represents concessions given to protectionism, it is probably not surprising that the rules are not always consistent with economic theory. Instead, they represent what countries, collectively, can "live with" as part of the compromise.

The original framers of the GATT purposely left the wording of the agreement vague because they were opposed to a legalistic approach to dispute settlement. The original GATT dispute settlement system was, for all intents and purposes, based on a consensus model, thus denying a judicial solution. Terms such as "export subsidy" were also left vague to provide the flexibility required for a consensus-based resolution of disputes. For the original framers of the GATT, disputes would be settled by the GATT diplomatic community—a group of reasonable persons applying economic principles:

When the GATT organization was first started there was considerable distrust of lawyers, for it was felt that the GATT was a club inhabited by diplomats of impeccable reputation who would ensure that its affairs would

be conducted with all seemly propriety. Should any unhappy differences arise they would be settled privately according to the feelings of the general consensus. In this way it was possible to keep the General Agreement flexible and thus assure its survival. ... This ... together with the concept that the better solutions were to be found in the economic rather than the legalistic field, resulted in a preference for conciliation on the basis of agreed compromise rather than a decision on a legal basis.²¹⁹

Over time, the “club” approach to dispute settlement became progressively more unwieldy due to changing circumstances, including the loss of the prerequisites for consensus building—similarity in economic philosophy, small numbers, trust.²²⁰

The alternative to the club approach was to move to a more legalistic model for dispute settlement. This, in turn, led to further negotiations both to move the dispute system out of the consensus model and to progressively clarify the economic meaning of the agreement, including the meaning of “export subsidy”. The culmination of this long process was Uruguay Round agreements to establish the WTO. The Dispute Settlement Understanding of the WTO sets out a dispute settlement regime that is not based on consensus. The Uruguay Round also attempted to further clarify the meaning of a number of terms. Further, the dispute panels’ decisions help to interpret, and hopefully clarify, the agreements, adding increased transparency for those engaging in international commerce and those charged with developing and administering government trade policy. Their judgements may also provide the spur for new negotiations if the interpretation is not in line with countries’ political priorities.

²¹⁹ See Editorial (1981) *Journal of World Trade Law*, 15 (6): 469-470 at p 469.

It should be clear then, that the existing definitions of export subsidies in the WTO represent the current compromise between the desire for strong rules by firms engaging in international commerce and the need of governments to have the flexibility to expand economic opportunities for particular vested interests. The bottom line is that WTO definitions are not based on standard economic criteria such as welfare maximization.

Before proceeding to the economic question of what constitutes a resource transfer, it will be expedient to deal with the question of the appropriate “market” benchmark. After all, to deal with the issue of resource transfers, it is first necessary to establish the point from which the transfer takes place. This is, of course, the benchmark or reference price. Of course, the reference price has been important for panel decisions because they are interested in determining if the resource transfer takes place at “full fair market value”. Thus the panels proceed from the question of whether there is a transfer of resources, to whether such a transfer takes place at rates that reflect full market value. For panels, if there is no transfer of resources the question of the benchmark is no longer relevant. While the panels’ approach follows a different logical sequence than we will follow in developing the economic argument, there is no inherent conflict. The ordering in the economic analysis is expositional to facilitate the logical development of the argument.

B. THE BENCHMARK PRICE

Economic models are, by definition, simplifications. The tradition in economics is to make assumptions regarding what aspects of the actual economic environment can be simplified

²²⁰ Kerr, W. A. and Perdakis, N (1995) *The Economics of International Business*, Chapman and Hall,

so that economic science can be brought to bear to analyze a set of circumstances or a problem. For example, as all markets in the economy are interrelated, if those interrelationships are important to the question at hand, then the method of analysis should be general equilibrium. However, due to the complexity of the interactions, as the number of interactions increases problems quickly become intractable. As a result, if general equilibrium is the appropriate methodological approach, the number of sectors included is limited and the assumption made that a high degree of sectoral aggregation does not unduly restrict the usefulness of the analysis.

Economic relationships are dynamic and, for example, reactions to external shocks to a system follow paths of adjustment. If these paths of adjustment are considered important, then dynamic analysis is used as the analytical tool. Again, the sheer complexity of dynamic systems means that assumptions must be made to limit the number of dynamic paths which can be modeled at any given time. In many cases, however, the paths of adjustment are not considered to be particularly important, and instead, it is sufficient to compare the starting point with the end point after all adjustments have taken place. This analytical framework is known as “comparative statics”.

The most common framework for the conduct of economic analysis is what is known as “partial equilibrium–comparative statics”.²²¹ Within this framework, the dynamic paths of adjustment are assumed to be sufficiently unimportant to be safely ignored, and any

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general equilibrium effects (i.e., any effects on markets other than the market of primary interest) can also be ignored. This means that analysis is carried out by comparing two states of a single market—prior to a change and after the change. Of course, determining the appropriate assumptions to make is an art rather than a science and disagreements among economists are often based on differences over the appropriateness of assumptions in a particular case.

The framework under which economic analysis is undertaken is important for the establishment of the appropriate reference price. As suggested above, the WTO does not have a welfare-enhancing role—nor according to economic theory can it. In economics, there is a theoretical state of the economy known as a “first best world” or the “first best”. This is a welfare-maximizing, general equilibrium concept. Its properties are complex and its details are not important for the task at hand. The important point is that once the economy moves away from the “first best” through the imposition of constraints on the economy such as taxes, monopolies and regulations, it is not possible to be sure that removing a single constraint or attempting to compensate for a distortion through a policy initiative—using “piecemeal policy”—will be welfare enhancing.²²² In other words, in a multiple constraint world—a “second best world”—it is not possible to determine if, for example, the removal of an export subsidy will be welfare enhancing for the international

²²¹ See Klein, K. K. and Kerr, W. A. (1996) The Crow Rate Issue: A Retrospective on the Contributions of the Agricultural Economics Profession, *Canadian Journal of Agricultural Economics*, 44, 1-18.

²²² See Lipsey, R. G. and Lancaster, K. (1956-7) The General Theory of the Second Best, *Review of Economic Studies*, 24:11-32; Allingham, M. G. and Archibald, G. C. (1975) Second Best and Decentralization, *Journal of Economic Theory* 10 (2):157-173.

economy. In theory, movement toward the “first best” could only be achieved if there were an all-knowing dictator in charge of the economy.

The real world within which the WTO operates is characterized by a multitude of constraints—tariffs, non-tariff barriers, subsidies, regulations, etc. It is clearly a “second best” world. In a general equilibrium framework, for example, the removal of an export subsidy would, because all markets are interrelated, lead to changes in all prices and, through feedback mechanisms, to changes to the prices in the original market. Hence, a case might be made for using some alternative configuration of prices as an appropriate reference point. Given the “problem of the second best”, however, it is not possible to determine whether any configuration of prices is superior to any other. Thus, no theoretical case can be made for any particular set of reference prices being superior to any other. Given this theoretical conundrum, how does the economic practice of the WTO proceed?

The observed international prices for many commodities in agriculture reflect a heavy degree of intervention, including subsidization. It might be possible to estimate an international price for a commodity with all subsidies removed. Given that many other distortions will continue to exist both in international markets and the domestic markets of trading countries, however, due to the “second best” problem no case can be made that the “subsidy-free” price is superior to the “observed price” as a reference price. Of course, no theoretical case can be made regarding the superiority of the “observed price” to the “subsidy-free” price either, and some alternative justification for the use of any particular price as the reference price must be found.

The WTO is firmly rooted in the “partial equilibrium–comparative statics” tradition. The original intent of the GATT was that negotiations would take place to reduce tariffs on the basis of countries offering to reduce tariffs on a market-by-market basis. Although there have been proposals to remove blocks of tariffs or to harmonize the removal of tariffs across broad commodity groups, these have been rejected for the most part. This suggests that multiple market effects are largely ignored in the GATT/WTO negotiations.

Antidumping actions, countervail actions, safeguard actions, etc. are all constrained to a single market. There is considerable importance attached to defining “like goods”.²²³ Products can only be included in a WTO action if they pertain to “like goods”. This means that related products such as upstream inputs or close substitutes in consumption or industrial use, which may actually be injured economically due to dumping or a countervailable subsidy, cannot be considered as being injured because they are not “like goods”.²²⁴

“Standing” in antidumping and countervailing duties cases is only granted to those who produce “like goods”. Standing relates to the ability to bring a complaint to the appropriate domestic authority in antidumping or countervail cases. For example, the EU argued that the Canadian Cattlemen’s Association, which represents the producers of beef cattle, should not have standing in a countervail suit pertaining to Canadian imports of subsidized EU

²²³ See Kerr, W. A. (1987) The Recent Findings of the Canadian Import Tribunal Regarding Beef Originating in the European Economic Community, *Journal of World Trade Law*, 21 (5): 55-65.

beef, because cattle were not “like” products to beef. Beef, the EU claimed, is a processed product and hence different from cattle. The EU suggested that only the representatives of the Canadian beef processing industry should have standing. While the Canadian Import Tribunal found in favour of the Canadian Cattlemen’s Association, on appeal the GATT panel upheld the EU position.²²⁵ Thus, it seems clear that the WTO uses a fairly strict definition of the scope of the market which should be considered when economic analysis is conducted for the purposes of interpreting WTO obligations.

All of this suggests that the appropriate framework for economic analysis underlying WTO activities is “partial equilibrium”. This means that the appropriate reference price would be contained within the single market for the product. This does not mean, however, that domestic and international components of a market (e.g., milk) are to be considered separate markets. Further, any effects arising from changes in the price in one market, say due to a subsidy on milk production, that may have effects on other markets, say the market for chocolate bars which use milk as an input, are not relevant when determining whether the subsidy is in compliance with WTO obligations.

Partial equilibrium also implies that one is comparing markets that are “assumed to be in equilibrium or sufficiently close to equilibrium such that any deviations from the equilibrium are unimportant”. Of course, the economy and individual markets are probably never in equilibrium because they are constantly being bombarded by exogenous shocks

²²⁴ See Bierwagen, R. M. and Hailbronner, K. (1988) Input, Downstream, Secondary and Components or Subassembly Dumping, *Journal of World Trade*, 22 (3) 27-59.

(weather, innovation, resource depletion, etc.) as well as because all markets are interrelated and adjustments do not take place immediately. The equilibrium assumption used in partial equilibrium analysis suggests that the market in question is sufficiently isolated from other markets that exogenous shocks in those markets have not moved the market in question far from equilibrium. Further, it is assumed that no exogenous shocks that might directly affect the market in question are currently moving the market away from equilibrium. The significance of this assumption is that the market in question can be considered to represent the normal state of that market. It should be clear, however, that the normal state of the market—its equilibrium—is constrained by the distortions imposed on it. In other words, the normal state of the market is not considered to be the equilibrium that would arise if the market were at a “first best” equilibrium. The partial equilibrium is determined by the market on an “as is” basis.

The comparative statics framework thus compares two “as is” equilibria. Methodologically, comparative statics seeks to determine the effects of a shock (imposition of a tax, a quantitative restriction, payment of a subsidy) on a market, *ceteris paribus*. *Ceteris paribus* means “all other things held constant”. Thus, it seeks to isolate the effects of a single shock. While it may be possible to examine the net effects of multiple shocks if sophisticated modeling is done, the basis is first isolating the individual effects.

The WTO seems firmly rooted in the “comparative statics” tradition in economics. Dispute panels tend to examine individual trade restrictions. Even if a case might involve, for

²²⁵ See Kerr, W. A. (1987) The Recent Findings of the Canadian Import Tribunal Regarding Beef

example, multiple export subsidies, panels look at them individually. Once determinations are made on the individual subsidies, then combinations of subsidies may be examined to determine, for example, if the multiple subsidies exceed the *de minimus* level.

Comparative statics compares two “as is” equilibria. Comparative statics can be undertaken in two ways. Either a hypothetical shock such as an import tariff can be imposed on an observed market and a new *ex post* equilibrium constructed, or an existing shock such as an export subsidy can be removed from an observed market and a new *ex ante* equilibrium constructed. In either case, the appropriate starting point is the array of prices that exist in the observed market prior to the change. This means that the effects of a change are always measured from an observed set of “as is” market conditions. The array of non-observed prices that are calculated after the addition or removal of, for example, a subsidy are those the model predicts would exist, *ceteris paribus*. In other words, they are the array of prices that the model predicts would exist after the addition or removal of the single shock.

In economics, either the observed price or the constructed *ceteris paribus* price is considered to be the appropriate reference price, depending upon the question to be answered. For example, if one wished to determine whether an existing export subsidy was trade distorting or not one would proceed as follows. The observed market with the export subsidy in place would be the starting point for the comparative statics exercise. This would be the reference price. The subsidy would then be removed and the new market equilibrium calculated. This calculated market equilibrium is then treated as the appropriate reference

Originating in the European Economic Community, *Journal of World Trade Law*, 21 (5): 55-65.

price for determining the effect of the implementation of an export subsidy. Thus, the true point of reference for the partial equilibrium–comparative statics exercise is the observable “as is” market that exists prior to the analysis being conducted.

The degree of sophistication in modeling will determine the preciseness of the calculated equilibrium. Often, it is sufficient for directions of change to be determined rather than the new equilibrium to be formally calculated. For example, if one is interested in whether an export subsidy is trade distorting, then showing that the new equilibrium is one where exports are expected to increase may be sufficient. Hence, the reference point for the effect of a subsidy when an existing subsidy is hypothetically removed may simply be a non-specified quantity of exports that is less than the existing quantity. In other words, relative magnitudes are sufficient. Other cases require more sophisticated modeling so that a new equilibrium can actually be calculated. This might be the case if one needs to determine if the effect of a subsidy is within the *de minimus* specifications set out in WTO articles.

The important point is that, given that the WTO seems to fall squarely within the partial equilibrium–comparative statics methodology common in the study of economics, the basis for reference prices is observed prices in the market of interest. This may be the single market price in the market of interest or an array of prices that define a market at the point in time. For example, a demand curve is typically defined as $Q_d = f(P_{own} | \mathbf{P} \dots)$ where P_{own} is the price of the product in the market in question and \mathbf{P} is a vector of prices of products considered important substitutes and complements for the product whose market is being examined. This vector of prices is considered to be constant (in keeping with the

ceteris paribus method of analysis) when a trade barrier is imposed on the market. Hence, the observed prices in **P** may also be important for determining the reference point. Again, the market of interest may be broadly defined to include both the domestic and international markets for the same product.

The use of observed prices to provide a reference point means that any inefficiencies built into markets will not be considered when the analysis of an individual policy is undertaken for WTO purposes. Hence, if the observed domestic market prices for milk are the result of a myriad of trade and domestic milk policy interventions, no attempt is made to correct for those distortions when establishing the price for milk to be used in a partial equilibrium–comparative statics exercise pertaining to the impact of Canadian dairy policy on trade.

The “as is” approach to markets also reflects the realities of doing business in a market. The observed prices are those upon which firms in the market base their decisions. Those firms would make different decisions and collectively alter the market if they were presented with some “ideal” set of prices. As the “ideal” prices are not received by firms, it makes little sense to use them as a benchmark for analysing trade policy. One is interested in the effect of trade barriers or subsidies on firms or consumers. Observed market conditions provide their economic environment. Trade barriers are imposed or subsidies granted in response to existing market conditions. Thus, referencing to an “ideal” set of prices would seem inappropriate for assessing trade barriers. In other words, trade barriers or subsidies are imposed in response to imperfections in the market. Undertaking analysis referenced to prices that do not reflect those imperfections would seem antipathetic to the

role of the WTO. Thus if, in the absence of the individual policy of interest, milk can only be obtained in the domestic market, then the domestic market is the appropriate market to use as the reference price. The international market price is not relevant because product could not be obtained from that market in the absence of the policy under investigation.

Of course, prices fluctuate and, at times, deviate considerably from equilibrium. As a result, legitimate arguments may arise regarding the set of prices that should be used to determine the “observed” price when analysis is to be undertaken. The number of observations, the period over which they are collected, and the method used to average the observations are all legitimate considerations which must be addressed when determining the reference price for calculation purposes. Being able to choose or influence the method used in determining the reference price may also provide a strategic advantage. These technical difficulties do not alter the conclusion that observed prices represent the true reference point for WTO analysis. It is important not to confuse arguments over the technical questions of the appropriate observed prices to use with arguments regarding the principle of using observed prices as the starting point for evaluating subsidies.

While the assumptions underlying partial equilibrium–comparative statics analysis represent compromises made by economists to simplify the analysis of complex economic systems, they are compromises that can be “lived with” by a large segment of the economics profession. Partial equilibrium–comparative statics has become the analytical methodology that underlies the WTO in contrast to the general equilibrium–comparative statics analysis preferred by the majority of trade theorists in the economics profession.

As with any compromise made in the name of analytical convenience, arguments can always be made that too much has been compromised and thus, decisions based on partial equilibrium–comparative statics analysis will always be open to criticism. It seems clear, however, that the WTO is willing to accept the general analytical approach as being applicable and useful in answering questions of interest. As a result, the appropriate reference prices for undertaking analysis to answer questions pertaining to the WTO are the observed market prices prior to conducting the comparative statics exercise.

C. TRANSFER OF ECONOMIC RESOURCES

Now that the question of the appropriate reference price has been answered, the question of what constitutes a transfer of resources can now be addressed. A transfer of resources must take place within the partial equilibrium–comparative statics framework. This means that the transfer of resources represents a shock to the model. Again, the appropriate starting point is the observed state of the market prior to undertaking the comparative statics exercise, that is, the state of the market when the reference price is determined. Thus, the starting point for determining if a transfer of resources has taken place is the allocation of resources that exists at the time when the reference price is established.

Given that the starting point for economic analysis of export subsidies is an existing array of prices, and hence the existing mix of policies both domestic and foreign, the question of whether a transfer of economic resources takes place is a counterfactual partial equilibrium exercise. In other words, the questions are: (1) Do those who are engaged in exporting have

more resources than they did before the policy? and, equally important for economic analysis, (2) Do those extra resources lead to an increase in exports?

The compromise reached at the Uruguay Round negotiations, however, fails to take into account the second question. The contracting parties agreed that export subsidies were prohibited. In effect this means that export subsidies are to be presumed to be trade distorting by panels. As a result, the panels only need to consider the first question. Thus there is a divergence between economic questions relating to export subsidies and legal questions. Resolving this difference in analysis will have to await renegotiation. This does not mean, however, that the economic question is not of interest. Without understanding the economic deficiencies of the current WTO rules, one cannot fully comprehend the difficulties faced by panels in their deliberations.

The question relating to resource transfers appears to be quite straightforward but in actual fact it is quite complex. There are two aspects that add complexity. The first is whether the policy-induced change which increases the resources of those engaged in exporting activities must reduce the economic resources available to other activities. The second is whether the increase in resources received by those engaged in exporting increases the quantity of goods exported. The WTO clauses relating to export subsidies have as their primary goal the reduction of trade distortions—i.e., increased exports arising from the transfer of resources that arise from subsidization. As suggested above, however, the current WTO compromise presumes that the latter is taking place in the case of export subsidies.

Thus, evidence of an increase in resources accruing to those engaged in exporting can only be a necessary, but not a sufficient condition, for a WTO judgement regarding whether a policy constitutes a prohibited subsidy. Sufficient conditions will only arise when: (1) there is an increase in economic resources accruing to those engaged in exporting and (2) some activity experiences reduced resources as a result of the policy. The latter may be quite general, as in the case of broad-based tax revenues being used to fund export subsidies, or specific, as in the case of an import tax (which raises prices to consumers, *ceteris paribus*) whose revenues are transferred to a group of exporters.

One central question is: When would a policy change that results in a larger quantity of resources accruing to a group of exporters not result in some other activity having less economic resources, *ceteris paribus*? This situation will arise if the policy increases the overall efficiency of the system. The inefficiency might be technological and the policy, by facilitating an increase in technical efficiency, may lead to an increase in the efficiency of resources used in the export sector, causing a transfer of resources from other sectors. The owners of the resources previously employed in other sectors have not lost, because they are simply responding to higher returns in the export sector. In a similar fashion, a policy change may simply remove an existing inefficiency, *ceteris paribus* improving relative returns for those engaged in exporting and again inducing a movement of additional resources into export activities. These additional resources could result in more exports, but no group would have less economic resources. In this case, the policy should not be

considered as prohibited even if it results in an increase in exports. It is not clear if panels have made this distinction.

As second important question is whether a transfer must be interpreted as a movement of economic resources between distinct groups in society—from taxpayers to exporters or from consumers to producers. A policy that transfers additional resources to export activities may not lead to a transfer between groups in society if the policy simply transfers resources among the same group. Constructing such a scenario may, however, require alternative assumptions pertaining to the state of equilibrium in the market than those which typically underlie the analysis undertaken in WTO cases.

It is common to assume that profits are “competed away” in equilibrium. It might be, however, that existing policies act to prevent the competing away of profits. For example, assume that existing producers of a product are mandated by government policy to belong to a group with closed membership. All producers in the industry must belong to the group and no new producers are allowed in so that profits are not competed away. Assume the producers are profitable and that they sell at the world price in both the domestic and foreign market. In addition, assume that domestic and foreign sales accounts are kept separate. Further, assume that export marketing costs are higher than domestic marketing costs. The government could choose to tax the profits producers make in the domestic market and transfer those revenues to the group’s export activities if it wished to expand export sales for political reasons. There is no transfer among groups as the same group of producers is being taxed as is engaged in export sales. The result is, however, an increase in

export sales. Thus, one would have trade distortion (which panels must ignore) but no subsidy (because no intergroup transfer takes place).

If one removes the competitive assumptions to allow for market power in the domestic market, then a similar transfer within a group can be achieved through government policy. Assume that market power in the domestic market allows producers to charge in excess of the price received for exports. Domestic sales are profitable. The government could tax the profits in the domestic market and transfer those revenues to export activities if it wished to increase exports for political reasons. The results would be an increase in exports. Again, there would be no subsidy, but there would be an increase in exports.

Thus, it is not necessary to have a transfer of resources among groups in society to have a trade-distorting transfer of resources. Failure to consider trade-distorting effects while only looking for transfers may lead to error regarding the true effect of the policy. The fault would lie not with the panel but rather with the current state of political compromise that underlies the WTO. Of course, transfers between groups are more common. Transferring general tax revenues from taxpayers to those engaged in export activities is the most common example. Consumers may also be charged a higher price in the domestic market through a quantitative restriction on domestic marketing of the product, with some or all of the increased domestic revenues being transferred to producers' export activities. Note, this is different from the case discussed above where producers can exercise market power to increase the price to consumers. In the former case, there is no government intervention to increase the price to consumers, but rather relaxing the assumption of a competitive

market allows for the increase in consumer price. The government only taxes the profits that arise from being able to exercise market power. The price would be the same to consumers whether or not the government put in place the tax policy.

Thus it seems clear that a domestic price in excess of the export price is not in itself incompatible with the WTO rules relating to export subsidies. It may be of interest to antidumping authorities but it does not fall into the purview of a countervailing duty authority. A domestic price in excess of an export price is not evidence of an export subsidy. What is necessary for an export subsidy is a government intervention that transfers economic resources to export activities from some other group or activity. Exports will increase because producers respond to a higher average or “blended” price for the product.²²⁶ In this case the *ex ante* presumption that export subsidies are trade distorting is correct.

This leads to the question of pooling. In the market power case above, if the government put in place a pooling policy because it wished to ensure that all producers benefited equally from the opportunity to sell at a higher price in the domestic market, then there would be no transfer of resources to the export sector. Hence, pooling is not synonymous with a transfer of resources. Pooling may also be used to allow farmers to share equally in revenues over a period of time when markets exhibit volatility. Again, this cannot be taken as evidence of export subsidization if the pooling is based on revenues from both domestic and foreign sales. This would be the case even if the domestic prices received were

consistently higher than foreign prices, as the price differential over time may simply reflect evolving opportunities to exercise market power in the domestic market. Without some intervention to induce the transfer of resources, pooling should be neutral. A separate pool could be maintained for domestic and foreign sales. These separate pools could then be paid separately to producers. Adding the two pools together and paying producers would be resource neutral even if market power were being exercised domestically.

This is a different case, however, from one where the government intervenes to reduce the supply of product in the domestic market to raise the price. If the demand curve for the product is inelastic, then increasing the price increases total revenue in the domestic market. If those revenues are transferred to export activities, then consumers are being forced to transfer resources to export activities. One way to do this would be through the pooling of revenues and providing a higher “blend” price. The key point, however, is that consumers are being forced to transfer economic resources to producers.

It may also be that establishing a marketing institution, with or without the ability to pool, is simply more resource efficient than alternative methods of marketing. As a result, export activities may receive more resources than they would have, *ceteris paribus*. This increase in resources cannot be considered a transfer of resources. The reasons for the increase in efficiency may lie in the reduction of transaction costs.²²⁷ Reductions in transaction costs

²²⁶ See Ippolito, R. A. and Masson, R. T. (1978) The Social Cost of Government Regulation of Milk, *Journal of Law and Economics*, 21 (1): 33-65.

²²⁷ See Hobbs, J. E. and Young, L. M. (2000) Closer Vertical Co-ordination in Agri-food Supply Chains: A Conceptual Model and Some Preliminary Evidence, *Supply Chain Management*, 5 (3): 131-142.

can arise in three areas: information costs, negotiation costs, and monitoring/enforcement costs.²²⁸ A marketing institution may be able to reduce the information costs associated with identifying foreign customers, verifying the reputation of foreign customers, determining the appropriate price, etc. The institution may be able to reduce the negotiation costs associated with negotiating a transaction once foreign customers have been identified. This may arise from development of the human capital required for negotiations, and from the ability to offer a wide range of services or products and to organize transportation, etc. Finally, the costs of ensuring that the agreed terms of the transaction are adhered to may be reduced. Monitoring systems can be put in place and mechanisms to prevent or deal with contract breaches made more efficient. As a result of these increases in efficiency, more resources may be available to export activities than would be the case if the policy establishing the marketing institution had not existed. The policy leads to increased resources being made available for export activities without any reduction in resources being made available to other activities. Of course, this is premised on the assumption that the export institution is financed out of its sales activities and does not receive a transfer of economic resources directly or indirectly from the government.

A transfer of economic resources to those engaged in export activities as a result of a policy initiative by the government does not necessarily mean that exports are distorted. In the simplest case, the government may wish to increase the incomes of exporters. For example, exports to a foreign country may be limited by a tariff rate quota applied by the importing country. If exports are constrained by the importers' quantitative restrictions, then an

increase in resources transferred to those engaged in export activities will not lead to an increase in exports. This does not mean that rent-seeking exporters will not lobby the government for a transfer of resources or that the government will not grant it. The resources in this case could be tied directly to export activities but would not lead to any increase in exports. Governments have always guarded the right to redistribute economic resources among their citizens, for whatever reason, and the WTO has no interest in this process. Countries have made commitments at the WTO not to transfer resources in ways that distort international trade. The exact nature of these commitments, however, is the subject of much debate and requires interpretation. It would seem that a transfer of economic resources to those engaged in export activities that does not lead to an increase in exports should be within the domestic purview.

While it is now recognized that in the absence of other policy measures all subsidies distort trade, there was a long search for *decoupled* subsidies—implying that subsidies that could be considered non-trade distorting would be allowed in the WTO. The compromise agreed to at the Uruguay Round whereby domestic subsidies were grouped into non-actionable and actionable, while acknowledging that non-trade-distorting subsidies do not exist, clearly made the distinction that some subsidies are acceptable under the WTO. Those put in the allowable category were those that were considered less trade distorting. Thus, while export subsidies were prohibited, it would seem inconsistent not to allow export subsidies—those tied to export activities—that do not lead to an increase in exports.

²²⁸ See Hobbs, J. E. and Kerr, W. A. (1999) Transaction Costs, in Dahiya, S. B. (Ed) *The Current*

One final question needs to be addressed in this section dealing with economic analysis. That is the question of whether revenue foregone by the government constitutes a subsidy. Following our counterfactual partial equilibrium–comparative statics methodology, the central question is whether those engaged in export activities have more resources than they would have had in the absence of the policy. In the absence of a policy whereby a government agrees to forego tax revenues paid by those engaged in export activities, those engaged in export activities would have to transfer some of their existing resources to the government. Once such a policy is put in place they retain those resources and, hence, have more resources than they would have had in the absence of the policy. There has been a *de facto* transfer of resources to exporters from the government. The existing tax is part of the “as is” economic environment upon which the counterfactual comparative statics methodology is based.

Of course for economic analysis, the second condition should also be applied. Does the *tax subsidy* lead to an increase in exports? Again, there may be other policies in the “as is” economic environment which prevent any increase in exports even if additional economic resources end up in the hands of those engaged in export activities. The *ex ante* presumption that export subsidies distort trade, however, means that panels do not have to consider this question.

D. ECONOMIC QUESTIONS

The WTO appears to be firmly rooted in the economic methodology that applies counterfactual partial equilibrium–comparative statics for analysis. This implies that the “as is” economic environment is the appropriate “benchmark” for initiating economic assessments of policies for the purposes of determining their compliance with WTO commitments. If the “as is” economic environment is the benchmark, then other aspects of the “as is” economic environment need to be examined as well. In particular, it cannot be assumed that an increase in resources arising in the export sector as a result of a policy represents a transfer from other activities. In particular, the increase in resources accruing to those engaged in export activities may arise from policy-induced increases in efficiency.

Depending on other aspects of the “as is” environment, policies such as pooling, the existence of different domestic and export prices, or the existence of export marketing institutions may not be indications of export subsidies. The key questions to be answered are: (1) Do those involved in export activities end up with more resources than they would in the absence of the policy? (2) Has there been a transfer of resources from other activities? and (3) Has the increase in resources to those engaged in export activities led to an increase in exports? At present, panels only need to examine the first two questions. As discussed in the literature review which began this study, Jackson²²⁹ suggests that a major deficiency in the case of actionable subsidies is the absence of a requirement for finding “substantial cross border effects”. This would seem equally applicable for export subsidies.

VII. CONCLUSION

We've come a long way, baby! From the 1955 prohibition on export subsidies on all industrial products, the members of the WTO took the bold new step in 1995 to outlaw almost all export subsidies and limit domestic subsidization as well. But the transition from permitted to outlawed subsidies has not been without challenges and uncertainty.

This study shows that new international law delineating illegal from legal export subsidies has rapidly developed in the WTO. Five years of jurisprudence from the WTO's Dispute Settlement Body demonstrates that the words of the *SCM Agreement* and the *AOA* will be interpreted quite literally and legalistically by the DSB. The DSB has developed a very broad definition of an export subsidy. The requirement of a financial contribution is now defined as any transfer of economic resources. The requirement of a benefit is defined as a transfer of resources for less than full consideration, using the marketplace to provide a benchmark for comparison of the value and consideration. Finally, export contingency can be defined as conditionality, in law or in fact, upon objectively anticipated exportation.

Furthermore, the DSB has extended its broad definition of "export subsidy" from the *SCM Agreement* into the *AOA* context. But the DSB has not stopped there. There are additional measures defined in the *AOA* to be export subsidies even though the measures may not satisfy the *SCM* test.

The definitions of "export subsidies" under the two WTO agreements now make it possible to more accurately determine if a government policy is an illegal export subsidy. We argue

²²⁹ See Jackson, J. H. (1997) *The World Trading System*, MIT Press, Cambridge and London at 301-

that if the legal tests developed in this study are applied to existing government policies and programs, then one will be able to have a rough idea as to their WTO compatibility.

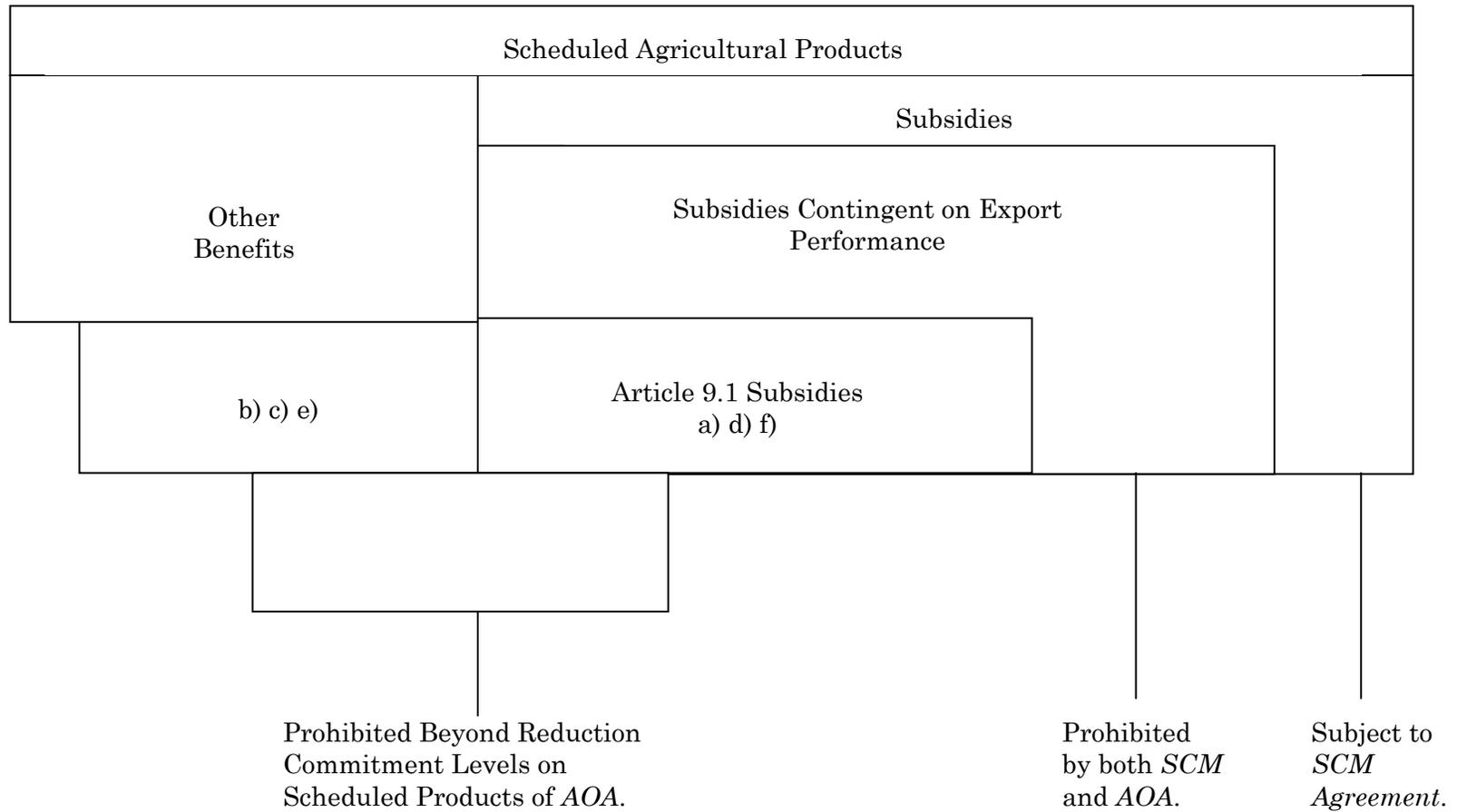
While the work of the DSB on the difficult job of defining “export subsidy” is laudable, its approach is not without its shortcomings. By legalistically and sometimes rigidly following the literal interpretation, the DSB has, to this point, failed to fully explore appropriate economic principles upon which to base its decisions. This is especially true with respect to its selection of the appropriate benchmark or reference price as being unequivocally that of the home market. Ultimately, the question that remains to be answered is whether the DSB’s literal definitions, without appropriate reference to solid economics, will ultimately help to eliminate trade-distorting export subsidies. Are the legalistic decisions apt to create more confusion about what practices are allowed because they are out of sync with the economic realities of international trade?

Many questions remain about export subsidies, particularly relating to agricultural products. Did member states really intend that any type of co-operative action by exporters that has the benefit of a legislative framework be caught in the illegal export subsidy net? Regardless of member intention, will members now accept that their national marketing schemes may be illegal based on this new international legal standard? It will take a few more years to answer these questions.

In spite of the questions and uncertainty remaining, the DSB's broad legal tests will give the DSB the flexibility to deal with all types of potentially trade-distorting measures under both the *SCM Agreement* and the *AOA*. The uncertainty resulting from some of the language in the reports is a growing pain in a newly developing legal system. This is only short-term pain for the long-term gain of a sound world trading system.

The examination of export subsidies provided in this study points to the type of work that will be important as the WTO moves towards a rule-based legal system. This type of legal and economic analysis will ultimately encourage members to accept the limitations placed on their domestic policy making by the new international trade law regime.

Appendix A - Figure 1



Appendix A - Figure 2

