The Enduring Problem of WTO Export Subsidies Rules

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I  INTRODUCTION

Export subsidies have been at the centre of a long series of high profile disputes at the World Trade Organization (WTO). For example, in the 1990s Canada and Brazil initiated reciprocal complaints that each gave subsidies for the export of domestically made regional aircraft.¹ A number of countries challenged the U.S. over its rules for “foreign sales corporations”. The dispute centred on billions of dollars of tax exemptions for these corporations that the WTO eventually found to be, in some cases, prohibited export subsidies.² On the agricultural side, export subsidies have also been central to the negotiations in the Doha Round and have been subject to a range of disputes such as recent challenges to the U.S. policies on cotton.³ The recent dispute between the U.S. and the European Communities regarding alleged export (and other) subsidies to their respective manufacturers of large civil aircraft is another in this line of highly contentious disputes.

Export subsidies are, in a general sense, subsidies “granted only to products when they are exported.”⁴ Economists view export subsidies as beneficial to the subsidized producers in the exporting country and to consumers in the importing countries. However, they also tend to see them as harmful in many cases to the welfare of the subsidizing country as a whole, with a possible exception where export subsidies provide


a country’s producers with a first mover advantage in imperfectly competitive markets.\(^5\) Further, export subsidies are harmful to more efficient producers of the good in other countries, whether in the importing country or in third country exporters. In some cases, there may, on net, be global benefits from subsidized exports because, for example, the harm to the more efficient producers in the importing country is more than off-set by the gain to consumers.\(^6\) Even though there are possible global gains from export subsidies in certain cases, the *Agreement on Subsidies and Countervailing Measures* (SCM Agreement) adopted by the WTO during the Uruguay Round contains a broad prohibition on export subsidies for non-agricultural products.\(^7\) The Uruguay Round’s *Agreement on Agriculture* permits some export subsidies subject to reduction commitments and a prohibition on export subsidies used to circumvent these commitments.\(^8\)

Despite what appear to be rather clear rules, disputes over export subsidies (high profile and otherwise) constitute a significant share of all cases that have gone to Panels since the WTO was formed (roughly 10.5 percent).\(^9\) Panels have been established in ten cases (including both agricultural and non-agricultural disputes). Seven of these Panel findings were appealed to the Appellate Body. In five cases, there were further compliance proceedings under Article 21.5 of the *Dispute and Settlement Understanding* (*DSU*), with a further three cases going before an Article 21.5 Panel a second time. In three cases, the respondent country refused to withdraw its subsidies, leading to arbitration proceedings to determine the appropriate imposition of countermeasures.\(^10\)

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7 SCM Agreement, Article 3.1(a).

8 Agreement on Agriculture, Articles 3.3, 9.2(a) and 10.


These numbers do not include export subsidy disputes that are settled before a Panel is appointed. They also only include disputes about measures that the complaining party alleged were export subsidies; as we will discuss, in some cases, complaining parties prefer to allege other forms of subsidies instead.

This article examines the WTO rules and decisions concerning export subsidies in the non-agricultural context to determine why these disputes are so prevalent and contentious and whether the rules or their interpretation should be altered. Part II discusses the basic economic case against export subsidies and political economy explanations for their continued use. Part III briefly sets out the history and structure of WTO rules concerning non-agricultural export subsidies. Parts IV and V then review two central concerns about the WTO rules on export subsidies. Part IV examines issues surrounding identification of export subsidies including defining what constitutes a subsidy, distinguishing export subsidies from other types of subsidies and how closely the WTO should review domestic policies for potential (rather than actual) export subsidies. Part V then discusses the difficulty the WTO has had in finding an appropriate remedy for violations of the prohibition against export subsidies. Finally, Part VI concludes by discussing the difficulties posed by high-profile, high-stakes disputes such as the dispute between the U.S. and the E.C. over subsidies for large commercial aircraft.

II Why Prohibit Export Subsidies?

The SCM Agreement’s prohibition of non-agricultural export subsidies reflects what appears to be a long-standing near-consensus that export subsidies are undesirable and that their primary purpose is to distort trade. The main reason for this proposition’s appeal is undoubtedly its intuitiveness: if the intent was not to distort trade, why would the subsidy not apply to both domestic and foreign sales? This would allow domestic consumers to receive at least some of the benefits, while in the case of an export subsidy, foreigner consumers would derive most of the benefits.

However, export subsidies are, in general, welfare-reducing for the subsidizing country (with the possible exception of the strategic trade theory explanation discussed

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While they provide a benefit to the producers of the exported good, they worsen the country’s terms of trade – the rate at which a country can trade its exports for imports from other countries. The terms of trade worsen because the subsidy increases the domestic (and, if not a small economy, the world) supply of the good and decreases the domestic (and therefore the world) demand for the good, thereby causing the relative price of the good to fall. Moreover, export subsidies distort resource allocation towards the higher-cost subsidized good and, because the subsidizing government needs to raise revenues to finance the subsidies, generally impose a deadweight loss on the economy. Further, Sykes argues that, even where there is some domestic reason that may point to the need for subsidies (such as a market failure of some form), export subsidies never appear to be the best response and other policy responses would usually be more efficient and effective. He argues that the prohibition of non-agricultural export subsidies is “useful and sensible from an economic perspective.”

Export subsidies cannot therefore be explained in terms of a benefit to the subsidizing country. Instead, the most prominent explanation is the political economy story of the political officials of a particular country providing benefits to concentrated interests – the subsidized exporting industry. These exporting producers benefit, as do foreign consumers, from the lower cost of the good. However, domestic consumers lose because of the higher relative cost of the good (and worsened terms of trade), taxpayers lose because they have to pay for the increased subsidies and/or the government loses revenue. The political officials may provide these subsidies to gain an advantage from

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14 Regan (2006) notes that “an export subsidy (by which I mean any subsidy to an exporting industry, not just a subsidy conditioned on export performance), must be primarily motivated by protectionism (in the broad sense of being a law designed to enhance the competitiveness of domestic producers), since it has a perverse terms-of-trade effect.” (p. 29)).

these concentrated interests (such as revenue for re-election campaigns or future employment). The officials may face losses (such as a loss of votes or revenue for re-election) because they have imposed costs on consumers and taxpayers (and an overall loss to the country as a whole). However, these losses are likely to be lower than the benefits to concentrated interests because the more diffuse consumer and taxpayer interests face information and collective action asymmetries.\footnote{Krugman and Obstfeld (2005), pp. 219-20; Sykes (2005)}

A possible exception to this view of export subsidies as beneficial to the subsidizing industry (and to political officials of the subsidizing government) but harmful to the country as a whole derives from strategic trade theory. As was first shown by Brander and Spencer, in certain circumstances it can actually be welfare-increasing for a government to provide export subsidies.\footnote{James A. Brander and Barbara J. Spencer, “Export Subsidies and International Market Share Rivalry” (1985) 18 Journal of International Economics 83. See also Elhanan Helpman and Paul R. Krugman, Trade Policy and Market Structure (Cambridge: The MIT Press, 1989) at 83-115.} They demonstrate that, in a simple Cournot oligopoly model with two firms (one in each exporting country) selling to third-country markets, where governments set subsidy levels before these firms make their decisions, subsidies allow the domestic firm to capture a larger share of the international market and increase its profits. Such a subsidy may increase domestic welfare (by increasing the profits of the subsidized firm) despite worsening the terms of trade.

Strategic trade theory typically views benefits to export subsidies as arising in imperfectly competitive markets, with the commercial aircraft industry being a paradigmatic example.\footnote{See, for example, Krugman and Obstfeld (2005), 262-3 (using a hypothetical dispute between Airbus and Boeing to explain strategic trade theory). But see Kyle Bagwell and Robert W. Staiger, The Economics of the World Trading System (Cambridge: The MIT Press, 2002) at 168-179 (adding a political economy component to the basic Brander-Spender framework in order to apply it to agricultural export subsidy disputes (a perfectly competitive market)).} However, to gain the benefits, governments need a significant amount of information including the costs of both the domestic and foreign industries and the demand for the good.\footnote{Krugman and Obstfeld (2005), p. 264-5.} The need for this information raises concerns about government failure – either subsidizing an industry when it is not necessary or providing too high or too low a subsidy.
There may be some other benefits from export subsidies. For example, Bagwell and Staiger find a potential use for export subsidies where foreign buyers are unaware of the quality of an exporting firm’s product. They argue that higher-quality exporting firms may not be able to credibly inform foreign consumers of their high quality especially with respect to experience goods. As such, they must initially sell at the low-quality price until they have established a reputation for high quality. If, given the higher costs of producing a high-quality product, they cannot do so profitably, then they would be unable to enter this foreign market. An export subsidy can allow the firm to export profitably in this initial period until it can develop a reputation for quality. This may explain why developing countries, whose products would be more likely to be perceived as low quality in developed country markets, would have bargained for a temporary exemption from the export subsidy prohibition. It also explains why this exemption is temporary: developing countries would have an incentive to restrict the use of export subsidies in order for their producers to benefit from informational asymmetries.

Political interests of the subsidizing country therefore often appear to favour export subsidies (and such subsidies may in some cases be good for the country). Further, importing countries tend to gain when other countries use export subsidies because the gain to domestic consumers in general more than off-sets any losses to domestic producers of the good (leading to the claim that importing countries should not complain about export subsidies but instead send “Thank You” notes). Why then did the GATT Contracting Parties and later the WTO members agree to prohibit export subsidies? Any attempt to tie the prohibition merely to the desire to reduce harm in the exporting country appears to be mere paternalism. There have been a number of other explanations proposed. First, governments may be attempting to “tie themselves to the mast” – that is, they may wish to adopt an international prohibition in order to be able to


22 See, for example, Regan (2006), p. 17 (noting that the prohibition on export subsidies is puzzling because of the benefits to importing countries).
resist the pressure from exporting industries for (domestic welfare reducing) subsidies.\(^2\) The difficulty with this explanation is that it is not clear why, if governments could overcome domestic exporting interests to agree on the prohibition, they could not simply say no to the demands for export subsidies. Regan suggests one possible answer – the framing of the issue makes one result possible and the other not.\(^4\) It may be, for example, that framing a broad prohibition against export subsidies as a “fairness” issue enables mobilization of more general public support for a prohibition than would be possible for resisting a claim by a domestic industry for export subsidies.\(^5\) The “fairness” claims would be that foreign governments are unfairly subsidizing their exports and harming either the domestic industry in the importing country or exporters to third country markets. These claims of “unfair” trade may be sufficient to overcome potentially subsidized exporting interests where countries (such as the US) are both importers and exporters.\(^6\)

Second, while in general importing countries appear to benefit from export subsidies, there may be reasons why importing countries are harmed and therefore may agree to a prohibition on export subsidies. For example, Sykes argues that there may be special cases where export subsidies harm the importing country by providing the exporting country’s industry with monopoly profits (including strategic trade policies).\(^7\) However, these are special cases and, in general, importing countries would be expected to benefit on net and therefore not agree to a prohibition. Janow and Staiger offer a more general argument for why importing countries may agree to a prohibition. They argue that export subsidies are welfare-enhancing for importing states unless those states are


\(^{24}\) Regan (2006).


\(^{26}\) Krugman and Obstfeld (2005), pp. 101-2.

\(^{27}\) Sykes (2003), p. 11.
concerned about injuries to domestic producers and lack the ability to respond. Countries cannot respond by raising tariffs directly under GATT if they are bound. However, they may be able to respond in other ways such as renegotiation of tariff bindings or countervailing duties. They may wish to prohibit export subsidies if the transaction costs of using these other measures are too high.

Finally, exporting countries may wish to prohibit export subsidies because they feel that a prohibition will on balance aid their exporting industries. For example, export subsidy prohibitions may be the result of negotiations among exporters to restrict trade. Such restrictions, by decreasing trade volumes and raising prices, come at the expense of importers. Further, exporting governments may wish to avoid a subsidies war. Under strategic trade theory, for example, the subsidizing country has the advantage of providing a subsidy to its industry so that it can gain an advantage over the competing industry in another country. Of course, the government in the other country also has the same opportunity to benefit from an export subsidy but if both countries subsidize exports, no advantage is gained. At that point, the exporting countries’ welfare could be increased through a mutual reduction in subsidies. These countries face a form of Prisoner’s Dilemma: if the countries could cooperate and reduce their subsidies, they would both benefit. The result may be a commitment by these countries not to subsidize exports.

As the economic literature provides a breadth of diverging arguments both for and against the prohibition of export subsidies, it is unclear which argument might have provided Uruguay Round negotiators with the primary motivation for adopting a broad prohibition. Looking at the case law, however, we observe several trends. First, several cases (the Canada-Brazil and now U.S. – E.C. disputes over civil aircraft are the best examples) have involved two-firm industries similar to those in the Brander-Spencer


29 Janow and Staiger (2003) at 250 and Bagwell (2007) (discussing the terms of trade effect of restricting export subsidies).

strategic trade model. Second, the cases tend to involve disputes over sales to third-country markets, not exports to the complaining party’s domestic markets. Third, the complaints have been filed by rival countries, not importers, which suggests that subsidy competition is not considered to be harmful by importers who lack a competing industry. Fourth, we observe, especially in the context of Article 21.5 compliance proceedings, a clear desire by subsidizers to “cheat”, as predicted again by the Brander-Spencer model. Overall, these trends suggest that some version of the strategic trade policy argument may best describe real-world subsidy policy and disputes.

Export subsidies then seem to be welfare-reducing in most cases for the exporting country but may be politically advantageous for the government of the exporting country. Given that they should in general spark gratitude in the importing country (as the gain to consumers tends to outweigh any loss to domestic producers), we need to consider whether export subsides are on balance beneficial globally. If so, the prohibition on export subsidies may either be paternalism (to stop harm in the subsidizing country) or be reducing (global) efficiency in order to provide a benefit to certain parties. The answer appears to be that export subsidies “are (normally) globally inefficient”.31 Consider first a single country without any exports or imports. Economists in general do not favour subsidies (with the potential exception of certain instances of market failure) because they induce consumers to demand too much of the (lower priced) good and producers to produce too much.32 For example, subsidies to electricity producers induce consumers to increase their use of electricity and electricity producers to increase their supply. There is a distortion of resource allocation away from other, more efficient uses of resources (or lower cost suppliers in the case of subsidies to specific firms) because of the subsidy.

The same holds true when we consider a three country world where two countries are exporting a good to a third country. The export subsidy squeezes out producers in the

31 Regan (2006), p. 17. But see Bagwell (2007), at 29 (“While it is certainly true that important circumstances exist in which the use of export subsidies can decrease welfare, the competing-exporter models support the following basic conclusion: the economic case for rules that facilitate a reduction in export subsidies is much weaker than the economic case for rules that facilitate a reduction in import tariffs.”).

32 See Green (2006) and Sykes (2003) discussing some of the potential rationales for subsidies in some circumstances.
other exporter and in the importing country in favour of less efficient producers in the
subsidizing country.\textsuperscript{33} The consumers in the importing country consume too much, the
producers in the subsidized country produce too much and there is a misallocation of
resources across producers. The same amount of the good could be produced with fewer
resources. Even in the cases where strategic trade theory appears to provide a domestic
benefit greater than the cost of the subsidy, from a global perspective the result is merely
a transfer from one (potentially lower cost) exporting country to another and may allow
monopoly profits (harming importing countries).\textsuperscript{34} Further, Sykes argues that as export
subsidies undermine market access expectations under existing trade agreements, they
reduce the value of such agreements and thereby the likelihood of such agreements.\textsuperscript{35} To
the extent such agreements increase global welfare, the reduced probability is a concern.
As a result, while export subsidies may benefit the economy of the importing country,
they appear likely to be globally inefficient.

Export subsidies therefore in general can be explained as a domestic political
response to pressure from exporting industries. They are not in general welfare-
enhancing from the perspective of the subsidizing country and do not appear to be
welfare-enhancing globally. As a result, a prohibition on balance is reasonable. After
describing the relevant provisions under the SCM Agreement in Part III, Parts IV and V
of this paper will draw on this discussion of the economics of export subsidies to examine
the actual wording and interpretation of the prohibition.

III THE WTO FRAMEWORK FOR EXPORT SUBSIDIES
(a) Pre-Uruguay Round Export Subsidy Rules

\textsuperscript{33} Sykes (2003).

\textsuperscript{34} Sykes (2003), p. 11 (arguing that strategic trade policy may result in monopoly pricing). If there is an
oligopoly, there may be too little of the particular good produced. To the extent the export subsidy not only
transfers production from one company (country) to another but increases overall production, there may be
a global benefit.

\textsuperscript{35} Sykes (2003), p. 9.
The search for a mechanism to discipline export subsidies dates back to the early 1950s. The 1947 GATT created few substantive rules governing subsidies, although Article VI did permit countervailing duties as a response. However, countervailing duties were authorized only when subsidized imports caused material injury to the importer’s competing domestic industry. Amendments to the GATT in 1955 introduced the first rules on export subsidies. For non-primary goods, Article XVI provided that parties should cease to grant subsidies on exports if the subsidy would result in the export price being lower than the domestic price. For various reasons, few countries were prepared to accept the declaration implementing these provisions, so these commitments were binding on only a few GATT contracting parties. GATT contained no specific enforcement mechanism relating to export subsidies.

Negotiations in the Tokyo Round resulted in a 1979 Subsidies Code, the “first general comprehensive multilateral discipline of the use of subsidies.” This agreement established two tracks. Track I governed unilateral responses to subsidies (countervailing duties), but did not clearly define a countervailable subsidy. Track II prohibited the granting of export subsidies on non-primary products and requested that signatories not use export subsidies on primary products to increase their share of world trade beyond what was equitable. The Code did not contain a precise definition of what constituted an export subsidy. Instead an annex to the Code contained an Illustrative List of Export Subsidies describing practices that were deemed to be export subsidies. Track II sets out a procedure for consultations, adjudication by a Panel, and the possible authorization of countermeasures by a Committee on Subsidies and Countervailing Measures.

This framework proved only modestly effective and by the end of Uruguay Round negotiations in 1994, only twenty-four countries had ratified the Tokyo Round

36 See Jackson (1997) at 285-293.
37 See Jackson (1997) at 286.
38 Jackson (1997) at 288.
40 Trebilcock and Howse (2005) at 266.
Because of the weaknesses in this system, the Uruguay Round included negotiations over new subsidies rules. These negotiations resulted in the SCM Agreement to which all WTO members are parties.

(b) The WTO Framework on Export Subsidies

The SCM Agreement divides subsidies into three categories: prohibited, actionable and non-actionable. Subsidies contingent on export performance, along with import-substitution subsidies, are expressly prohibited. Other subsidies are subject to less stringent disciplines. Actionable subsidies are non-agricultural subsidies that are “specific” and cause “adverse effects” to the interests of another member. In the case of actionable subsidies, the subsidizing member can be required to remove the adverse effects or withdraw the subsidy or, alternatively, the member claiming injury can impose countervailing duties against the subsidizing member. Finally, the SCM Agreement initially recognized a category of non-actionable subsidies that included certain subsidies for research and development, regional development and environmental upgrades to existing facilities. However, this non-actionable category expired in 2000.

There are a few provisions in the SCM Agreement central to the analysis of export subsidies. Article 1 defines the term “subsidy”. Article 3.1(a) explicitly prohibits subsidies contingent, in law or in fact, on export performance. Annex I complements this

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41 Jackson (1997) at 290.

42 SCM Agreement, Article 3 states: “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 fact, whether solely or as one of several 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.” [footnotes omitted]

43 As discussed below, the term “specific” is poorly defined in the SCM Agreement but is intended to capture subsidies targeted at a relatively narrow range of firms or industries (Articles 1 and 2). “Adverse effects” include injury to another member’s domestic industry, nullification or impairment of benefits under the GATT 1994, and serious prejudice to the interests of another member, as defined in Article 6 of the SCM Agreement. See SCM Agreement, Art. 5.

44 SCM Agreement, Article 7.8.

prohibition with an Illustrative List of governmental actions that are deemed to be export subsidies. Finally, Article 4 creates an expedited process for dispute resolution, which, under Article 4.7, leads to a mandatory requirement of withdrawal of subsidies found to be prohibited. These provisions and the jurisprudence surrounding them will be examined in detail later in this paper.

This framework applies “except as provided in the Agreement on Agriculture.” Unlike the SCM Agreement, the Agreement on Agriculture authorizes some export subsidies, subject to reduction commitments. These subsidies must be disclosed in the subsidizing member’s schedule to the Agreement. The Agreement prohibits export subsidies used to circumvent these commitments. While this paper focuses on non-agricultural subsidies, the Appellate Body has found at times that certain substantive requirements (such as export contingency) are the same under both Agreements. The jurisprudence under the Agreement on Agriculture can therefore sometimes be relevant to the analysis of the SCM Agreement and will be discussed below where relevant.

One final provision is important to mention at the outset. Article 27 of the SCM Agreement exempts developing country members from the prohibition on export subsidies. The developing countries listed in Annex VII are exempt until they achieve

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46 The Uruguay Round Illustrative List is substantially identical to the Illustrative List in the Tokyo Round Subsidies Code.

47 SCM Agreement, Art. 3.1.


49 Agreement on Agriculture, Arts. 3.3 and 10.

50 Agreement on Agriculture, Art. 10.1.


52 Conversely, the SCM Agreement is relevant in the agricultural context: the Appellate Body has stated that it is erroneous judicial economy for a Panel not to consider parties’ SCM Article 3 claims even if the Panel has already made a determination under the Agreement on Agriculture. European Communities - Export Subsidies on Sugar (Complaints by Thailand, Brazil and Australia) (2004), WTO Doc. WT/DS283/AB/R (Thailand) / WT/DS266/AB/R (Brazil) / WT/DS265/AB/R (Australia) at para. 335 (Appellate Body Report).
export competitiveness in a product, at which point they are required to phase out export subsidies for that product over a period of eight years. Other developing countries were given eight years from the date of entry into force of the WTO Agreement (1995) to phase out their export subsidies. For those countries, the exemption has now expired. In the one case involving export subsidies where the respondent country sought to rely on this exemption, the Appellate Body upheld the Panel’s ruling that the exemption did not apply.\footnote{Brazil – Export Financing Programme for Aircraft (Complaint by Canada) (1999), WTO Doc. WT/DS46/R at para. 7.86 (Panel Report) and Brazil – Export Financing Programme for Aircraft (Complaint by Canada) (1999), WTO Doc. WT/DS46/AB/R at para. 164 (Appellate Body Report).} Brazil had increased the level of its export subsidies in violation of Article 27.4, so the general Article 3.1(a) prohibition on export subsidies was held to apply to Brazil.\footnote{Article 27.4, which provides for the gradual phasing out of developing country export subsidies, prohibits developing country members from increasing the level of their export subsidies.}

IV WHAT IS AN EXPORT SUBSIDY?
A key issue that arises from the SCM Agreement is how to identify an export subsidy. As noted above, separating export subsidies from other types of subsidies is important because export subsidies are prohibited per se while other types are merely actionable (requiring evidence of specificity and some form of harm to be successfully challenged). This Part discusses three questions central to identifying export subsidies. First, does the government action fall within the general definition of a “subsidy” under the SCM Agreement? Second, if so, is the subsidy “contingent on export performance”? Finally, is the enabling domestic legislation mandatory or discretionary – that is, does it require that the government provide a prohibited export subsidy or is such a subsidy merely a possibility within the discretion of the government? Each of these questions will be discussed in turn.

(a) What is a “Subsidy”?
Article 1.1 of the SCM Agreement sets out the operative definition of a subsidy:

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 (referred to in this Agreement as “government”), i.e. where:

(i) a government practice involves a direct transfer 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 GATT 1994;

and

(b) a benefit is thereby conferred.

For a measure to be classified as a subsidy under the SCM Agreement, it therefore needs to satisfy two main requirements: firstly, there must be a financial contribution by a government or public body; secondly, a benefit must be conferred.

The various elements of the financial contribution requirement are relatively straight-forward and have not been the source of extensive controversy, particularly in export subsidy cases. The definition is very broad and encompasses most government action that would be considered subsidies. One contentious issue has been the term “otherwise due” discussed in the various United States – Foreign Sales Corporations cases. The difficulty is finding an appropriate baseline – should “otherwise due” be seen in reference to what other countries generally do or solely in reference to other actions of the member whose actions have been challenged? The Appellate Body stated that “otherwise due” meant revenue that would otherwise be taxed by the member state but

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for the contested measure – that is, the baseline is the actions of the particular member not other states.\textsuperscript{56}

The definition of “benefit” is more problematic. Sykes argues that it is difficult to define a subsidy other than in theory. While in theory a subsidy is a government measure that changes the market equilibrium, there is no pure market equilibrium that exists without government intervention.\textsuperscript{57} Any pure definition of subsidy therefore should take account of all government action (including all other subsidies and taxes) to determine whether the measure is distortionary (which is an unrealistic standard) and a subsidy should only be found where the action has an impact on the subsidized industry’s production levels.\textsuperscript{58}

The Appellate Body in \textit{Canada – Aircraft}, an early case on export subsidies, held that a financial contribution will only confer a benefit if it was provided on terms more advantageous than those the recipient could have obtained on the market.\textsuperscript{59} This approach is administratively simple as the existing market provides a straightforward comparator. However, it catches actions which may merely off-set other government measures (such as taxes or regulations) rather than provide any advantage. This definition of benefit therefore appears overly-broad. For domestic (non-export) subsidies, such an off-setting effect may be seen to be part of an effort to adjust for a market failure (by, for example, providing subsidies to environmentally friendly industries that off-set subsidies to more harmful industries).\textsuperscript{60} However, there is, in principle, no reason to provide such subsidies contingent on export, rather than have these subsidies available for all products that are potentially disadvantaged through other government measures.\textsuperscript{61} An overbreadth in the definition of “benefit” therefore seems


\textsuperscript{57} Sykes (2003).

\textsuperscript{58} Sykes (2003).

\textsuperscript{59} \textit{Canada – Measures Affecting the Export of Civilian Aircraft (Complaint by Brazil)} (1999), WTO Doc. WT/DS70/AB/R at paras. 149-161 (Appellate Body Report).

\textsuperscript{60} For a discussion of this over-breadth in the context of domestic environmental subsidies, see Green (2006).

\textsuperscript{61} Sykes (2003).
acceptable if the export contingency requirement (discussed in the next section) appropriately separates export from domestic subsidies.\textsuperscript{62}

Further, the use of the market as a comparator for whether a benefit has been conferred captures actions which may have no actual impact on exports of the subsidized firm. The “subsidy” under this definition may have no actual impact on export levels or costs of production and yet be potentially prohibited (e.g., a subsidy for decommissioning a hazardous plant).\textsuperscript{63} In one sense, the government measure should decrease the costs (and increase the production) of the subsidized good in order to have the negative efficiency impacts discussed in Part II. However, this is not necessarily the case. A threat of a production benefit may be sufficient to deter investment by foreign competitors under strategic trade theory. The actual impact on production and costs is therefore less of a concern for export subsidies than potentially is the case for domestic subsidies.

There is one further issue that arises under Article 1. Article 1.2 of the SCM Agreement requires that a measure be “specific” in order to fall within the terms of the SCM Agreement. While the SCM Agreement does not clearly define the term “specific”, it states that a subsidy must be specific to “certain enterprises” which includes “an enterprise or industry or group of enterprises or industries”.\textsuperscript{64} This specificity requirement is intended to capture subsidies that are targeted at a few industries and to exclude generally available government-provided benefits such as transportation infrastructure or public education. In part, this requirement is intended to identify distortionary or protectionist measures. Broad-based measures are argued not to cause distortion as any effects are spread across the whole economy and, given their non-targeted nature, to be less likely to be protectionist (that is, less likely to be the result of interest group pressure).\textsuperscript{65}

\textsuperscript{62} The export contingency requirement is discussed in Part IV(b) below.

\textsuperscript{63} Sykes (2003), p. 20-1.

\textsuperscript{64} SCM Agreement, Article 2.

However, the SCM Agreement deems all prohibited subsidies (including export subsidies) to be specific. The result is that all export subsidies fall within the terms of the SCM Agreement even if they would not otherwise be “specific”. This deemed specificity reflects a consistent concern about distortion and protectionist action. As discussed in Part II, export subsidies in general are distortionary (on both a global and domestic level). Moreover, the most plausible general explanation for export subsidies is protectionism – the desire to promote domestic industry at the expense of foreign competitors. There is therefore no general reason to separate out more specific from more broadly based export subsidies. Specificity is thus not an issue in Art. 3.1(a) export subsidy cases.

The definition of subsidy under the SCM Agreement therefore is very broad, capturing a wide range of government measures (whether specific or not) that provide any advantage relative to the market. For domestic (non-export) subsidies, this definition seems overly broad. However, for export subsidies, the potentially over-breadth is less of a concern as it responds to the concerns about the distortionary or protectionist nature of export subsidies. A key issue then is whether the SCM Agreement adequately separates domestic subsidies from export subsidies.

(b) Is the Subsidy “Contingent … upon Export Performance”?

In order for a subsidy to be prohibited as an export subsidy, it must fall within the scope of Article 3.1(a), which prohibits “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”. Contingency on export performance can be demonstrated in two ways: either de jure or de facto. In Canada – Aircraft, its first decision involving this issue, the Appellate Body explained that the word “contingent” expresses a single legal standard.

principled justification for a subsidy exists, it will likely arise narrowly and case-by-case, so that the policy response will often appear specific” (p. 20)) and that relatively broadly applicable measures may be protectionist such as subsidies to the entire agricultural sector) (Sykes (2003) and W. Wilcox, “GATT-Based Protectionism and the Definition of a Subsidy” (1998) 16 Boston University International Law Journal 129).

66 Art. 2.3.
Contingent means conditional or “dependent for its existence on something else”. The difference between *de jure* and *de facto* contingency lies in the evidence that is used to demonstrate this relationship. In the *de jure* case, contingency is “demonstrated on the basis of the words of the relevant legislation, regulation or other legal instruments”. In *Canada – Autos*, the Appellate Body added that *de jure* contingency does not have to be set out expressly, but can also be derived by necessary implication from the terms of a legal instrument. Accordingly, it upheld a finding that ratio requirements for duty-free imports of motor vehicles constituted a *de jure* export subsidy.

As the Appellate Body acknowledged in *Canada – Aircraft*, *de facto* contingency, which seeks to prevent circumvention of the prohibition against *de jure*-contingent export subsidies, is more difficult to establish. The Appellate Body attempted to articulate a standard beginning with footnote 4 of the SCM Agreement, which specifies some requirements for contingency “in fact”. Footnote 4 states “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.” The Appellate Body held that *de facto* contingency requires that three

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70 *Canada – Certain Measures Affecting the Automotive Industry (Complaint by Japan and the European Communities)* (2000), WTO Doc. WT/DS139/AB/R / WT/DS142/AB/R at paras. 106-109 (Appellate Body Report). The Canadian measure at issue allowed manufacturers who produced motor vehicles in Canada to import motor vehicles duty-free if the ratio of their sales in Canada to the ratio of their production in Canada met or exceeded a required ratio. In the Panel and Appellate Body’s view, this implied that the only way for a manufacturer to increase the amount of duty-free imports it was entitled to was to export more cars produced in Canada. That made the subsidy contingent on exports (see paras. 103-4).

different elements from footnote 4 be demonstrated: “the *granting* of a subsidy”, “*tied*... to...” and “actual or anticipated exportation or export earnings.”

“The *granting* of a subsidy” implies a focus on the granting authority. The granting authority must have imposed a condition based on export performance. Since the prohibition is against *granting* subsidies, not against *receiving* them, the Appellate Body explicitly rejected arguments that the contingency analysis should focus on the reasonable knowledge of the recipient.

“The *tied to*” refers to the relationship between the granting of the subsidy and actual or anticipated exports. This relationship must be one of conditionality or dependence. The Appellate Body stated that it is not enough that a subsidy was granted in anticipation of exports, although the export-orientedness of the recipient’s business may be one of the factors to be taken into consideration. The granting of the subsidy must have been tied to (or contingent upon) actual or anticipated exports. The Appellate Body did not elaborate on this distinction, except for linking it to the second sentence of footnote 4 which it viewed as a specific expression of the “tied to” requirement.

“Anticipated” implies that exports were expected. The Appellate Body stated that there must be an examination based on objective evidence to determine whether exports were anticipated or expected. This is a separate inquiry from that conducted to determine whether a subsidy is *tied to* actual or anticipated exports. The Appellate Body

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75 The second sentence in footnote 4 reads “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.”


http://law.bepress.com/alea/17th/art9
seemed concerned about relying on the granting authority’s claims about its expectations of exports; this seems like a natural extension of its concerns about circumvention.\textsuperscript{77}

The earlier Panel decision in \textit{Australia – Automotive Leather} had reached a result that is consistent with this standard.\textsuperscript{78} In that case, the Panel found that grants conditional on the subsidized company achieving a level of production that was only possible through increased exports were contingent on exports. Conversely, it held that a loan to the parent company that could be repaid using revenue from any of its subsidiaries was not contingent on exports.

This methodology generally reflects an attempt to balance the purpose of the \textit{de facto} standard with the provision in footnote 4 that a subsidy to an exporter is not, by that fact alone, an export subsidy. However, while the Appellate Body has been fairly clear on what facts do not alone establish \textit{de facto} contingency, it has been far less precise about what \textit{does} establish \textit{de facto} contingency. Indeed, in \textit{Canada – Aircraft}, it cautioned that “there can be no general rule as to what facts or what kinds of facts must be taken into account.”\textsuperscript{79} While with \textit{de jure} contingency a single document will usually be determinative of contingency, in the \textit{de facto} situation the Appellate Body favours a more holistic approach. The use of this approach may reflect a concern that a very precise standard of \textit{de facto} contingency would defeat the anti-circumvention purpose.

An interesting question has arisen in cases where the challenged measure is part of a larger framework of subsidies. In the Article 21.5 compliance proceedings in \textit{U.S. – Foreign Sales Corporations}, the Appellate Body considered a tax exemption that was available both for property produced within the United States and held for use outside the United States and for property both produced and held for use outside the United States. The Appellate Body separated the two circumstances, finding that the export contingency

\textsuperscript{77} It is important to remember that the Appellate Body considered that the purpose behind the \textit{de facto} contingency language was to prevent circumvention of the \textit{de jure} prohibition; just as it is worried that legal instruments could mask the export contingency of a subsidy, it could have been concerned that granting authorities might mask anticipation of exports.

\textsuperscript{78} \textit{Australia – Subsidies Provided to Producers and Exporters of Automotive Leather (Complaint by the United States)} (1999), WTO Doc. WT/DS126/R at paras. 9.71, 9.74 (Panel Report).

\textsuperscript{79} \textit{Canada – Measures Affecting the Export of Civilian Aircraft (Complaint by Brazil)} (1999), WTO Doc. WT/DS70/AB/R at para. 169 (Appellate Body Report).
in the first circumstance had no bearing on whether the second circumstance created an export contingency.  

A similar situation arose in *U.S. – Cotton*. The United States’ Step 2 program provided subsidies both for export and for the domestic use of U.S.-grown cotton. The United States argued that, since payments were also available to domestic users, the whole Step 2 program was not contingent on exports. The Panel observed that the subsidy for domestic use was an import substitution subsidy prohibited by the SCM Agreement (under Art. 3.1(b)). It stated that joining two prohibited subsidies within a single measure could not somehow “unprohibit” these subsidies – “two wrongs cannot make a right.” The Appellate Body upheld the Panel’s findings, citing its previous holding from *United States – Foreign Sales Corporations (Article 21.5)* that "the fact that the subsidies granted in the second set of circumstances might not be export contingent does not dissolve the export contingency arising in the first set of circumstances". 

The Illustrative List (Annex I to the SCM Agreement) provides examples of practices that are deemed to be export subsidies. As Article 3.1 refers to subsidies contingent on export performance as “including those illustrated in Annex I”, the Illustrative List is not to be read as an exhaustive list of prohibited subsidies. Measures

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explicitly prohibited by the Illustrative List include direct export-contingent subsidies\textsuperscript{87}, discounted domestic shipping on export shipment\textsuperscript{88}, various forms of preferential tax treatment for exports\textsuperscript{89}, and the provision of export credit at below-market rates\textsuperscript{90}.

As well as using the Illustrative List to identify prohibited export subsidies, members have invoked it in two different ways to defend measures that would \textit{prima facie} be prohibited. First, they have argued that a particular item in the Illustrative List, by setting out certain requirements for a particular type of prohibited subsidy, implicitly permits subsidies of that nature that do not meet that requirement. Second, members have argued that a particular measure fits within the subsidies explicitly allowed in the Illustrative List.

Several respondent countries have attempted the first (\textit{a contrario}) interpretation of the Illustrative List, arguing that because a particular measure does not meet one of the requirements stated in the relevant item of the Illustrative List, it is not prohibited. This use of the Illustrative List as an affirmative defence has been unsuccessful. Brazil, in its defence of its PROEX export subsidy program, contended that PROEX was not prohibited as it did not provide a “material advantage” as required by item (k) of the Illustrative List.\textsuperscript{91} The Appellate Body rejected this argument because Brazil had not provided sufficient evidence to make a \textit{prima facie} case supporting its contention in light of the Appellate Body’s standard for material advantage.\textsuperscript{92} The Appellate Body thereby

\textsuperscript{87} Annex I, item (a).

\textsuperscript{88} Annex I, item (c).

\textsuperscript{89} Annex I, items (e), (f), (g) and (h).

\textsuperscript{90} Annex I, items (j) and (k).

\textsuperscript{91} The first paragraph of item (k) prohibits “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, \textit{in so far as they are used to secure a material advantage in the fields of export credit terms}.” (Emphasis added)

\textsuperscript{92} Brazil – Export Financing Programme for Aircraft (1999), WTO Doc. WT/DS46/AB/R at para. 184 (Appellate Body Report). It was agreed that, as the party raising the affirmative defence, \textit{it was up to Brazil to make a prima facie case supporting its alleged defence.} Brazil would have had to show that the
avoided addressing the broader question of the availability of *a contrario* interpretations.\(^9^3\)

In the subsequent Article 21.5 proceeding, Brazil argued that its revised program did not provide a material advantage. The Panel explicitly rejected the use of item (k) as an affirmative defence.\(^9^4\) In its subsequent analysis, however, the Appellate Body was again able to reach a decision without considering the availability of item (k) as an affirmative defence. It thus deemed the Panel’s finding on this question to be “moot, and thus, … of no legal effect.”\(^9^5\) When this issue arose again in the second Article 21.5 proceeding in this dispute, the Panel referred to its earlier decision on the question and adopted its previous reasoning.\(^9^6\) More recently, the Panel in *Korea – Vessels* again rejected an *a contrario* interpretation of item (k) as well as of item (j).\(^9^7\)

Panels have therefore tended to treat *a contrario* interpretations of items in the Illustrative List as unavailable, although the Appellate Body has not examined this issue. This position is consistent with a broad interpretation of export contingency. It also comports with the language of Article 3.2 of the SCM Agreement which implies that the Illustrative List is not exhaustive.\(^9^8\)

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\(^9^7\) *Korea – Measures Affecting Trade in Commercial Vessels (Complaint by the European Communities)* (2005), WTO Doc. WT/DS273/R at paras. 7.310 and 7.207 (Panel Report). Item (j) prohibits “the provision by governments (or special institutions controlled by governments) of export credits guarantee or insurance programmes, of insurance or guarantee programmes against increases in the cost of exported products or of exchange risk programmes, at premium rates which are inadequate to cover the long-term operating costs and losses of the programmes.” Korea argued its program was charging premium rates which were adequate to cover its long-term operating costs and losses.

As noted above, in addition to a contrario interpretations, respondent countries have also sought to rely on the specific exceptions in the Illustrative List. As provided for by footnote 5 of the SCM Agreement, the Illustrative List expressly permits some measures that might otherwise be deemed to be export subsidies.\footnote{Footnote 5 specifies that “Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.”} Panels and the Appellate Body have generally interpreted these exemptions narrowly. For example, item (e) of the Illustrative List prohibits “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.” However, footnote 59 states that item (e) of the Illustrative List 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 sought to rely on footnote 59 to defend tax exemptions for exporters that it argued were necessary because the United States’ use of a worldwide income-based tax system created a competitive disadvantage for its exporters. The Appellate Body rejected this argument in the Article 21.5 proceeding in \textit{United States – Foreign Sales Corporations}.\footnote{The item (e) argument had been made to the Appellate Body in the first \textit{United States – Foreign Sales Corporations} proceeding, but as it had not been submitted to the Panel, the Appellate Body refused to consider it. See \textit{United States – Tax Treatment for “Foreign Sales Corporations” (Complaint by the European Communities)} (2000), WTO Doc. WT/DS108/AB/R at para. 103 (Appellate Body Report).} For the Appellate Body, this provision is restricted to measures that exempt from taxation income actually earned through foreign activities that might form a basis for taxation by a foreign state, which was not the case with the challenged American Extraterritorial Income Exclusion (ETI) Act.\footnote{For a summary of the Appellate Body’s analysis, see Robert E. Hudec, “Industrial Subsidies: Tax Treatment of ‘Foreign Sales’ Corporations” in Ernst-Ulrich Petersmann and Mark A. Pollack, eds., \textit{Transatlantic Economic Disputes: The EU, the US, and the WTO} (Oxford: Oxford University Press, 2003) 175 at 201-202.}

Similarly, panels have read relatively narrowly the second paragraph of item (k) of the Illustrative List which is an important exemption relied on in several disputes involving export subsidies. It states that export credit practices in conformity with the interest rates provisions of an international undertaking on official export credits (or its successor) to which at least twelve original Members to the SCM Agreement are parties...
as of 1 January 1979 are not to be considered a prohibited export subsidy. After several other item (k) arguments had been rejected, Brazil successfully convinced a Panel that its revised PROEX III export subsidy program could be administered in compliance with the interest rate provisions of the *OECD Arrangement* and thus managed to take advantage of this safe haven.

However, in *Canada – Export Credits for Aircraft*, the Panel examined whether the second paragraph of item (k) allowed Canada to match export credits offered by Brazil that derogated from the *OECD Arrangement*. It concluded that the matching of a derogation, while permitted under the *OECD Arrangement*, was not in conformity with the *Arrangement*’s “interest rates provisions”

104 Therefore, this matching fell outside of the second paragraph of item (k) and constituted a prohibited subsidy under the SCM Agreement. The Panel justified its conclusion by relying on a general prohibition against self-help in the WTO system. Its reasoning has been called “clearly erroneous” by commentators who point out that the WTO system, instead of prohibiting self-help, implicitly permits it by allowing states to take unilateral countervailing measures against prohibited subsidies.

Panels and the Appellate Body have therefore fairly broadly interpreted the export contingency requirement under the SCM Agreement. Article 3.1(a) already has a wide ambit on its face as it captures both de jure and de facto contingency. This wording has

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103 *Brazil – Export Financing Programme for Aircraft – Second Recourse by Canada to Article 21.5 of the DSU* (2001), WTO Doc. WT/DS46/RW/2 at para. 5.207 (Panel Report). The PROEX III program could also be administered in ways that were not compliant with the *OECD Arrangement*, but under the mandatory/discretionary distinction, which is discussed subsequently, that is not relevant.


been made more inclusive with the contextual reading of the de facto contingency requirement and the use of the Illustrative List in a manner which allows a wider reach for the prohibition. This broad interpretation is consistent with the view of the prohibition as an attempt to resist political pressure since it aims at prevention of even hidden forms of protectionism. It also is consistent with the view that export subsidies are globally inefficient as it requires a close tie between the subsidy and exports in an attempt not to capture domestic subsidies that may be legitimate. At the same time, it allows panels to examine the actual measures closely to determine if the respondent country is cheating on its commitment. The desire to identify cheating comports with the view that exporting countries may be trying to use the prohibition to further their own welfare either by restricting the supply of the good or by overcoming the prisoners’ dilemma arising under strategic trade theory. Under such a view, each country has an incentive to attempt to cheat on its commitment and obtain added benefits of the arrangement at the expense of other exporters. The wording of the SCM Agreement and its interpretation lacks clarity in many respects (and could potentially be improved with a bright line (though somewhat arbitrary) rule such as, for example, where some high percentage (e.g., 80%) of the output of an industry is exported and subsidized, the measure is deemed to be an export subsidy regardless of any de jure or de facto export contingency analysis). However, the export contingency requirement seems generally to be consistent with both the positive and normative reasoning behind the prohibition.

(c) Is the Enabling Legislation Mandatory or Discretionary?
While panels and the Appellate Body have adopted a rather broad definition of export contingency and a very narrow interpretation of subsidies explicitly permitted under the Illustrative List, they have been willing to rely on another principle to avoid finding measures to be in violation of the SCM Agreement’s prohibition on export subsidies: a
long-standing\textsuperscript{107} distinction in public international law and GATT/WTO law between mandatory and discretionary measures.\textsuperscript{108}

Mandatory legislation requires the government of the member state to violate its WTO obligations. Mandatory measures can be challenged as such - if a panel finds a measure to be mandatory, then it can require that that measure be withdrawn. Legislation that grants a member government discretion as to whether or not to apply it consistently with its WTO commitments is described as discretionary. Discretionary measures can only be challenged as applied - the complaining member must prove that these measures have been applied in a way that contravenes the WTO Agreements.

The use of this distinction in WTO export subsidy jurisprudence dates back to one of the first cases, \textit{Canada – Aircraft}. In that case, the Panel used the distinction to reject Brazil’s assertion that Canada’s EDC programme was a \textit{per se} prohibited export subsidy.\textsuperscript{109} The Panel was unable to find evidence that EDC’s mandate required the grant of export subsidies, and therefore classified the EDC programme as discretionary legislation. The Panel then examined and rejected the claim that the EDC programme, as applied, provided prohibited export subsidies.

In the \textit{Canada – Aircraft} case, the Panel could successfully undertake this two-step analysis because EDC had operated for years and there was therefore available evidence as to its operation. However, the mandatory/discretionary argument in the second Article 21.5 compliance proceeding in \textit{Brazil – Export Financing for Aircraft} arose in a very different context. The Brazilian government’s PROEX export financing program had been deemed to be a prohibited export subsidy in two previous proceedings. Following these decisions, Brazil modified the program (now called PROEX III) such

\textsuperscript{107} For the history of this rule, see Kwan Kiat Sim, “Rethinking the mandatory/discretionary legislation distinction in WTO jurisprudence” (2003) 2 World Trade Review 33 at 8-21.

\textsuperscript{108} For a review of the use of this distinction in GATT/WTO law, see Sharif Bhuiyan, “Mandatory and Discretionary Legislation: The Continued Relevance of the Distinction under the WTO” (2002) 5 J. Int’l Econ. L. 571.

\textsuperscript{109} \textit{Canada – Measures Affecting the Export of Civilian Aircraft (Complaint by Brazil)} (1999), WTO Doc. WT/DS70/R at paras. 9.124-9.129 (Panel Report). Brazil alleged that Canada’s Export Development Corporation (EDC) was providing a variety of financial and risk absorption services, the combination of which made EDC itself an export subsidy programme. See \textit{Canada – Measures Affecting the Export of Civilian Aircraft (Complaint by Brazil)} (1999), WTO Doc. WT/DS70/R at paras. 6.1-6.2 (Panel Report).
that it was discretionary whether or not the financing would exceed what the previous Panels and the Appellate Body had said was acceptable under item (k) of the Illustrative List. The second 21.5 compliance Panel applied the mandatory/discretionary principle and found that PROEX III, as such, could be applied in conformity with the requirements of item (k), and therefore that it was not a prohibited export subsidy per se. Since there was no evidence relating to the actual application of PROEX III, the Panel ended its inquiry there. Canada would have to return to the WTO should the Brazilian authorities actually provide prohibited subsidies by exercising their discretion in the administration of PROEX III in a manner that exceeded what is permitted by item (k).

This dichotomy has been weakened in several cases not involving export subsidies. In US – Section 301, the Panel examined U.S. legislation that gave officials discretion to impose measures without following the procedures in the DSU Agreement. Given that the United States Trade Representative could nonetheless act in compliance with the DSU procedures, the United States sought to defend this by classifying it as discretionary legislation. The Panel disagreed. It found that some WTO obligations were such that they were violated by inconsistent discretionary legislation that, by its mere existence, had the potential to create a “chilling effect.” As the Panel decision was not appealed, this move away from a rigid application of the mandatory-discretionary dichotomy was not reviewed by Appellate Body.

The Appellate Body, in U.S. – Corrosion-Resistant Steel Sunset Review, which also did not involve export subsidies, stated that it saw “no reason for concluding that, in principle, non-mandatory measures cannot be challenged ‘as such’.” It added that it has not “been required to pronounce generally upon the continuing relevance or

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111 See, e.g., Kwan Kiat Sim, “Rethinking the mandatory/discretionary legislation distinction in WTO jurisprudence” (2003) 2 World Trade Review 33 at 48-50.


significance of the mandatory/discretionary distinction” but “caution[ed] against the application of this distinction in a mechanistic fashion.” Further, the Appellate Body appeared to adopt the more contextual approach of the Panel in US – Section 301 as it noted that “the import of the ‘mandatory/discretionary distinction’ may vary from case to case.” While the Panel in the latest export subsidy case, Korea – Vessels, reiterated a commitment to the traditional approach, the Appellate Body subsequently in U.S – Zeroing of Dumping Margins referred to its statement in U.S – Corrosion-Resistant Steel Sunset Review that “the import of the 'mandatory/discretionary distinction' may vary from case to case.”

It remains to be seen whether future Panels will continue to apply the mandatory/discretionary distinction rigidly, or whether they will follow the Appellate Body’s apparent move towards a more contextual approach. The purpose of the distinction is to respect states’ sovereignty by affording them a presumption of good faith in the application of legislation. Further, without such a distinction, states are exposed to spurious complaints. However, the contextual approach signaled by the Appellate Body is more consistent with the economic theory behind the export subsidy prohibition than is the former rigid classification. The contextual application of the distinction would require examination of the content and purpose of the obligation in issue as well as the purpose and effect of the challenged measure.

116 Korea – Measures Affecting Trade in Commercial Vessels (Complaint by the European Communities) (2005), WTO Doc. WT/DS273/R at paras. 7.60-7.67 (Panel Report).
118 Sim (2003), pp. 59 and 63.
In the context of export subsidies, the obligation is a prohibition on export subsidies which has as its apparent purpose the avoidance of trade distortions and protectionist measures (thereby potentially enhancing global welfare). The purpose could also be seen as overcoming a prisoners’ dilemma that fosters competing export subsidies. Either of these purposes would lead to a desire for a broad restriction on export subsidies including on discretionary legislation that may impact the actions of foreign producers. Strategic trade theory, in particular, is based not only on actual subsidies but also on the threat of subsidies that deter entry into a market. Discretionary legislation can impact behaviour through threats as well as actual action.\textsuperscript{120} Given this purpose, it seems reasonable for a complaining party to be able to raise the possibility that a discretionary measure, even though not yet applied, has a “chilling effect” that benefits the producers in the respondent member.

The contextual approach signaled by the Appellate Body accords with the purposes underlying the prohibition on export subsidies. The distinction between mandatory and discretionary legislation could be interpreted as a presumption in favour of the legitimacy of discretionary legislation subject to rebuttal by the complaining party based on a consideration of the purpose and effect of the measure.\textsuperscript{121} Such a presumption would aid in reducing colourable challenges and yet still allow challenges where the threat of subsidies has an impact on trade. As will be discussed in Part V, however, one of the major difficulties for both actual and potential measures that have been found to violate the prohibition is the appropriate remedy.

\section{Remedies}

Part IV examined how the SCM Agreement and its interpretation by panels and the Appellate Body have sought to identify prohibited export subsidies. In large measure, it found that the rules as written and interpreted are consistent with the theory behind export subsidies set out in Part II. While as we have seen, the identification of export subsidies

\textsuperscript{120} Sim (2003), p. 63-4 (citing a claim about section 301 of the US Trade Act of 1974 that it has an impact on foreign governments largely through the threat of its possible application).

\textsuperscript{121} Sim (2003), p. 59.
has been contentious, the remedies for violations of the prohibition have proven even more vexing, leading at times to a lack of compliance and multiple recourse to the DSB. This Part examines the three main types of remedies for violations of export subsidies: withdrawal of the subsidy, countermeasures and unilateral domestic measures.

Following Schwartz and Sykes, we will view WTO agreements as contracts and examine the remedies from the point of view of contractual remedies.\textsuperscript{122} In standard law and economics theory, the remedy for breach of contract should be sufficient to deter inefficient breach but not so large as to deter efficient breach (that is, where the benefit of the breach exceeds the costs arising from non-performance).\textsuperscript{123} Contracts can be enforced through liability rules which involve the breaching party paying the harmed party expectation damages. As expectation damages are in theory sufficient to place the harmed party in the position it would have been in had the contract not been breached, a party will only breach if it is efficient (the benefits of breach exceeds the value of the prior agreement). The difficulty with liability rules is determining the appropriate level of expectation damages and therefore creating the proper incentive for breach.\textsuperscript{124} Contracts can also be enforced through property rules – a requirement to perform (specific performance) subject to a very severe penalty.\textsuperscript{125}


\textsuperscript{124} See, for example, Pauwelyn (2006), Trachtman (2006) and Bagwell (2007).

\textsuperscript{125} This paper will discuss the alternatives of a property rule and a liability rule, although there is also the potential to view WTO remedies (and export subsidies rules in particular) as inalienable (see Pauwelyn (2006) for a discussion of inalienable rules, property rules and liability rules).
to be exact but to achieve efficient breach the parties need to renegotiate the contract which can involve significant transaction costs. As Schwartz and Sykes note, the property rule is in general preferable if breach is inefficient in all cases.¹²⁶

As noted in Part II, the prohibition on export subsidies can be viewed in a number of ways. First, it may be viewed as an agreement to prevent a measure that has negative global or domestic welfare effects. If export subsidies are globally or domestically inefficient in all cases, a form of property rule with a significant penalty may be optimal as it would deter breach. The question then becomes how to choose the level of penalty for breach. In theory, an optimal level of deterrence should take into account both the level of benefit from providing the export subsidy as well as the probability that the prohibited activity will be detected and punished. The member state would then compare the expected penalty (taking account of the probability of detection and punishment) and the expected benefit.¹²⁷ Second, the prohibition may be viewed as overcoming a prisoners’ dilemma between exporting members with enforcement designed to stop any cheating on the agreement. In such a case, there may be instances where breach is efficient, particularly if WTO agreements are seen as designed not to foster global welfare or even the welfare of domestic countries but the political interests of governments.¹²⁸ The concern for members then would be to determine the optimal level of remedy on the basis of expectation damages or to ensure that, if a property rule was used, the transaction costs of renegotiations were not so high as to preclude the efficient outcome. This liability rule would also be consistent with Janow and Staiger’s view that export subsidies may be globally efficient in some circumstances but are prohibited because the transaction costs of renegotiation in face of the subsidies or other responses

¹²⁶ This general description of the law and economics of contract remedies is based on Schwartz and Sykes (2002), pp. S181-3. See also Pauwelyn (2006) (arguing that international rules in general and most WTO rules in particular can and should be seen as default property rules) and Trachtman (2006).

¹²⁷ See, for example, Paulwelyn (2006), p. 57 (discussing property rules and “back up enforcement” in the international law context) and Trachtman (2006).

¹²⁸ See Schwartz and Sykes (2002) (arguing that WTO rules on dispute resolution “are explicable by this logic of joint political welfare maximization” where the political welfare is measured by political support for political officials (p. S180)).
are in general too high.\footnote{Janow and Staiger (2003). See discussion of the global welfare effects of exports subsidies in Part II.} As will be discussed, the remedy provisions of the SCM Agreement may reduce the transaction costs of responding to an export subsidy and therefore provide scope for separating efficient and inefficient subsidies. The following discussion will examine the three existing remedies in light of these basic ideas.

\textbf{(a) Withdrawal Without Delay}

Article 4.7 of the SCM Agreement states that “If the measure in question is found to be a prohibited subsidy, the panel shall recommend that the subsidizing Member withdraw the subsidy without delay.” The Panel is required to specify the time period within which the measure is to be withdrawn. Unfortunately, while it seems clear the agreement seeks rapid compliance with the prohibition, it has often not been clear what exactly withdrawing the subsidy actually entails. As a result, this question has motivated several Article 21.5 compliance proceedings.\footnote{Article 21.5 of the \textit{DSU} provides for disagreements about compliance with recommendations and rules to be decided by a Panel, preferably the original Panel.}

The Article 21.5 disputes concerning exports have proven very controversial, particularly the first of these proceedings, \textit{Australia – Automotive Leather}. In that case, the Panel required Australia to obtain repayment of the prohibited subsidy that the Australian government had provided to Howe, a manufacturer of automotive leather. A number of critical issues relating to the withdrawal remedy that arise out of the \textit{Automotive Leather} 21.5 decision have also arisen in subsequent cases. Firstly, is withdrawal to be interpreted as a retrospective or a prospective remedy? Secondly, how should pre-existing subsidy commitments be treated? Thirdly, are any obligations under domestic law to be taken into consideration?

\textbf{(i) Retrospective or Prospective Withdrawal?}

At first glance, the withdrawal of the subsidy should at least partially remove the benefit from the granting of the export subsidy. The company will be returned to its prior cost structure and any increase in production resulting from the subsidy should end. Both the protective and terms of trade impact of the export subsidy should cease. However, the
effect of the remedy is closely related to the issue of whether the withdrawal should be interpreted as retrospective or prospective. This issue arose in *Australia – Automotive Leather*, the third Panel decision involving export subsidies which, unlike the previous two (the disputes between Canada and Brazil over regional aircraft), was not appealed to the Appellate Body. While the dispute between Canada and Brazil went through the appeal process, the *Australia – Automotive Leather* dispute continued on to an Article 21.5 compliance proceeding – as a result, the Panel’s decision in that proceeding was the first Article 21.5 decision involving export subsidies.

Faced with the initial Panel order to withdraw the subsidy that had been found to be prohibited, Australia entered into an agreement with Howe. Howe repaid the part of the subsidy that the Australian government considered to be the “prospective element”. The government also terminated all existing obligations under the grant contract. In exchange, the government gave Howe’s parent company a new loan. The United States argued under Article 21.5 that this was insufficient and proposed an alternate formula for calculating how much Howe should repay based on the “prospective portion” of the subsidy. In addition, they alleged that the new loan was structured in a way that negated any financial impact on Howe from the repayment.

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131 *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States* (2000), WTO Doc. WT/DS126/RW at paras. 1.3-1.4 (Panel Report). The subsidy consisted of a grant contract that provided for three payments by the Australian government to Howe. The first payment was made upon signing the contract, while the two later payments were conditioned on Howe meeting targets. *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather* (1999), WTO Doc. WT/DS126/R at para. 9.62 (Panel Report). All three payments, including the first one, were found to be contingent on exports: *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather* (1999), WTO Doc. WT/DS126/R at paras. 9.71-72 (Panel Report).


133 A similar loan had been found not to be contingent on exports in the original Panel decision.

134 The “prospective portion” was calculated by estimating the value of the benefits that Howe would continue to receive after the Panel decision from the assets it invested in. See *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States* (2000), WTO Doc. WT/DS126/RW at para. 6.10 (Panel Report).

135 *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather – Recourse to Article 21.5 of the DSU by the United States* (2000), WTO Doc. WT/DS126/RW at para. 6.13 (Panel Report). The American argument was that the loan was such that, after using part of the loan to repay the required
Both of these approaches to remedies were entirely prospective; indeed, the Panel noted that “Australia, like the United States, contends that only a “prospective” remedy is envisioned under Article 4.7 of the SCM Agreement.” The Panel refused to limit itself to the arguments that the two countries had made. Instead, it examined what exactly withdrawal of the subsidy entails. In the Panel’s view, withdrawal is not limited to purely prospective actions, but may encompass repayment of prohibited subsidies. The Panel concluded that repayment of the entire subsidy at issue, though without interest, was required. Accordingly, it found Australia had not withdrawn the subsidy.

The decision in Australian – Automotive Leather was unexpected and several members reacted against it. When the Canada/Brazil regional aircraft dispute subsequently entered the Article 21.5 process, both countries were adamant that they were not seeking a retrospective remedy against the other. In addition, the European Communities made a third-party submission on this point. Using strong language, they criticized the Australia – Automotive Leather panel on two grounds. The first was procedural: they argued that the Panel should not consider alternatives beyond what the complaining party had raised. The second was substantive: they argued against the availability of retroactive remedies. In the Canada-Brazil aircraft case, the Article 21.5 Panels restricted their discussion to the prospective remedies discussed by the parties.

portion of the prohibited subsidies, Howe could conservatively invest the remainder of the loan at a rate of return that would enable it to repay the whole loan at maturity.


These remedies were essentially limited to ensuring that reforms made by both countries to their respective measures made those measures compliant with the SCM Agreement.\textsuperscript{141}

Subsequent Article 21.5 Panel and Appellate Body rulings have also limited themselves to prospective remedies, leading two commentators to conclude that “Canada’s comments […] – that the findings [in Australia – Automotive Leather] will be treated by WTO Members ‘as a one-time aberration of no precedential value’ – have therefore proved prophetic.”\textsuperscript{142} The requirement for remedies to be prospective currently appears to be solidly anchored in WTO law, notwithstanding the Australia – Automotive Leather anomaly.

The retrospective approach provides strong incentives to member states not to provide subsidies since they know that the recipient firm will not be able to keep the subsidy if it is successfully challenged through the WTO. It would have a dramatic impact in a case such as U.S. – Foreign Sales Corporations where billions of dollars of subsidies were granted to many recipients over an extended period of time. It also would discourage reliance on governmental measures with the potential of being deemed contingent on exports out of a well-founded fear that, years later, governments would be forced by the WTO to recover subsidies from firms or, even worse, export buyers. The use of a retrospective remedy would therefore align with a view of the prohibition on export subsidies as responding to negative global and domestic welfare effects. The penalty would be severe and therefore discourage their use.\textsuperscript{143}

The prospective remedy avoids these issues, but at a serious potential incentive cost. The reasoning of the Article 21.5 Panel in Australia - Automotive Leather is convincing in this regard - without retrospective remedies, nothing could be done in the

\textsuperscript{141} In the Brazil case, there were also issues relating to subsidies that Brazil had committed to provide before being ordered to withdraw the subsidies, but that had not been paid. These issues, which arose solely because a prospective approach was used, will be discussed below in Part (a) (ii).


\textsuperscript{143} There would, however, be other impacts such as potentially greater unwillingness of counties to enter into trade agreements (see, for example, Pauwelyn (2006)).
case of a one-time subsidy contingent on export performance. The prospective nature of the remedy therefore accords with a view of the prohibition and its remedy as providing scope for “efficient” breach where efficiency corresponds to the political interests of political officials rather than global or domestic welfare. The remedy allows for short term, one-time breaches but not on-going violations. It provides a form of political safeguard allowing governments to respond if necessary to significant interest group pressure but not over the long term. Each country appears to be willing to allow others to use this safeguard while reserving its own ability to do so, which may explain the “marked reluctance… of complainants to claim retrospective withdrawal”.

However, there is another concern about this remedy. In cases where the impact of the export subsidy is to increase the country’s share of the export market (rather than provide the subsidized firm with control of the market as under strategic trade theory), the ‘prospective’ interpretation of withdrawal of the subsidy may eliminate the impact going forward, although not the impact in the past. However, if the impact was to deter entry of foreign competitors and provide a first-mover advantage to the subsidized industry, removal of the subsidy would not have an impact. The damage would already have been done and the subsidized industry would have control of the market. The prospective remedy therefore would not respond to the prisoners’ dilemma arising from strategic trade theory as the subsidy that gives rise to the harm (the diversion of trade from the initial subsidy) is not eliminated.

As a result, the prospective interpretation of the requirement to remove the subsidy without delay points towards the remedy for export subsidies being a liability rule tied to the political interests of governments. It ensures that the remedy for the


145 See Trachtman (2006) (arguing that prospective remedies are too low to be a welfare-based remedy).


147 See, for example, Schwartz and Sykes (2002) (arguing that WTO rules should be seen as liability rules) and Trachtman (2006). But see Pauwelyn (2006) (arguing that the WTO rules should not necessarily be seen as liability rules) and Nzelibe (2007).
violation is not too severe – including potential bankruptcy of the industries involved. It creates an incentive for short-term efficient breach (a form of political safeguard subject only to informal sanctions such as the international reputation of the subsidizing government) but not for on-going violations.\textsuperscript{148} It may also allow scope for good faith differences in opinion about interpretations of the SCM Agreement.\textsuperscript{149} Unfortunately, such an interpretation does not eliminate the use of export subsidies for strategic trade purposes. If the concern was with the negative effects of the export subsidies on global and domestic welfare (including the elimination of strategic trade measures), the remedy would be retrospective. Such a rule would make the remedy more akin to a property rule as the penalty could conceivably be very high. However, such a remedy is likely politically infeasible, particularly in the case of large subsidies to important domestic industries such as commercial aircraft.

(ii) Pre-Existing Commitments

Often there is a delay between the time when a legal entitlement to a subsidy is created and the time that the subsidy is actually paid out. In the meantime, a Panel’s recommendation to withdraw the subsidy could be adopted. In Australia – Automotive Leather, this was not an issue because the last payment was made in July 1998 while the Panel report was issued in May of the following year.\textsuperscript{150} Even if payments had been scheduled for later, the broad retrospective remedial approach adopted by the Panel would have led to the result that, if past payments had to be returned, no future payments could be made. With the more common prospective interpretation of withdrawal, however, this timing issue can become significant.

The prohibition on export subsidies (Art. 3.2) states that a “Member shall neither grant nor maintain [prohibited] subsidies.” Article 4.7, when read within the context of

\textsuperscript{148} There is the potential for other sanctions from non-compliance with WTO rules including reputation. See Pauwelyn (2006) (discussing the “community costs” of non-compliance with international law which include reputation) and Trachtman (2006) (discussing the effect of reputation).


\textsuperscript{150} Australia – Subsidies Provided to Producers and Exporters of Automotive Leather (1999), WTO Doc. WT/DS126/R at para. 2.3 (Panel Report).
the entire Article 4, requires that members that are found to have granted or maintained prohibited subsidies withdraw these measures without delay. A prospective remedy implies that subsidies granted (or maintained) prior to the deadline set by the Panel under Article 4.7 are unaffected, but that the member state must not grant further subsidies after that date. A question that arises therefore is when is a subsidy is actually "granted"? Is it when the legal entitlement to it is created, or is it when the subsidizing state actually pays the subsidy?

This question was tangentially examined in *Australia – Automotive Leather* in the context of a procedural argument. As the final payment had been made after the Panel had been established, Australia sought to have it excluded from the Panel’s terms of reference.\(^{151}\) The Panel rejected this argument and stated that the government’s commitment to make payments constituted part of the grant of the subsidies.\(^{152}\) In this factual context, that reasoning was sensible and allowed for the inclusion in the Panel’s terms of reference of something that common sense would dictate should be included.

In the *Brazil – Export Financing for Aircraft* case, the factual situation was substantially different. Under Brazil’s PROEX program, prior to concluding a formal agreement with a buyer, Embraer would submit details of the proposed transaction to the committee administering PROEX.\(^{153}\) The committee would issue a letter of commitment to Embraer committing the government of Brazil to providing support provided that the sales contract was entered into in the subsequent ninety days. After an aircraft is delivered (exported) and paid for, bonds are issued by the Brazilian National Treasury through the Banco de Brasil (the Brazilian central bank) to the bank that is financing the transaction.

Under this structure, a number of years could elapse between the time the Brazilian government makes the commitment and the issuance of the bonds that make up

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the actual subsidy. An additional complication is that the bonds are issued directly to the buyer’s bank or its Brazilian agent, not to Embraer. A prospective remedy would not affect the bonds that have already been issued and withdrawing the subsidy implies not issuing further letters of commitment. It is not, however, as obvious what happens in the case where the Brazilian government has committed to providing these bonds, but has not actually done so and may not do so for years.

This situation was examined by the Panel and the Appellate Body in the first Article 21.5 compliance proceeding. The Panel observed that, in the previous proceedings, the Appellate Body had said that, for the purposes of Article 27.4 (the developing country exemption), PROEX subsidies were granted when the bonds were issued. Despite Brazil’s objections that applying this interpretation would constitute a retrospective remedy and that it would raise issues within domestic law, the Panel concluded that for Article 3.2 purposes, the subsidies were granted when the bonds were issued. Accordingly, the Panel found that by continuing to issue bonds under letters of commitment issued prior to the Panel decision, Brazil had not withdrawn the subsidy. The Appellate Body upheld this conclusion, although it did not discuss the Panel’s reasoning. The Appellate Body’s approach was simpler: PROEX had been found to be a prohibited export-contingent subsidy. Withdrawing such a subsidy, for the AB, entailed not making any additional payments under the prohibited program. Issuance of the bonds constituted payments under the program after the date by which Brazil was required to withdraw its subsidy, and thus Brazil was not in compliance.

Brazil did not comply with this recommendation and countermeasures were authorized. Brazil’s reluctance to comply is understandable: not only are there potential domestic civil liability issues, which will be discussed in the subsequent section, but the structure of the program makes it difficult for Brazil to comply. Given that the Brazilian government paid the bonds directly to the purchaser’s bank and not to Embraer, either the purchaser or its bank (depending on the legal arrangements between them) would have to

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absorb the loss of the subsidy should the Brazilian government not issue the bonds.\textsuperscript{156}

Brazil’s defence in the initial proceeding was that its subsidies were needed to offset a negative perception of Brazil and “Brazil risk” in world capital markets. Causing international financial institutions to lose substantial amounts of money on their customers’ purchases of Embraer planes would no doubt aggravate this negative perception. Canada, of course, would potentially benefit from the resulting impairment of Brazil/Embraer’s credibility on world capital and regional aircraft markets, which may explain why this was an important element of the Article 21.5 proceedings. Ironically, in the subsequent \textit{Canada – Export Credits for Aircraft} case, Canada faced exactly the same dilemma and it, too, openly refused to withdraw the subsidies.\textsuperscript{157}

A similar fact situation arose in the \textit{U.S. – Foreign Sales Corporations} case. The United States’ Foreign Sales Corporations tax mechanism was found to be a prohibited subsidy. The U.S. subsequently repealed it, but transitionally allowed all transactions made by existing foreign sales corporations to receive the subsidy for an additional year, while transactions made under contracts prior to the withdrawal deadline could receive FSC tax treatment indefinitely. The Panel in the Article 21.5 proceeding, citing the Appellate Body’s reasoning in \textit{Brazil – Export Financing for Aircraft (21.5)}, found that the United States had not fully withdrawn the prohibited subsidy.\textsuperscript{158} The Appellate Body upheld this decision, adding that “a Member's obligation to withdraw prohibited export subsidies, under Article 4.7 of the SCM Agreement, cannot be affected by contractual obligations which private parties may have assumed \textit{inter se} in reliance on laws conferring prohibited export subsidies.”\textsuperscript{159}

\textsuperscript{156} They could also not take delivery of the Embraer planes, but that might raise its own set of contractual legal issues; it would also frustrate whatever business activities the customers had planned in reliance on the Embraer order.

\textsuperscript{157} \textit{Canada – Export Credits and Loan Guarantees for Regional Aircraft - Recourse to Arbitration by Canada under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement} (2003), WTO Doc. WT/DS222/ARB at para. 3.106 (Arbitration Report).


Subsequently, the United States introduced legislation that not only maintained these grandfathered FSC subsidies, but also grandfathered some subsidies under the replacement measure, the Extraterritorial Income Exclusion (ETI) Act. The ETI Act had been deemed a prohibited subsidy in the first Article 21.5 proceeding. The Panel and the Appellate Body had no difficulty finding that the United States had not fully withdrawn the subsidy.  

The rule, then, seems to be clear: the conferral of benefits through prohibited subsidies must stop at the date set by the Panel, no matter when or how the state had made the commitment. This interpretation seems to be an attempt by Panels and the Appellate Body to compensate for some of the weaknesses inherent in the prospective approach. Had they decided that a subsidy was granted when the legal entitlement to it was created, this would enable subsidizing governments to create long-term subsidy arrangements that could effectively never be withdrawn. This approach ensures that only payments that were already made are “immune” from withdrawal, at the cost of creating potential problems under domestic law (which will be discussed in the next section).

(iii) **Obligations Under Domestic Law**

Export subsidies are often provided through contracts between subsidizing governments (or their agencies) and either the exporting firm or foreign buyers. Such legal arrangements can lead to two potential conflicts if the subsidy is ordered to be withdrawn. First, a panel could order the subsidizing government to retrospectively make the subsidized firm repay the subsidy after the subsidy had been entirely, or partly, paid out, as happened in Australia – Automotive Leather. As was observed by commentators and the Australian government, the Australian government had no basis in domestic law for demanding repayment of its money. Furthermore, such repayment could constitute

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a form of expropriation or breach of contract, for which the firm might be entitled to compensation under domestic law. Payment of this compensation might itself amount to a failure to withdraw the subsidy.

Second, the subsidizing government might have entered into an agreement committing it to pay subsidies at a later date and, consistent with the definition of “grant” outlined in the previous section, a panel may order it to withdraw the subsidy before the date at which the subsidy is to be paid. The government would be breaching its agreement to provide the subsidy by not making the payment when it is due and it would potentially be exposed to liability under domestic law for breach of contract. This issue was central in the first Article 21.5 proceeding in Brazil – Export Financing for Aircraft, which was discussed previously. In that case, Brazil was required not to issue bonds that it had committed to issuing under domestic law. The Panel and the Appellate Body dismissed Brazil’s argument that it could not do so because not issuing the bonds might give rise to liability under domestic law.

The WTO has not concerned itself with the domestic legal issues that might arise from its recommendations reflecting a principle in international law that domestic law cannot be an excuse for not performing treaty obligations. While this stance may initially appear problematic, the rationale behind it is that if domestic legal issues were taken into consideration, a subsidizing government would be able to structure its domestic law and domestic legal arrangements to frustrate the withdrawal of prohibited subsidies. This concern was explicitly recognized by the Brazil – Export Financing for Aircraft 21.5 Panel.

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162 Goh and Ziegler (2003) at 556.

163 Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU (2000), WTO Doc. WT/DS46/RW at para. 6.16 (Panel Report) and Brazil – Export Financing Programme for Aircraft – Recourse by Canada to Article 21.5 of the DSU (2000), WTO Doc. WT/DS46/AB/RW at para. 46 (Appellate Body Report). Brazil did not comply and continued to issue the bonds, so any analysis of what might have happened had a case been brought in Brazilian courts is entirely hypothetical.

164 This principle is laid out explicitly in Article 27 of the Vienna Convention on the Law of Treaties and states that “A party may not invoke the provisions of its internal law as justification for the failure to perform a treaty.” See Goh and Ziegler (2003) at 555-556.

However, in either of the two situations outlined above, there is a potentially serious problem should the subsidy’s recipient decide to enforce its rights under domestic law. If the recipient is successful, the member state could face the following paradox: domestic law requires the government to either pay damages for breach of contract or provide compensation for the seizure of property, but any such payment might, under the *Australia – Automotive Leather* reasoning at least, constitute a failure to withdraw the subsidy.\textsuperscript{166} In such a case, the government would be unable to comply with its WTO obligations without violating domestic law. This problem may prove to be largely theoretical in cases involving a subsidy paid directly to a domestic firm. In practice, the relationship between the government and the subsidized firm may be so close that the firm would not have to sue the government to enforce its domestic law right to the subsidy because the government will try to find solutions that comply with the WTO (including negotiations with the importing country). As seen in the case of *Australian Leather*, governments will go to great lengths to avoid actually taking back the subsidy.\textsuperscript{167}

The greater danger may be in cases such as the Brazilian PROEX program where the government provides the subsidy to a foreign buyer or its agent. A foreign buyer that bought a particular product in reliance on a substantial subsidy might be inclined to pursue all available remedies under the subsidizing state’s domestic law (or under another country’s laws pursuant to choice of law and choice of forum clauses) if that state repudiated the subsidy contract. If what happened in the Brazil case, or the subsequent *Canada – Export Credits for Aircraft* case is any indication, however, the subsidizing state may rather not comply and face countermeasures than breach such a contract.

These situations could be avoided if domestic law incorporated WTO norms in a way that made a contract in violation of the WTO Agreements unenforceable and

\textsuperscript{166} The damages or compensation would presumably be in the same amount as the subsidy that was to have been provided. See Goh and Ziegler (2003) at 556.

\textsuperscript{167} In that case, the Australian government reached a settlement with the United States that required Howe to repay a portion of the subsidy over twelve years, but agreed to make substantial concessions on other products. This settlement shows the extent to which the Australian government was willing to compromise in other areas to spare Howe. See Daniel Moulis and Benjamin O'Donnell, “Does "Withdraw the Subsidy" Mean "Repay the Subsidy"? The Implications of the Howe Leather Case for Firms in Receipt of Government Subsidies”, 6 *Int. T.L.R.* 168 (2000) at 171.
explicitly permitted governments to require repayment. However, not only would most countries object to giving direct domestic legal effect to WTO norms, but such domestic law might have a chilling effect on trade and investment. Would an aircraft buyer, for instance, have purchased Embraer planes for delivery years later if it knew Brazilian law left it with no remedy if the government was forced to retract its commitment to provide the subsidy? Would an export-oriented industry invest in new facilities if it knew it risked being ordered to repay the subsidy? Member states may rather promote reliance on their subsidy programs, including making those subsidies enforceable under domestic law, even if this entails being unable to comply with a WTO recommendation and facing countermeasures. Such a view is consistent with the view of export subsidy remedies as responding to domestic political interests. It would promote efficient subsidies to the extent that the subsidizing country negotiates a settlement with the harmed country or, as discussed in the next section, submits to an appropriate level of countermeasures.

(b) Countermeasures

The current interpretation of the requirement to withdraw export subsidies without delay therefore appears to correspond to a liability rule. The prospective interpretation of the requirement (including the approach to pre-existing commitments) permits breaches of the agreement in the form of one-time payments but not long-term on-going subsidies. It ensures that the penalty for export subsidies is not so high as to completely deter breaches and therefore allows governments short-term responses to political pressures. However, the effect of this interpretation and the prohibition in general depends on the penalty for non-compliance with the requirement to withdraw the subsidy.  

The apparent aim of the dispute settlement process is that the subsidy be withdrawn or that some other “mutually acceptable” settlement be reached between the

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168 Of course, such legislation might raise constitutional issues in some countries that constitutionally mandate due process or compensation for expropriation. See Goh and Ziegler (2003) at 556 (suggesting constitutional amendments might be necessary to permit requiring repayment).

169 Pauwelyn (2006) terms such penalties “back-up enforcement”.

http://law.bepress.com/alea/17th/art9
parties.  If the parties fail to reach a settlement and the prohibited subsidy is not withdrawn, Article 4.10 of the SCM Agreement requires the DSB to authorize the complaining member to take “appropriate countermeasures” unless the DSB decides by consensus to reject the request. The complaining state decides what countermeasures are appropriate. If the member which provided the subsidy considers that the complaining state’s countermeasures are not appropriate, it can submit the countermeasures to arbitration under Article 22.6 of the DSU. The SCM Agreement does not define what are “appropriate” countermeasures except to note, somewhat cryptically, “this expression [“appropriate countermeasures”] is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited.”

There have been three Article 22.6 arbitrations in the Article 4.11 export subsidy context. They involve, unsurprisingly, the three disputes discussed previously in which the subsidizing country refused to withdraw a portion of the subsidies and failed to reach an agreement with the complaining state: Brazil – Export Financing for Aircraft, U.S. – Foreign Sales Corporations, and Canada – Export Credits for Aircraft. In Brazil – Export Financing for Aircraft, the parties agreed that what Canada was proposing (the suspension of concessions or other obligations on various Brazilian products) qualified as countermeasures. However, the arbitrator had to determine what constituted the subsidy about which Canada could take action: was it all PROEX payments in the relevant time period, or only the portion of PROEX payments that exceeded what was

170 Dispute Settlement Understanding, Article 3.7.

171 The obligation under Article 4.10 of the SCM Agreement that countermeasures be “appropriate” is somewhat different than the general requirement under Article 22.4 of the Dispute Settlement Understanding that countermeasures be “equivalent” to the nullification and impairment. See Holger Spaman, “The Myth of ‘Rebalancing’ Retaliation in WTO Dispute Settlement Practice” (2006) 9(1) Journal of International Economic Law 31 (discussing the issue of whether retaliation leads to rebalancing of concessions).

172 SCM Agreement, Article 4.11.

173 SCM Agreement, footnotes 9 and 10.

permissible under item (k) of the Illustrative List? The Arbitrators concluded that as it was the whole PROEX program that had been deemed a prohibited subsidy in the prior proceedings, calculation of the countermeasure should be based on the full amount.\(^\text{175}\)

The Arbitrators then went on to consider precisely what “appropriate” countermeasures entail. They found that “when dealing with a prohibited export subsidy, an amount of countermeasures which corresponds to the total amount of the subsidy is "appropriate"."\(^\text{176}\) Brazil attempted to exclude from the calculation the subsidies it had committed to providing under domestic law. The Arbitrators, explicitly citing the reasoning used to dismiss that argument in the Article 21.5 proceeding, held that those subsidies should be included.\(^\text{177}\) They undertook their own calculations about what an appropriate amount of countermeasures would be and, citing Article 22.8 of the DSU, emphasized the temporary nature of the countermeasures.

Different issues arose in \textit{U.S. – Foreign Sales Corporations}. The United States sought to argue that countermeasures should be calculated based on the impact the infringing measures had on the European Communities. The Arbitrators disagreed, finding that “the entitlement to countermeasures is to be assessed taking into account the legal status of the wrongful act and the manner in which the breach of that obligation has upset the balance of rights and obligations as between Members.”\(^\text{178}\) They also stated that “members may take countermeasures that are not disproportionate in light of the gravity of the initial wrongful act and the objective of securing the withdrawal of a


\(^{176}\) \textit{Brazil} – \textit{Export Financing Programme for Aircraft - Recourse to Arbitration by Brazil under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement} (2000), WTO Doc. WT/DS46/ARB at para. 3.60 (Arbitration Report).

\(^{177}\) \textit{Brazil} – \textit{Export Financing Programme for Aircraft - Recourse to Arbitration by Brazil under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement} (2000), WTO Doc. WT/DS46/ARB at para. 3.65 (Arbitration Report).

prohibited export subsidy, so as to restore the balance of rights and obligations upset by that wrongful act.”

This approach led the Arbitrators to conclude that the European Communities were entitled to countermeasures based on the total amount that the United States continued to spend on its FSC/ETI subsidies after the deadline for withdrawal (approximately US$4 billion/year). In their view, countermeasures are a response to an initial wrongful violation (the granting of subsidies) of obligations owed by the United States. Accordingly, the European Communities were entitled to respond by suspending a numerically-equivalent obligation they owed the United States. Thus, the Arbitrators found that suspending around US$4 billion in tariff concessions owed by the E.C. to the U.S. was appropriate. They noted that there was only one complaining state in this case; if there had been more, there could have been issues regarding allocation of the countermeasures among the multiple complainants.

The third case is Canada – Export Credits for Aircraft, where Canada was ordered to withdraw subsidies that, *as applied*, constituted prohibited subsidies. Unlike the previous two cases, where the amount of the subsidy was used to calculate countermeasures, Brazil sought to base its countermeasures on what it claimed were the adverse effects of the Canadian subsidies. The Arbitrators rejected this basis for countermeasures, along with the calculations used by Brazil. Canada argued that, as the subsidies were granted in response to the imminent granting of prohibited subsidies by Brazil, countermeasures should be lowered. However, the Arbitrators found that Canada was not entitled to take the law into its own hands.

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In the Article 22.6 proceeding, Canada openly admitted that it had no intention of withdrawing any portion of the subsidy, including portions that had not yet been granted.\(^{183}\) Given that, in their view, countermeasures are intended to end breaches, the Arbitrators found that Canada’s intention not to comply mandated higher countermeasures than what Canada deemed appropriate.\(^{184}\) Brazil also raised concerns about the need to deter so-called “hit and run” actions – the granting of one-time subsidies that cannot be ordered withdrawn. Here, the mandatory/discretionary distinction intervened again on Canada’s side: the Panel found that the countermeasures cannot extend to subsidy programs that, as such, are not prohibited.\(^{185}\) The Panel noted that doing otherwise would negate the difference between mandatory and discretionary legislation. They did, however, increase the countermeasures by 20% above what they had calculated in order to account for Canada’s stated unwillingness to comply.\(^{186}\) Finally, the Arbitrators expressed their opinion that a mutually agreeable agreement dealing with the broader context of this dispute would be the most appropriate solution.

These Article 22.6 Arbitration decisions have therefore, at least in the rhetoric of panels, been based on a property rule approach to the export subsidy prohibition.\(^{187}\) The Arbitrators have stated that the principle behind countermeasures is to bring about compliance and the penalty must be sufficiently large to do so. Further, the arbitrator in

\(^{183}\) Canada – Export Credits and Loan Guarantees for Regional Aircraft - Recourse to Arbitration by Canada under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement (2003), WTO Doc. WT/DS222/ARB at para. 3.06 (Arbitration Report).


\(^{185}\) Canada – Export Credits and Loan Guarantees for Regional Aircraft - Recourse to Arbitration by Canada under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement (2003), WTO Doc. WT/DS222/ARB at para. 3.110 (Arbitration Report).

\(^{186}\) Canada – Export Credits and Loan Guarantees for Regional Aircraft - Recourse to Arbitration by Canada under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement (2003), WTO Doc. WT/DS222/ARB at para. 3.121 (Arbitration Report).

Canada – Export Credits for Aircraft even added an extra penalty for deliberate non-compliance. A property rule approach to countermeasures is consistent with the view of the prohibition on export subsidies as a resolution of a prisoners dilemma (a high penalty is required to stop cheating) as well as with the view that export subsidies are in most cases globally (and domestically) inefficient. It therefore is consistent with both a political economy explanation of the prohibition and a welfare approach.

However, Arbitrators have used a poor measure on which to base the level of the “appropriate” countermeasure if they wished to create a property rule. The Arbitrators have chosen the level of the subsidy provided as the basis for the countermeasure (with in some cases an additional penalty). However, there is no clear or necessary connection between the level of the subsidy and incentives to comply (and, in US – FSC, the Arbitrators never really considered the incentive effects of this level of countermeasure). In some cases it could be higher than the level of benefit (judged either in terms of welfare or political interests of officials) obtained by the subsidizing government. A high penalty would be desirable under a property rule as the intention is to stop non-compliance.

However, a level of penalty calibrated by reference to the size of the subsidy will often be too low – much lower than the benefits provided to the subsidizing country by the subsidy. In such a case, the countermeasure does not provide an incentive to comply and it becomes in effect a liability rule. For example, in strategic trade theory, the subsidy may provide profit to the subsidized firm (and economic benefit to the subsidizing country) in excess of the subsidy. In other cases, the subsidy may inflict economic harm on the subsidizing country as a whole but provide significant gain to the

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189 Spamann (2006), at 74 (stating that “[w]ith the current regime, it is hard to see what exactly it achieves, except generating huge suspension awards.”). There may also be a concern that a high penalty violates the principle of proportionality in international law (Howse and Neven (2005)). See Bagwell (2007) (arguing that neither the broad prohibition on export subsidies nor the use of disproportionate remedies to back this prohibition are firmly support by a terms of trade approach).


political interests of the government officials because of the benefit to a specific concentrated interest. The issue then becomes whether a series of retaliatory measures set at the level of the subsidy will sufficiently harm the political interests of the subsidizing government so as to end the subsidy. They may have such a result, particularly if the subsidizing country and the complaining country have a sufficiently large trade in the particular good such that the subsidized industry feels the full extent of the countermeasures. However, in cases where the countermeasures are levied because of subsidies to exports to third countries and/or the complaining member needs to impose countermeasures on other goods, the impact of the countermeasure will depend on the political interests that these countermeasures harm. There is no necessary reason to believe that in such a case the level of countermeasure will be sufficiently large so as to induce compliance. As Howse and Neven point out, the more appropriate remedy in terms of a property rule would be the benefit to the subsidizing country, however measured. Such a measure (assuming it is possible to quantify) would negate the incentive for non-compliance.

The insufficiency of the penalty would be exacerbated if the complaining party could only bring countermeasures to the extent that it was harmed (in some proportion to its trade with the subsidizing country as the US argued in US – FSC). In such a case, the strength of the complaining members’ countermeasures will depend on the volume of trade between the complainant and the respondent. The Arbitrator’s approach in US – FSC, on the other hand, entitles the complaining party to take countermeasures equal to the full subsidy even if it is not the only member that is harmed. While there may be concerns about the basis of such an approach in international law, it at least has the virtue of making it more likely that the penalty will be sufficiently large to induce compliance. There is, of course, the concern with WTO remedies that the complaining party may often not practically be able to impose sufficient harm where trade between the

193 Howse and Neven (2005), p. 115.
194 See Trachtman (2006) (arguing for taking into account harm to all members).
195 Howse and Neven (2005).
non-complying country and the complaining country is not extensive and that the actual
countermeasures themselves may harm the complaining country.\textsuperscript{196}

However, there is a potential further concern with the current approach to
“appropriate” countermeasures. Even if the penalty is sufficiently high to induce
compliance with the prohibition, it may leave no scope for efficient breaches. Recall that
a property rule leads to efficiency where the transaction costs are not too high to prevent
bargaining.\textsuperscript{197} If the transaction costs of bargaining around the prohibition are too high,
then countries will never breach the prohibition. Transaction costs are not a concern to
the extent that export subsidies are viewed as always inefficient from a global welfare
perspective. However, as noted in Part II, Janow and Staiger argue that export subsidies
may sometimes be efficient provided that the transaction costs are not too high for a
country to respond to the export subsidies.\textsuperscript{198} There may also be instances where, from
the perspective of political officials, there may be a desire to allow non-compliance
where there are large political gains that exceed the (political) harms caused in other
countries.

The issue then becomes whether the transaction costs are too high in the context
of export subsidies to allow efficient breach either from a welfare or political perspective.
Howse and Neven argue that in some cases, a property rule may bring about efficient
breaches even in the absence of explicit bargaining as the complaining party (or parties)
may have an incentive to set the countermeasure high enough to provide it with the
benefits of the countermeasures (such as political benefits from protecting certain
industries) but not so high as to induce compliance (such that the complaining party
continues to receive the benefits of the countermeasure).\textsuperscript{199} It is not clear that there are

\textsuperscript{196} Pauwelyn (2006), Spamann (2006), at 74 (stating “it is almost inconceivable that the retaliating Member
will ever have all at once the ability, the economic incentive, and the need to use ‘appropriate
countermeasures’ to ‘skim off’ the subsidy.”), Nzelibe (2007) and Bronckers and Broek (2005). In terms of
the harm to the complaining country, see Trachtman (2006) and Pauwelyn (2006) but see Bagwell (2007).

\textsuperscript{197} Schwartz and Sykes (2002). But see Pauwelyn (2006) (citing arguments that an efficient breach
approach is inappropriate for WTO rules) and Nzelibe (2007) (arguing that this measure of ‘harm’ may be
all that WTO can obtain in an international setting without centralized enforcement).

\textsuperscript{198} Janow and Staiger (2003) and Bagwell (2007).

\textsuperscript{199} Howse and Neven (2005).
low transaction costs in all cases. However, if, as Janow and Staiger argue, one of the
reasons for the prohibition may be that the transaction costs of bargaining are too high to
allow efficient adjustments for importing countries, these transaction costs may be
reduced by the use of the WTO mechanism for countermeasures. By requiring the
approval of the Arbitrator before any level of countermeasures can be imposed, it limits
the ability of countries to be hold outs. However, It sets an upper limit on the complaining
countries’ claims and defines the parties who are to be included in the negotiations.

If the desire is to permit globally efficient breach, the main alternative to a
property rule would be to interpret “appropriate” countermeasures as a form of liability
rule with the level of the remedy set at harm to other countries. However, the
arbitrators in the US- FSC decision rejected the use of harm or injury as a basis for
countermeasures. Such a rule would allow for efficient buy-out of compliance by the
subsidizing country – that is, the government would subsidize when the benefits of the
subsidy (either in terms of welfare or political interest) exceed the harm that the subsidy
causes to others. Using the level of subsidy as the basis for countermeasures does not
necessarily correspond to such expectation damages – that is, the harm from the breach of
the agreement either in terms of welfare loss in other countries or harm to political
interests of other governments. It may be larger that the harm in some cases (in which
case it would over-deter efficient activities (whether efficiency is judged in terms of
welfare or political interests)) and smaller than the harm in others (resulting in under-
deterrence and fostering inefficient breach).

200 See Pauwelyn (2006) and Schwartz and Sykes (2002) discussing hold outs and liability rules in the
international context.


202 Howse and Neven (2005).

203 Note, however, that there are political economy concerns with this depiction, given that governments’
decisions may reflect public choice concerns in terms of both who is paying for the penalty and who
receives any compensation. See, for example, Nzelibe (2007) and Pauwelyn (2006).

tariff, when the complaining party is able to withdraw substantially equivalent concessions, there is at least
some connection between the costs and benefits of breach. However, the use of the level of subsidy does
not appear to create any such connection.
The level of subsidy, however, is relatively easy to calculate. The harm caused by the subsidy would in contrast be very difficult for arbitrators to estimate. From a global welfare perspective, the arbitrator would be required to estimate the impact of the subsidy on the markets in the complaining country as well as the harm in other, non-complaining countries. Moreover, to be complete, it would also require estimating the harm caused to the welfare of the subsidizing country (such as from the terms of trade effect). From a political economy perspective, the remedy should equate in at least a rough sense to the harm the subsidy has imposed on other countries’ governments in political terms. The subsidizing country would then assess its political benefits against the political costs it is imposing on other countries. The notion of “equivalent” concessions used as the basis of remedies for other violations of WTO agreements may correspond to this political harm. In either case (welfarist or political), however, the arbitrators in all likelihood would have difficulty making such estimations yielding either excessive breach (if as likely the estimate is too low) or deterrence of efficient breach (if the estimate is too high). Further, as noted above, there are concerns where the complaining country does not have sufficient trade with the subsidizing country to impose this level of damages and that, even if it did, the “compensatory” measures (countermeasures) would actually cause it harm rather than place it in the position it would have been in but for the subsidy (as is generally the case for a liability rule).

As a result, the potential use by arbitrators of a property rule as a basis for “appropriate” countermeasures means that they do not face the potential costs of mistakes in estimating harm (as is the case for a liability rule) but are confronted with a potential lack of bargaining in the case of subsidies that are efficient (either in terms of welfare or

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206 The harm can be seen in not just trade volumes but also importantly in the terms of trade effect. See Bagwell (2007) and Trachtman (2006).


209 Such concerns about the effectiveness of remedies for non-compliance with WTO obligations have led to a range of reform suggestions such as monetary compensation, auctioning of retaliation and collective remedies. See, for example, Trachtman (2006), Pauwelyn (2006), Pelzman and Shoham (2007), Bronckers and Broek (2005), Bagwell (2007) and Nzelibe (2007).
political interests) and the transaction costs of bargaining are high. In terms of a prisoners’ dilemma explanation of the prohibition or the view that export subsidies are always inefficient, such a trade-off makes sense. Further, bargaining (or at least efficient subsidies) may be possible under a property rule interpretation, allowing efficient breach in some cases. However, arbitrators have used total subsidy as the basis for the remedy which is inappropriate for a property rule as in many cases it provides insufficient incentive to deter subsidies and potentially leads to excessive breach.

(c) Unilateral Domestic Remedies
Countries harmed by export subsidies have an alternative remedial option under the SCM Agreement - the unilateral imposition of countervailing duties. In fact, as Schwartz and Sykes note, unilateral domestic remedies have provided an important source for ensuring compliance with trade agreements. If a country uses unilateral remedies, exporting countries may challenge their use before the WTO. While panels and the Appellate Body have reviewed many countervailing decisions, in none of these cases were countervailing duties imposed in response to an alleged export subsidy.

Challenges to countervailing measures may not involve export subsidies because there may be significant strategic advantages to treating a subsidy as an actionable subsidy instead of an export subsidy in such challenges. The SCM Agreement requires evidence of injury to the domestic industry (which is one form of adverse effects) for the imposition of countervailing duties no matter what kind of subsidy is being countervailed. Assuming the country is in a position to countervail the subsidy, classifying it as export-contingent would carry the additional burden of having to prove

210 Pauwelyn (2006) discusses some of the trade-offs in the choice of property rule versus liability rule such as the difficulty in setting the proper remedy, flexibility, credible commitment and stability.

211 Michael J. Trebilcock and Robert Howse, The Regulation of International Trade, 3rd ed. (London/New York: Routledge, 2005) at 272 (“Countervailing duties may only be imposed in respect of actionable or prohibited subsidies as defined in the Agreement.”).


213 SCM Agreement, Art. 11.2(iv).
export contingency. Classifying it as actionable, on the other hand, leads to an additional requirement that the subsidy be “specific”. Whether or not the complaining party will wish to proceed by classifying the subsidy as prohibited or actionable will depend in part on whether it is easier for the complaining country to obtain information about specificity than export contingency in some cases. Further, classifying a subsidy as actionable and imposing countervailing duties is not a workable solution in certain circumstances. The additional requirement of specificity for actionable subsidies would prohibit countervailing broadly-available export-contingent subsidies such as the American measures in the various *U.S. – Foreign Sales Corporations* cases.214

In addition, while there are drawbacks to the arbitration process, countries may not want to use unilateral domestic remedies in the case of export subsidies because of benefits provided by the arbitration process for countermeasures under the SCM Agreement. The drawbacks to the arbitration process include, for example, that it may take longer to impose a penalty by pursuing the WTO process than if the country imposes the penalty unilaterally. Under the arbitration process, the complaining country will need to challenge the measure successfully and then seek arbitration of the appropriateness of the level of the countermeasure. In contrast, it has more control over how quickly it can invoke countervailing measures, although the time difference between domestic and multilateral remedies for export subsidies is reduced by an expedited procedure in the SCM Agreement for claims concerning prohibited subsidies. However, the benefit of the arbitration process may be that any remedy under this process is evaluated by a neutral third party before it is imposed.215 This resort to a neutral third party before any imposition of a remedy may reduce the potential for retaliation by the subsidizing country. The subsidizing country can always challenge the countervailing measure

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214 In such a case, the subsidy could presumably be countervailed as a prohibited subsidy instead of an actionable one, though it seems difficult to imagine a country applying the single-product-centric countervailing procedures of the *SCM Agreement* on essentially every product they import from the subsidizing country. In such a case, attacking the subsidy measure itself through the multilateral track would be more practical.

before the WTO but it may not wish to wait for a response before taking such
retaliation.216

There is, however, another important difference between the unilateral and
multilateral tracks - the size of the potential remedy is greater under the multilateral track.
The amount of countervailing duty allowed under WTO rules would be the same whether
the subsidy is classified as actionable or prohibited.217 Further, the SCM Agreement sets
an upper limit on countervailing duties at the amount of the subsidy found to exist and
notes that it is “desirable” that the duty be lower if it would be sufficient to remove the
injury.218 Given that, as discussed above, “appropriate” countermeasure has been
interpreted as the amount of the subsidy and may include a penalty for deliberate non-
compliance, the upper limit on countermeasures is potentially higher than for
countervailing duties.

Further, and more importantly in many cases, countervailing duties may not even
be a potential remedy. Countervailing duties, unlike countermeasures authorized by the
Dispute Settlement Body, must be imposed on the subsidized product.219 For these
countervailing duties to have an impact, the complaining country must be an importer of
the subsidized good. In many cases, there is little trade in the subsidized products
between the two parties. Instead, as in the case of the Canada-Brazil disputes involving
regional aircraft, both parties’ producers are rivals competing in larger third-country
markets. Those third countries would be the ones able to impose effective countervailing
duties. However, given that their consumers benefit from the export subsidies and that
they typically lack a significant domestic industry in that sector, these countries would
have nothing to gain from doing so. In addition, under the multilateral track, if the
subsidy is not withdrawn, the complaining country is able to impose countermeasures on

216 The use of unilateral sanctions may not be constrained by reputational impact from other countries (that
is, other countries may not be able to sanction excessive countervailing measures) given that these other
countries would have poor information about the harms of the subsidy or the legitimacy of the challenge.

217 SCM Agreement, Art. 19.4.

218 SCM Agreement, Article 19.2.

219 SCM Agreement, Arts. 19.3 and 19.4.
any goods it imports from the subsidizing country. However, countervailing duties may only be imposed only on the subsidized product and even then, only to the extent that those imported products are causing injury.220

This increased retaliatory ability through the use of countermeasures presumably increases the likelihood of withdrawal of the export subsidy. Further, unlike actionable subsidies, where removing the adverse effects of the subsidies is enough, the SCM Agreement requires the withdrawal of the export subsidies. While countries do not necessarily always do so, they may suffer a reputational impact from not withdrawing the subsidy which may add to the incentive to eliminate the subsidy. These differences in the size of the remedy (as well as potentially the decreased risk of retaliation) may have led members to rely more on the multilateral response to export subsidies than unilateral responses.

VI CONCLUSION
The rules relating to export subsidies have been, and continue to be, the subject of numerous disputes. These disputes result in part from the lack of clarity in the rules such as about what constitutes an export subsidy. However, the greater concern relates to the appropriate remedy for the use of export subsidies. While the current prospective nature of the remedies makes some sense, it permits the use of subsidies on a one-time basis including for the purpose of gaining a strategic trade advantage over competitors in other countries. Further, the level of “appropriate” countermeasures available where the export subsidy is not withdrawn may in many cases be too low to provide an adequate incentive for withdrawal.

What does this lack of clarity and interpretation of countermeasures mean for the continued use of subsidies by members? The current dispute between the US and the EC over subsidies to commercial aircraft illustrates the on-going problem. The U.S. government, for example, claims that the EC provided (and is providing) subsidies or “launch aid” to aid in the design and development of Airbus aircraft that would not be

220 SCM Agreement, Article 19.3.
commercially viable without the aid. The definition of “subsidy” in the SCM Agreement is broad enough to capture the provision of most types of financial aid that the US claims the EC has provided to Airbus including provision of interest at below market rates (with no requirement to repay the financing if the aircraft is not successful) and financing through the European Investment Bank to Airbus for “large aircraft design, development and other purposes” (including for the A380).

The issue of de facto contingency may be more contentious. The current contextual approach makes it easier to prove that there has been de facto contingency but there remains a lack of clarity in what actually is required for a showing of de facto contingency. In particular, the export-orientedness of the industry is one factor to take into account in determining whether the subsidy is “tied to” exports but not the sole factor. Is it unclear, however, what other factors are to be taken into account or how “export oriented” an industry must be for this factor to be a dominant consideration.

The remedy for the US will prove even more difficult assuming it can prove that there have been prohibited subsidies. First, given the prospective nature of the remedy, any subsidies that have already been granted by the time of the decision will not be required to be withdrawn. The aid that the EC has given in terms of development of new models may therefore already have been provided and not subject to any countermeasures. The main exception would be any pre-existing commitments made by the EC which, as noted above, the EC would not be permitted to fulfill. In any event, the return of already provided subsidies is not likely politically realistic given the competitiveness of the civil aircraft industry and the significant negative political effects that the repayment of subsidies would likely entail.

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222 European Communities and Certain Member States – Measures Affecting Trade in Large Civil Aircraft (Request for Panel) (2005) WT/DS316/2, pp. 2 and 4.

223 On the competitiveness of the civil aircraft industry, see Marc L. Busch, “Testimony to the House Aviation Subcommittee” (May 25, 2005) (http://www.aei.org/events/eventID.1356/event_detail.asp, last accessed August 2006).
Second, for the on-going subsidies, if the EC refuses to withdraw the subsidies, the US can apply to impose “appropriate countermeasures”. As noted above, these countermeasures would likely be set at the level of the total subsidy. This level of penalty may not be sufficient to induce the EC to eliminate its subsidies given the potential benefits from financing the civil aircraft industry. The benefits of the subsidy can be large as “the civil aircraft industry remains a catalyst of economic growth and competitiveness, both because it provides a lot of high paying jobs, and because it exhibits leading-edge technological spillovers that benefit other sectors.”\(^{224}\) The US may therefore impose countermeasures on the EC but not bring about its hoped-for elimination of the subsidies. While in some cases the total level of subsidy will be very large and therefore provide an inducement to eliminate the export subsidies, it may be the case that that remedy would be insufficient in the case of subsidies to an industry with large spillovers such as civil aircraft. A penalty geared to the benefit to the subsidizing country from the subsidy would be more likely to induce compliance.

The existing rules on remedies may therefore not address the prisoners’ dilemma problem that appears to lie at the heart of the prohibition of export subsidies nor prevent export subsidies to the extent they are globally inefficient. It may encourage large upfront subsidies such as launch aid that can be provided (and can provide strategic benefits) before the WTO can hear a complaint. The existing remedies cannot affect these subsidies. The countermeasures may be sufficiently punitive to encourage the parties to negotiate a new agreement on the financing of civil aircraft.\(^{225}\) In such a case, the parties may bargain to an efficient solution on export subsidies. However, given the low level of the penalty, the bargaining may result in the subsidizing countries having more bargaining power (the complaining party having a lower threat point) than would the case with more appropriate level of penalty (that is, a penalty tied to the benefit to the subsidizing country from the subsidy). Panels and the Appellate Body will need to rethink the remedies issue in order to find a better solution to the on-going problems and disputes surrounding export subsidies.


\(^{225}\) Busch (2005).