WORLD TRADE ORGANIZATION

WT/DS108/ARB
30 August 2002

(02-4605)

Original: English

UNITED STATES – TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS"

Recourse to Arbitration by the United States under Article 22.6 of the *DSU* and Article 4.11 of the *SCM Agreement*

DECISION OF THE ARBITRATOR

The decision of the Arbitrator on *United States – Tax Treatment for "Foreign Sales Corporations"* is being circulated to all Members, pursuant to the *DSU*. The report is being circulated as an unrestricted document from 30 August 2002 pursuant to the Procedures for the Circulation and Derestriction of WTO Documents (WT/L/452).

Table of Contents

I. INTRODUCTION

A. INITIAL PROCEEDINGS

1.1 On 20 March 2000, the Dispute Settlement Body (DSB) adopted the Panel and Appellate Body reports in this dispute. The DSB recommended, in particular, that the United States bring into conformity the measures found to be inconsistent with its obligations under the *Agreement on Subsidies and Countervailing Measures* (*SCM Agreement*) and the *Agreement on Agriculture* and that the United States withdraw the FSC subsidies "at the latest with effect from 1 October 2000".[1] On 12 October 2000, the DSB agreed[2] to accede to a request by the United States that the DSB modify the time-period in this dispute so as to expire on 1 November 2000.[3] On 15 November 2000, the President of the United States signed into law an Act of the United States Congress entitled the "*FSC Repeal and Extraterritorial Income Exclusion Act of 2000*"[4] (the "ETI Act"). With the enactment of this legislation, the United States considered that it had implemented the DSB's recommendations and rulings in the dispute and that the legislation was consistent with the United States' WTO obligations.[5]

1.2 On 17 November 2000 the European Communities had recourse to Article 21.5 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "*DSU*"), considering that the United States had failed to withdraw the subsidies as required by Article 4.7 of the *SCM Agreement* and had thus failed to comply with the DSB recommendations and rulings. The

the arbitrator to suspend his work until either: (a) adoption of the Article 21.5 compliance panel report or, (b) if there was an appeal, adoption of the Appellate Body report.[9]

1.4 On 17 November 2000, the European Communities requested authorization from the DSB to take appropriate countermeasures and to suspend concessions pursuant to Article 4.10 of the *SCM Agreement* and Article 22.2 of the *DSU* in the amount of US$4,043 million per year. On 27 November 2000, the United States objected to the appropriateness of the countermeasures proposed by the European Communities and the level of suspension of concessions proposed by the European Communities and requested that, "as required by Article 22.6 of the *DSU* (and consequently Article 4.11 of the *SCM Agreement*), 'the matter be referred to arbitration'". [10]

1.5 At the meeting of the DSB on 28 November 2000, it was agreed that the matter raised by the United States in document WT/DS108/15 be referred to arbitration as required by Article 22.6 of the *DSU* and Article 4.11 of the *SCM Agreement*.[11] In the light of the establishment of a compliance panel under Article 21.5 and in accordance with the Procedures agreed between the European Communities and the United States, the European Communities and the United States requested the Arbitrator to suspend the arbitration proceeding until adoption of the Panel Report or, if there was an appeal, adoption of the Appellate Body Report.[12]

1.6 The panel and Appellate Body reports under Article 21.5 of the *DSU* were adopted by the DSB on 29 January 2002 and, in accordance with the parties' understanding referred to in paragraph 1.3 above, the Arbitrator then resumed its work.

1.7 The Arbitration was carried out by the original panel, namely:

Chairman: Mr. Crawford Falconer

Members: Mr. Didier Chambovey
Prof. Seung Wha Chang.

II. PRELIMINARY ISSUES

A. MANDATE OF THE ARBITRATOR

2.1 The United States has initiated these proceedings pursuant to Article 22.6 of the *DSU* and Article 4.11 of the *SCM Agreement*. Article 22.6 of the *DSU* provides in relevant part:

> "When the situation described in paragraph 2 occurs, the DSB, upon request, shall grant authorization to suspend concessions or other obligations within 30 days of the expiry of the reasonable period of time unless the DSB decides by consensus to reject the request. However, if the Member concerned objects to the level of suspension proposed, (…) the matter shall be referred to arbitration. (…)"

2.2 With regard to countermeasures taken in response to violations of Article 3.1 of the *SCM Agreement* on prohibited subsidies, however, Article 4.11 of that Agreement provides the following mandate for arbitrators:

[9] WT/DS108/12, para. 11.
[10] See WT/DS108/15.
[11] See WT/DS108/17.
[12] See WT/DS108/18.

"In the event a party to the dispute requests arbitration under paragraph 6 of Article 22 of the Dispute Settlement Understanding ('

B. BURDEN OF PROOF

2.8 Both parties agree that the United States, as the applicant in this case, bears the burden of proving its assertions that the requested level of suspension of concessions is not an appropriate countermeasure within the meaning of Article 4.11 of the *SCM Agreement* and is not equivalent to the level of nullification or impairment to the European Communities within the meaning of Article 22.4 of the *DSU*.[15]

2.9 The United States, however, disputes the European Communities' description of the duties of

2.13

not apply to transactions occurring before 1 January 2002. Furthermore, for FSCs already in existence on 30 September 2000, the FSC subsidies continued in operation for one year and, with respect to FSCs that entered into long-term binding contracts with unrelated parties before 30 September 2000, the ETI Act did not alter the tax treatment of those contracts for an indefinite period of time. Some aspects of the FSC regime are actually "grandfathered", in some cases indefinitely.[28]

(ii) Second, we noted that the United States suggested that the transitional provisions of the ETI Act mentioned above could be ignored for purposes of estimating the amount of the subsidy and the trade effect or trade impact. Both parties agreed that the amount of benefit to the taxpayer was the same under both the ETI and the FSC regimes.[29].

(iii) The United States agreed with the European Communities that an upward adjustment should be made to the amount of the subsidy to account for the additional product coverage in the ETI Act, as compared to the initial FSC scheme.[30]

2.15 We therefore decided to assess the proposed suspension of concessions at the time the United States should have withdrawn the prohibited subsidy at issue, in 2000. We consider it relevant, in light of the nature of the countermeasures proposed by the European Communities, to calculate the appropriate countermeasures on a yearly basis. We thus decided to include the whole of the year 2000 in our assessment, taking into account an adjustment for the shift to the ETI Act.

III. SUMMARY OF MAIN ARGUMENTS

3.2 The **European Communities** has argued that the amount of countermeasures it has proposed corresponds to the value of the subsidy, and that this amount is "appropriate" within the meaning of Article 4.10 of the *SCM Agreement*. In the European Communities view, Article 4.10 of the *SCM Agreement* sets out a unique benchmark for countermeasures in response to violations of a particular provision of the *SCM Agreement* – namely Article 3.[36] In the European Communities view, Article 4.10 of the *SCM Agreement* allows for countermeasures which will induce compliance, and in this instance, countermeasures in the amount of the value of the subsidy to be withdrawn are appropriate, although they reflect a conservative approach.

IV. APPROACH OF THE ARBITRATOR

4.1 We recall that Article 4.10 of the *SCM Agreement* provides as follows:

> "In the event the recommendation of the DSB is not followed within the time-period specified by the panel, which shall commence from the date of adoption of the panel's report or the Appellate Body's report, the DSB shall grant authorization to the complaining Member to take appropriate

on it; and (b) that the mode of calculation is comparable, although not identical in its precision, to an assessment under Article 22.4 of the *DSU*.

4.6 In order to examine the United States challenge, we therefore need to consider first whether indeed, as argued by the United States, countermeasures under Article 4.10 are required to be proportionate, or at least not disproportionate, to the trade impact of the violating measure on the complaining Member. We will then be in a position to assess, in light of our conclusion on that point, whether in the circumstances of this case, the proposed countermeasures are "appropriate" or not.

4.7 We will consider first the expression "appropriate countermeasures" contained in Articles 4.10 and 4.11 of the *SCM Agreement.* In this regard, we note that the scope of application of Article 3.2 of the *DSU* is not limited to panel and Appellate Body proceedings. Accordingly, in assessing the matter before us, we must clarify the relevant provisions, to the extent necessary, in accordance with the customary rules of interpretation of public international law. These rules are reflected in Articles 31, 32 and 33 of the Vienna Convention on the Law of Treaties ("Vienna Convention"). We recall in particular that Article 31.1 requires a treaty to be

> "interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose."[37]

4.8 We will therefore consider the terms of Article 4.10 of the *SCM Agreement* in accordance with these rules.

V. THE NOTION OF "APPROPRIATE COUNTERMEASURES" UNDER ARTICLE 4.10 OF THE *SCM AGREEMENT*

5.1 In assessing the validity of the US proposition that countermeasures under Article 4.10 of the *SCM Agreement* should not be disproportionate to the trade impact of the measure on the complaining Member, in this instance the European Communities, we find it useful to consider first the terms of

---

[37] The full text of Article 31 of the Vienna Convention reads as follows:

Article 31

General rule of interpretation

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

Article 4.10 in themselves.[38] This initial textual analysis will inform the rest of our analysis, where we will address the detail of the US interpretation and, more generally, our understanding of the

of the expression "*appropriate*" countermeasures with a view to clarifying what level of countermeasures may be legitimately authorized.

2. "*Appropriate* countermeasures"

5.8 The term "appropriate" countermeasures in Article 4.10 is informed by footnote 9, which provides guidance as to what the expression "appropriate" should be understood to mean. For the sake of clarity, we will first consider the term "appropriate", and then the terms of the footnote.

minor or insignificant consideration. On the contrary, it is rather to be an element that is to pervade or colour the whole assessment. That, at least, is the only reasonable way to construe viewing something "in light of" something else.

5.22 As we read it, the text refers us unambiguously to the provisions of Part II of the *SCM Agreement* and requires us to ensure that our perspective on countermeasures is invested with and coloured by consideration of the nature and legal status of the particular underlying measure in respect of which the countermeasures are applied. In short, this provides that, when assessing countermeasures under Article 4.10, account must be taken of the fact that the export subsidy at issue is prohibited and has to be withdrawn.

5.23 This emphasis on the unlawful character of export subsidies invites, in our view, a consideration of the impact which this unlawful character may have, in itself. We note in this respect that the maintenance of the unlawful measure by the Member concerned – in violation of its obligations – has, in itself, the effect of upsetting the balance of rights and obligations between the parties, irrespective of what might be, as a matter of fact, the actual trade effects on the complainant. We recall, in this regard, that the prohibition on export subsidies is a *per se* obligation, not itself conditioned on a trade effects test. Members are entitled to trade without other Members resorting to export subsidies. In our view, the second part of the footnote directs that this is in itself a required consideration when it comes to assessing whether countermeasures are not disproportionate within the meaning of Article 4.10. Such consideration can only be reasonably construed to be aggravating rather than a mitigating factor, to be duly reflected in our assessment of whether countermeasures are appropriate.[50] Indeed, it directs us to consider the "appropriateness" of countermeasures under Article 4.10 from this perspective of countering a wrongful act and taking into account its essential nature as an upsetting of the rights and obligations as between Members. This, we conclude, is the manner in which we are directed to assess the matter. We are not, by comparison, actually directed to, e.g., consider demonstrated trade effects of the measure on the complaining Member.

5.24 On the latter point, we would simply note that there has been – and remains – nothing in the text which precludes a Member from applying countermeasures in the sense of measures that are aimed at countering the injury, more narrowly conceived, that it has suffered as a consequence of the wrongful act.[51] However, what this footnote makes clear is that the text cannot be construed to *confine* the appropriateness test to the element of countering the injurious effects on a party, but also, and more importantly, 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. It is from that perspective that the judgement as to whether countermeasures are disproportionate is to be made.

5.25 Having considered the express terms of Article 4.10 of the *SCM Agreement*, we therefore note, at this stage of our analysis, that they do not suggest a specific quantum to be respected in each and every case in the determination of an amount of countermeasures which can be authorized under this provision. On the contrary, they direct us to consider whether the countermeasure proposed are in an adequate relation to the situation to be countered, instructing us specifically to consider that the subsidies under Part II of the *SCM Agreement* are prohibited in assessing whether the countermeasures proposed are disproportionate.

---

[50] On this point, see WT/DS46/ARB, para. 3.51.

[51] We would only add on this point that, as regards countering any demonstrated effects, the standard of judgement is still that of appropriateness, in the sense of being not disproportionate, by which we take it to mean a judgement that does not require mathematical exactness of equivalence but that of proportionality in the sense of not being manifestly excessive. We see this as consistent with the view of the arbitrator in *Brazil – Aircraft* (footnote 55) to the effect that " 'appropriate' should not be given the same meaning as 'equivalent', but should be understood as giving more discretion in the appraisal of the level of countermeasures against prohibited subsidies".

complaining Member.[53] In the US view, the term "countermeasures" as used in the *SCM Agreement* does not have a special meaning and these countermeasures do not have a unique objective in inducing compliance. Rather, Article 4 of the *SCM Agreement* should be interpreted in light of the objectives of the WTO dispute settlement, including the objective of maintaining a proper balance between the rights of obligations of Members, as foreseen in Article 3.3 of the *DSU*. An assessment of the appropriateness of countermeasures under Article 4.10 by reference to the trade impact of the violating measure on the complaining Member is, in the US view, the only approach that is consistent with the object and purpose of Article 4.10.[54]

5.30 To begin with, we recall that first, we have found not only that, *via* footnote 9, there is an entitlement to take account of the unlawful nature of the initial act which gives rise to the countermeasures, but also that this is the perspective for assessment specifically required for under the *SCM Agreement*. While we do not see the plain language of Article 4.10 as in any way precluding the application of countermeasures aimed at countering the effects of the wrongful act on a Member provided they otherwise satisfy the terms of the *SCM Agreement*, we do not find this to be the necessary standard of assessment laid down in Article 4.10 of the *SCM Agreement*. We saw nothing in the plain language of this text which, on its face, dictates that the term "appropriate countermeasures" must be *limited* in its meaning to "equivalence" or correspondence (or some synonym) with the "trade impact" on the complaining Member.[55]

5.31 We therefore must address the question of whether there is otherwise, in reading the provision in context, some overriding requirement to assess the appropriateness of countermeasures under Article 4.10 from the perspective of demonstrated trade effects on the complaining Member.

1. Article 4.10 in the context of the *SCM Agreement*

5.32 Recourse to countermeasures is foreseen in three provisions of the *SCM Agreement*: Article 4.10, which we are concerned with here, Article 7.9 and Article 9.[56] As regards actionable subsidies, Article 7.9 provides for authorization of countermeasures "commensurate with the degree and nature of the adverse effects determined to exist…". In a similar vein, Article 9.4 provides, in relation to non-actionable subsidies, for the authorization of countermeasures "commensurate with the nature and degree of the effects determined to exist". The explicit precision of these indications clearly highlights the lack of any analogous explicit textual indication in Article 4.10 and contrasts with the broader and more general test of "appropriateness" found in Articles 4.10 and 4.11.

5.33 In short, as far as prohibited subsidies are concerned, there is no reference whatsoever in remedies foreseen under Article 4 to such concepts as "trade effects", "adverse effects" or "trade impact". Yet, by contrast, such a concept is to be found very clearly in the context of remedies under Article 7, through the notion of "adverse effects".

5.34 We believe that this difference must be given a meaning and that we should give due consideration to the fact that the drafters – who obviously could have used other terms in order to quantify precisely the permissible amount of countermeasures in the context of Article 4.10 – chose

---

[53] See US first submission, paras. 32 ff.

[54] See US first submission, para. 44.

[55] The United States acknowledges that Article 4.10 does not require the strict equivalence imposed under Article 22.4 of the *D 3.l1 6.7pe not require qsmses Tw (54)T 0 T11w7xist". Nonetheless, it construes the "a Article 4.10 fundamentally as a "trade effects" test of a nature comparable to that foreseen under Article 22.4. See US answers to questions by the Arbitrator, paras. 4 and 5.*

[56] We are aware of the provisions of Article 31 of the *SCM Agreement and that Members took no on to extend the application of the provisions of Articles 8 and 9 of the Agreement concerning non- onable subsidies beyond the period of five years from the date of entry into force of the WTO Agreement*. wever, these provisions can nevertheless be helpful, in our view, in understanding the overall architecture of Agreement with respect to the different types of subsidies it sought and seeks to address.

not to do so. It is not our task to read into the treaty text words that are not there.[57] We are also cognizant that the terms that do appear in the text of the treaty must be presumed to have meaning and must be read effectively.[58] The implications of the use of the term "appropriate" must therefore be acknowledged and we must give this expression in Article 4.10 its full meaning.[59]

5.35 This cannot be viewed as a matter of simple difference in terminology in abstraction from any other consideration. Export subsidies do, after all, have "adverse effects" on third parties. Systemically speaking they are, as a category of subsidy, more inherently prone to do so than any other. Thus, there would have been no inherent reason why the drafters could not have, in relation to export subsidies, provided for disciplines of the type foreseen in Articles 5 and 7 in terms of "adverse effects" and made provision for countermeasures based on the same concept as is applied, e.g., in Article 7. On the contrary, there would have been every reason to treat this category of subsidies in the same way if the guiding intent had been to apply an "adverse effects" test. Yet it was decided not to do so. This, in our view, underlines all the more that this is meaningful and reflective of a rationale. In other words, the distinction cannot be presumed to be arbitrary or casual, much less effectively read out of the text in its entirety.

5.36 We consider that the rationale is not difficult to discern. These different wordings reflect, in our view, the distinct legal nature and treatment under the *SCM Agreement* of various types of subsidies. The fundamental distinction between actionable and prohibited subsidies which underlies the whole structure and logic of the *SCM Agreement* finds expression generally in the differences in the elements defining the applicable obligations and the differences of treatment given to these measures with regard to the remedies available to challenge them.[60]

5.37 The distinction in the terminology relating to countermeasures is, in turn, a corresponding reflection of the distinction when it comes to substantive disciplines for export subsidies: i.e. a clear and unambiguous intent to apply different and more exacting disciplines when it comes to export subsidies viz. a prohibition.

5.38 The underlying rationale for the distinction made is clear enough. The provisions regarding remedies pursuant to Articles 5 and 7 relate to subsidies that are accepted, in themselves, not to be illegal. But, while they are acceptable in themselves, other Members are, nevertheless, entitled to protection from their possible adverse effects. So the basis for actionability of such measures is their

---

[57] See for example the reports of the Appellate Body in *India – Quantitative Restrictions*, WT/DS90/AB/R, DSR 1999:IV, 1763, para 94; *EC – Hormones*, WT/DS26/AB/R, and WT/DS48/AB/R, DSR 1998:I, 135, para. 181; *India – Patents (US)*, WT/DS50/AB/R, DSR, 1998:I, 9, para. 45.

[58] See for example the reports of the Appellate Body on *US – Gasoline*, WT/DS2/AB/R, DSR 1996:I, 3, at 21 and *Korea – Dairy*, WT/DS98/AB/R, DSR 2000:I, 3, para. 81.

[59] See paras. 4.24-4.26 above.

[60] With respect to the differences in the elements defining the applicable obligations, we recall that Article 3.1(a) of the *SCM Agreement* – containing the defining elements of prohibited export subsidies -- provides:

> "3.1 Except as provided in the *Agreement on Agriculture*, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> (a) subsidies contingent, in law or in fact[4], whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I[5];"
>
> *(original footnote)*[4]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, wh0(05ry) Tj 0j 3.ancele the ract tie6i-0.2 footn6c 0 -11.2558 Tw 4de1839 Tc 1.5036 18(a 5421 6.75 Tf 0.372Tc 0

adverse effect on other Members.[61] In the case of a nullification or impairment claim, this adverse

effect of the persisting illegal measure on it. However, it does not *require* trade effects to be the effective standard by which the appropriateness of countermeasures should be ascertained. Nor can the relevant provisions be interpreted to *limit* the assessment to this standard. 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 prohibited export subsidy, so as to restore the balance of rights and obligations upset by that wrongful act.

5.42 To conclude otherwise would effectively erode the fundamental distinction in the *SCM Agreement* between those provisions regarding purely "effects-oriented" remedies and those distinctly provided for pursuant to Article 4. Under the former provisions, it is clear that the premise is that the Member is to retain the entitlement to persist with certain subsidies, as they are not prohibited *per se*. The obligation of such a Member goes to attenuating their demonstrated trade *effect.* Accordingly, the remedy to which an affected Member is entitled goes only as far as countering those effects. In such a situation, there is an effective "rebalancing", but only a rebalancing on the level of reciprocal actual trade effects. In such a case, the legal status of the original measure is not itself affected.

5.43 This contrasts with the situation *vis-à-vis* a prohibited export subsidy. To insist on a remedy limited to such effects would be precisely to entertain "rebalancing" at that level, which would neither specifically take into account the obligation to withdraw the original measure nor aim to restore the balance of rights and obligations that has been upset by the original wrongful action. It would be effectively to read away the fundamental distinction between the relevant provisions as well as to undermine the essential rationale of that distinction. In our view, footnotes 9 and 10, in their final part, require us specifically to account for, and give due force to, that distinction in our determination of whether countermeasures are "appropriate".

2. Article 4.10 and Article 22.4 of the DSU

5.44 While the aforementioned provisions appear to us to be the most direct and relevant context, we examine also whether there is anything which, taking Article 22.4 of the *DSU* into account, would in any way lead us to modify our interpretation. We do so in particular bearing in mind the fact that the United States considers that the *DSU* is relevant on the matter of the role of trade effects pursuant to Article 4.10.

5.45 We recall that Article 22.4 of the *DSU* provides as follows:

> "The level of the suspension of concessions or other obligations authorized by the DSB shall be equivalent to the level of the nullification or impairment."

5.46 The drafters have explicitly set a quantitative benchmark to the level of suspension of concessions or other obligations that might be authorized. This is similarly reflected in Article 22.7, which defines the arbitrators' mandate in such proceedings as follows:

> "The arbitrator acting pursuant to paragraph 6 … shall determine whether the level of such suspension is equivalent to the level of nullification or impairment…." (footnote omitted)

5.47 As we have already noted in our analysis of the text of Article 4.10 of the *SCM Agreement* above, there is, by contrast, no such indication of an explicit quantitative benchmark in that provision. It should be recalled here that Articles 4.10 and 4.11 of the *SCM Agreement* are "special or additional rules" under Appendix 2 of the *DSU*, and that in accordance with Article 1.2 of the *DSU*, it is possible for such rules or procedures to prevail over those of the *DSU*. There can be no presumption, therefore, that the drafters intended the standard under Article 4.10 to be necessarily coextensive with that under Article 22.4 so that the notion of "appropriate countermeasures" under Article 4.10 would limit such countermeasures to an amount "equivalent to the level of nullification or impairment"

suffered by the complaining Member. Rather, Articles 4.10 and 4.11 of the *SCM Agreement* use distinct language and that difference must be given meaning.

5.48 Indeed, reading the text of Article 4.10 in its context, one might reasonably observe that if the drafters had intended the provision to be construed in this way, they could certainly have made it clear. Indeed, relevant provisions both elsewhere in the *SCM Agreement* and in the *DSU* use distinct terms to convey precisely such a standard as described by the United States, in so many words. Yet the drafters chose terms for this provision in the *SCM Agreement* different from those found in Article 22.4 of the DSU. It would not be consistent with effective treaty interpretation to simply read away such differences in terminology.

5.49 We therefore find no basis in the language itself or in the context of Article 4.10 of the *SCM Agreement* to conclude that it can or should be read as amounting to a "trade effect-oriented" provision where explicitly alternative language is to be read away in order to conform it to a different wording to be found in Article 22.4 of the *DSU*.

5.50 We would simply add that, while we consider that the precise difference in language must be given proper meaning, this goes no further than that. Our interpretation of Article 4.10 of the *SCM Agreement* as embodying a different rule from Article 22.4 of the *DSU* does not make the *DSU* otherwise inapplicable or redundant.

C. OBJECT AND PURPOSE

5.51 Our understanding of the terms of Article 4.10, including footnote 9, based on an analysis of the relevant terms taken in their context is, in our view, also consistent with the object and purpose of the *SCM Agreement* in relation to Article 4.10, and of the *WTO Agreement*, as they relate to the dispute settlement remedies.

5.52 In our view, the object and purpose of the DSB's mandate to authorize countermeasures under Article 4.10 can first be drawn from the very language of Article 4.10. Article 4.10 requires that the DSB authorize the complaining Member to take appropriate countermeasures in case of non-compliance with the recommendation of the DSB. In other words, countermeasures are taken against non-compliance, and thus its authorization by the DSB is aimed at inducing or securing compliance with the DSB's recommendation. In this context, pursuant to Article 4.7, the DSB may *only* recommend that the subsidizing Member withdraw the subsidy without delay. We therefore consider that the objective of the *SCM Agreement* in relation to Article 4.10 in particular is to secure compliance with the DSB's recommendation to withdraw the subsidy without delay.

5.53 Article 4.10, by allowing for the imposition of countermeasures in case of non-compliance, provides a specific temporary instrument to WTO Members, in the context of disputes concerning prohibited subsidies. This instrument contributes to the ultimate achievement of the objectives of dispute settlement.

5.54 We note in this respect that Article 3.7 of the *DSU* also provides that "[i]n the absence of a mutually agreed solution, the first objective of the dispute settlement mechanism is usually to secure the withdrawal of the measures" found to be inconsistent with WTO obligations.

5.55 We also note that the *DSU* Article 3.2 provides that the WTO dispute settlement system (of which this type of arbitration is an integral part) is "a central element in providing security and predictability to the multilateral trading system", and "[t]he Members recognize that it serves to preserve the rights and obligations of Members under the covered agreements."

5.56 In the case of prohibited subsidies, we are of the view that the fact that a panel determining that a subsidy found to be prohibited can *only* recommend its withdrawal without delay is significant

and must be given some meaning when determining the appropriateness of proposed countermeasures. Furthermore, in our view, the legal means prescribed to ultimately restore the "balance of rights and obligations" of Members in relation to prohibited subsidies are specifically provided for under Article 4.7 of the *SCM Agreement.* In a situation where the balance of rights and obligations has been upset through the granting of

5.62 At the same time, Article 4.10 of the *SCM Agreement* does not amount to a blank cheque. There is nothing in the text or in its context which suggests an entitlement to manifestly punitive measures. On the contrary, footnote 9 specifically guards us against such an unbounded interpretation by clarifying that the expression "appropriate" cannot be understood to allow "disproportionate" countermeasures. However, to read this indication as effectively reintroducing into that provision a quantitative limit equivalent to that found in other provisions of the *SCM Agreement* or Article 22.4 of the DSU would effectively read the specific language of Article 4.10 of the *SCM Agreement* out of the text. Countermeasures under Article 4.10 of the *SCM Agreement* are not even, strictly speaking, obliged to be "proportionate" but not to be " disproportionate". Not only is a Member entitled to take countermeasures that are tailored to offset the original wrongful act and the upset of the balancing of rights and obligations which that wrongful act entails, but in assessing the "appropriateness" of such countermeasures – in light of the gravity of the breach – , a margin of appreciation is to be granted, due to the severity of that breach.

VI. ASSESSMENT OF THE COUNTERMEASURES PROPOSED BY THE EUROPEA/fx423"31.183 T

countermeasures that properly take into account the gravity of the breach and the nature of the upset

that it has expended, because such expenditure in breach – the expense incurred – is the very essence of the wrongful act.[74]

6.11 Thus, legally speaking, in terms of redressing the balance of rights and obligations, this is a significant consideration in our assessment of the European Communities' proposed countermeasures. In this respect, we recall our earlier conclusion that countermeasures under Article 4.10 may be tailored to the initial wrongful act they are to counter. In this instance, the European Communities has proposed to take countermeasures which would precisely tailor the response to the amount of this initial wrongful act. In light of our interpretation, in the previous section, of the terms of Article 4.10 of the *SCM Agreement*, we find such an approach, which aims to challenge the wrongful act itself – the breach of the obligation – to be permissible in principle. Indeed, it is in our view entirely compatible with the essence of the notion of countermeasures, in that it seeks to respond exactly to the violation, the persistence of which generates the entitlement to countermeasures.

6.12 We thus turn to a consideration of the proposed countermeasures in relation to the initial wrongful act which they are to counter, the prohibited subsidy.

A. THE PROPOSED COUNTERMEASURES IN RELATION TO THE PROHIBITED SUBSIDY

6.13 In order to proceed with an analysis of the proposed countermeasures in relation to the wrongful act they are to counter, we must first define the elements of that wrongful act. It seems to us that the relevant factors that can be used when it comes to defining the prohibited subsidy itself cannot be artificially constructed. They should be discerned from and grounded in the *SCM Agreement* itself. We recall in this respect the guidance provided in particular by footnote 9, which directs us to take into consideration that the underlying subsidy is prohibited under Part II of the *SCM Agreement*.

6.14 We turn first to what we consider to be fundamental when it comes to characterizing the measure *qua* measure, namely the "financial contribution", given that it is a core element of the definition of a subsidy within the meaning of Article 1 of the *SCM Agreement*.

6.15 In this regard, we first note that the amount of the countermeasures proposed certainly exhibits a manifest relationship of proportionality, as we understand the term[75], in regard to the amount of the export subsidy granted. In this instance, the parties effectively do not fundamentally disagree on the actual value of the export subsidy in respect of which the United States has been found to be in persistent violation.[76] Their disagreement rests only on the issue of whether that amount of countermeasures is "appropriate" within the meaning of Article 4.10.

6.16 As noted above, the quantitative element of the breach in this case is, in fact, that the United States has spent approximately US$4,000 million in breach of its obligations.[77] The European Communities, for its part, is requesting an authorization to take countermeasures in an amount of US$4,043 million.

6.17 The values concerned are not disproportionate. In purely numerical terms, they are in fact in virtual correspondence.[78]

6.18 But this is not just a matter of merely arithmetic proportionality in the abstract. There is an underlying more "structural" element of proportionality that is exhibited in the countermeasures

---

[74] One of the arbitrators wishes to stress that this and the following paragraph should not be read to mean that, without regard to the particular circumstances of individual cases, the total amount of the subsidy would be a universally and generally applicable standard at all times.

[75] See *supra* para. 5.18.

[76] For a detailed analysis of calculations of the amount of the subsidy, see Annex A below.

[77] For a detailed analysis of the value of the subsidy, see Annex A below.

[78] See WT/DS46/ARB, para. 3.60.

be viewed essentially from the perspective of countering the legal breach as a wrongful act. Be that as it may, in the case of a programme such as this, which applies to firms across a considerable range of industries and products, it is clearly impossible for a foreign government to counter precisely the specific benefits to specific firms. The task of calculation alone would be near impossible, let alone tailoring responses to particular firms.

6.23

6.28 The reasoning we have followed above could be construed – in a purely abstract manner – to be as inherently applicable to any other Member as to the complainant in this case viz. the European Communities.[82] We would simply underline, in this regard, that in this case, we were not presented with a multiple complaint but a complaint by one Member. Thus we have not been obliged to consider whether or how the entitlement to countermeasures based on our reasoning above should be allocated across more than one complainant. Thus to the extent that there would be an issue of allocation, as it were, it need not – and did not – enter into consideration as an element to otherwise "discount" the European Communities' entitlement to countermeasures in this particular case.

6.29 Understandably, it would be our expectation that this determination will have the practical effect of facilitating prompt compliance by the United States. On any hypothesis that there would be a future complainant, we can only observe that this would give rise inevitably to a different situation for assessment. To the extent that the basis sought for countermeasures was purely and simply that of countering the initial measure (as opposed to, e.g., the trade effects on the Member concerned) it is conceivable that the allocation issue would arise (although due regard should be given to the point made in footnote 84 above). We take note, on this point, of the statement by the European Communities:

> "…it may well be that the European Communities would be happy to share the task of applying countermeasures against the United States with another member and voluntarily agree to remove some of its countermeasures so as to provide more scope for another WTO Member to be authorized to do the same. This will be another fact that future arbitrators could take into consideration.".[83]

6.30 It must be stressed, however, that there is no mechanical automaticity to this. The essence of such assessments is that it is a matter of judging what is appropriate in the case at hand. There could well be other factors to take into account in their own right, e.g., if for instance the matter of bilateral trade effects were essentially at issue.

6.31 At this point of our analysis, we therefore have, in our view, elements sufficient to allow us to find that the countermeasures proposed could be considered "appropriate" within the meaning of Article 4.10, on the basis of their relation to the initial violating measure.

6.32 In doing so, we are conscious that we have not precisely considered the contention that the matter should be determined by means of reference to the adverse trade effects of the subsidy on the European Communities. We recall, moreover, that the United States has argued that the basis for assessing the "appropriateness" of countermeasures should precisely be these adverse trade effects (or "trade impact"). We address this issue further below.

B. THE TRADE EFFECTS OF THE SUBSIDY ON THE EUROPEAN COMMUNITIES

6.33 As discussed in the previous section, we have not interpreted Article 4.10 to preclude a Member from taking countermeasures that are tailored to counter the adverse effects it has suffered as a result of the illegal measure. We therefore do not rule out *a priori* that trade effects of the measure on the affected Member can enter into consideration in a particular case, as a relevant factor, in determining the "appropriate" amount of countermeasures within the meaning of Article 4.10 of the *SCM Agreement.* Indeed, as we have previously noted, the expression "appropriate countermeasures",

---

[82] One of the arbitrators wishes to stress that under different circumstances in a particular case, this consideration alone may not automatically lead to the conclusion that the countermeasures are "appropriate" within the meaning of Article 4.10 of the *SCM Agreement*.

[83] EC response to question 42 from the Arbitrator, para. 116.

in our view, would entitle the complaining Member to countermeasures which would at least counter the injurious effect of the persisting illegal measure on it.[84]

6.34 However, we have also determined that Article 4.10 of the *SCM Agreement* does not *require* trade effects to be the effective standard by which the appropriateness of countermeasures should be ascertained. Nor can the relevant provisions be interpreted to *limit* the assessment to this standard.

6.35 Bearing in mind, however, our view that trade effects are not *a priori* to be ruled out as relevant in a particular case, we see merit in examining whether, *even if* one addressed the matter of trade effects in this case, there would be any reason to reach a different conclusion. In this case, in fact, we find no reason to reach a different conclusion after examining the arguments presented by the United States in respect of the trade effects of the FSC/ETI scheme on the European Communities.

6.36 We recall in that regard that the United States presented essentially two lines of argument in relation to the assessment of the trade effects of the FSC/ETI scheme on the European Communities. Firstly, the United States principally suggested that in this case, the face value of the subsidy should be taken as a "proxy" for the trade impact of the measure and that this sum then should be apportioned on a percentage basis to the EC share of world trade as a proxy for the trade effect of the subsidy on the European Communities. Secondly, in the event that we would nonetheless decide to examine the economic data pertaining to the trade effects of the measure, the United States has presented a range of possible estimates of the trade impact of this measure using methodologies other than the "proxy" approach. The United States nonetheless argued in the first instance that these should not be used to estimate the trade effects of the measure in this case, by reason of their unreliability and the excessively broad range of the results of calculations. We will consider these two arguments in turn.

6.37 Turning first to the proposed "proxy" approach, under that approach, if the US$4,125 million[85] figure suggested by the United States is used as the starting-point, representing the value of the subsidy, and retaining 26.8 per cent of that figure as the European Communities' share of the global trade effects of the subsidy, as suggested by the United States[86], the appropriate amount of countermeasures would be in a range of approximately US$1,110 million.[87]

6.38 We have stated that we see nothing in the text that directs a trade effects test and that it cannot be construed to be limited to this. There is furthermore nothing in the text which would expressly direct *how* trade effects are to be estimated in a case relating to countermeasures in response to export subsidies. The "proxy" approach proposed by the United States, however, does not appear to have any sound support in the provisions at issue or in the facts of the case.

6.39 To begin with, the proxy approach proposed by the United States is based on no particular economic rationale. It simply presumes a one to one correspondence of dollar of subsidy to dollar of trade impact. This is manifestly arbitrary. Indeed one could even argue that it is a fundamentally self-contradictory concept: if a dollar of subsidy can always and everywhere only lead to a dollar of

---

[84] See para. 5.41 above. For instance, it is conceivable that some adverse effects on a Member could be manifestly greater than the amount of the subsidy that is expended. In such cases, the Agreement can hardly be construed to preclude a Member from taking countermeasures to deal with that situation precisely on the basis of adverse trade effects or that Member – especially when that would otherwise mean that they had recourse thereby only to countermeasures that would be *less* effective than those available to a Member under Article 5 of the *SCM Agreement* (or for that matter under the countervailing provisions of the Agreement, where the other conditions for application would also be present). That is not, of course, the situation we are dealing with here. The European Communities is not seeking entitlement to countermeasures greater than the face value of the subsidy.

[85] Amount of the subsidy for the year 2000 as calculated by the United States, including relevant adjustments.

[86] See US First submission, para. 69.

[87] See US Second Submission, para. 4.

trade effect, this is manifestly to determine in advance what the trade effect is. Yet the very concept of trade *effect* is precisely to assess what has occurred in the real world as the distinct *effect* of that dollar expended. One is, it seems to us, actually precluded from determining such effect if it is already determined that it *is* the actual expenditure. This renders the whole concept of "effect" redundant or meaningless. Under this approach, no such assessment would ever be required: the conclusion is predetermined once the amount of government expenditure is known.

6.40 Indeed, the approach suggested by the United States is hardly reconcilable with a coherent reading of the Agreement. Where trade effects are specifically dealt with under the *SCM Agreement*, in provisions other than Article 4, the criteria for assessment are not at all arbitrary or artificial in this way. This is evident in those provisions of the *SCM Agreement* where a demonstration of trade effects is relevant, and the provisions relating to such assessments (e.g. in relation to injury to the domestic industry or serious prejudice – Article 6 on actionable subsidies – and application of countervailing duties – Part V –). In such cases, the relevant concepts (such as price undercutting, price depression and suppression, etc) are manifestly aimed at objectively determining certain effects. There is not the slightest suggestion in these provisions that this can be ascertained by means of an arbitrary "proxy" such as that proposed by the United States in this case.

6.41 Indeed, were it a matter of merely determining the expenditure, this would completely obviate the need for any such precise concepts to be applied when ascertaining the effects. Bearing that in mind, it would scarcely be coherent to consider that, when it comes to the manifestly more stringent requirements relating to export subsidies, there should be any presumption of an implicit methodology which is *less* likely to bear an objective relationship to the facts of the case.

6.42 Nor has the United States convinced us of why this particular predetermination would be any more inherently plausible than any other. The arbitrator in the *Brazil – Aircraft* case suggests in fact that, if anything, a more likely presumption would be that the relationship of expenditure to effect is to be multiplied rather than static.[88] We take no position on that point in this case. We note, however, that the United States approach in fact amounts to assigning implicit values to the economic variables which the United States otherwise argues are too uncertain to devise, in the context of economic modelling. [89] It is not at all clear to us why these implicit values would be inherently more plausible than any of those that can be assigned in the context of economic modelling, which at least represents analytical estimates rather than an unreasoned assumption. This underlines, in our view, the inherently arbitrary nature of the US proposed approach.

6.43 We turn now to the alternative methodologies presented by the parties for estimating the trade effects of the measure on the European Communities. These methodologies are similar in nature. Nevertheless, different estimations were obtained, both below and above the amount of countermeasures proposed by the European Communities, due to differing assumptions about the values to be assigned to the relevant parameters in the calculations.[90]

---

[88] See the Decision of the Arbitrator, *Brazil – Aircraft (Article 22.6 – Brazil)* WT/DS46/ARB, para. 3.54 ("given that export subsidies usually operate with a multiplying effect (a given amount allows a company to make a number of sales, thus gaining a foothold in a given market with the possibility to expand and gain market shares), we are of the view that a calculation based on the level of nullification or impairment would, as suggested by the calculation of Canada based on the harm caused to its industry, produce higher figures than one based exclusively on the amount of the subsidy").

[89] Assuming full pass through of the subsidy, a value of –1.65 for the price elasticity of the aggregate US export demand curve will result in the value of the trade effect equalling the value of the subsidy (see exhibit US-17).

[90] The quantitative estimate of the impact of an export subsidy on trade depends upon the relationship between the mode of delivery of the subsidy and various economic parameters. In this case the subsidy is allocated on the basis of export income. Eligible export income is used to reduce the overall tax burden of a firm. The overall impact depends upon four factors: the value of the subsidy; the reduction in the price of the

6.44 The European Communities suggested that the Arbitrators should consider the methodology used by the US Treasury Department in 1997 in its report to the United States Congress on the trade impact of the FSC Scheme.[91] The United States objected to this methodology on the following grounds: (1) the price elasticity of export demand is estimated to be too high; (2) the price elasticities of export supply are also estimated to be too high and (3) the pass through of the subsidy to prices is overstated.

6.45 The methodology of the US Treasury is more sophisticated than the proposal by the United States to simply use the value of the subsidy as a proxy. In recognition of this fact, the United States made two further proposals for our consideration. The first was an alternative methodology that the United States claimed was more suitable for an estimation of trade effects on the European Communities.[92] The second was to resort to a different set of parameters for the US Treasury model.[93]

6.46 The United States itself subsequently questioned its own alternative proposed methodology due to the fact that it contained incomplete data.[94] Hence, the options before us for evaluating the trade effects would be limited to the US Treasury model, as proposed by the European Communities, and amendments to this model as suggested by the United States.

6.47 To the extent that we might consider it appropriate in this case to assess the trade effects of the measure on the European Communities, our task would not be to judge, with absolute precision,

---

good benefiting from the subsidy; the export response of producers benefiting from the subsidy; and the price elasticity of demand for US exports.

[91] EC First Submission, paragraph 62. For example, using the US Treasury model as proposed by the European Communities and the estimated subsidy values of both the European Communities and the United States for industrial products as set out in Annex A, the range of the estimated trade effects can be estimated between $3,253 million and $4,294 million.

[92] The United States proposed the Armington model, which assigns elasticities to products based on their country of origin. Therefore, the model, according to the United States, has the advantage of isolating the EC specific trade impact of the subsidy (US Second submission, para 122).

[93] The United States took the position that "imputed" elasticity estimates from estimated substitution elasticities are more robust than the estimates provided by the European Communities. The calculations provided by the United States were justified on the grounds that they were more recent and could be calculated at a disaggregate level.

[94] While we acknowledge the general contribution that the Armington approach to modelling differentiated products models of trade can make, the United States did not, in the case before us, satisfactorily explain why we would be obliged to find the particular approach suggested by it to be more reasonable than that generated by the proposed EC approach. On the contrary, the United States' approach had demonstrable flaws as it sought to apply it in this case. We note that, in this case, the estimation of the trade impact of the subsidy exp(European Tc 0.0821 Tw (doexp 97 Tc th0t the A3mington appr048re more 88cent and. the 97 T30priate in tington app

which is the single correct model or which are the correct parameters, but to examine the results of these models to see if they provide an insight into the range of trade effects caused by the FSC/ETI scheme carrying sufficient weight to materially affect our judgement on whether the countermeasures proposed are disproportionate.

6.48 In this regard, the very fact that the US Treasury report was submitted to Congress is, in our view, of considerable weight. That report did suggest that it may have somewhat overstated the results. Indeed, it may not be absolutely exact. Nonetheless, the US Treasury obviously made the judgement that, in the context of presenting the effects of the FSC scheme to US Congress (the authors, we note, of the legislation concerned), this report, including the modelling assumptions on which it is based, had sufficient credibility to represent a reliable reflection of the impact of the scheme when it came to the matter of informing the US Congress on its operation and effects. That was presumably not undertaken lightly and, at the very least, it was presumably considered to be not manifestly misleading. That perspective, it seems to us, is akin to the kind of judgement that is to be properly applied when an assessment is to be made of whether something is disproportionate. One is not expecting, or looking for, mathematical exactitude, but whether or not (to a reasonable eye) something is out of proportion. In these circumstances, it is not a matter of whether or not the US Treasury study might not be certain as to its conclusions. It is a matter of whether there is, available to us, a more fundamental reason to reliably reject the Treasury study. In this sense, we see that there is, in practical terms, a burden on the United States in this case, in our view, to successfully challenge the model that its own Treasury Department had developed to evaluate the scheme before the US Congress.

6.49 Of course, we have to take due note of the reservations now expressed by the United States about its own study. One can always debate all estimates, but the real issue is not whether some alternatives are possible, but whether there is something reliable that would oblige us to see the broad parameters of that study's outcome as being unreasonable. In that context, we are mindful that the task of evaluating the trade effects of the scheme cannot be accomplished with mathematical precision. Nevertheless, economic science does allow us to consider a range of possible trade effects with a certain degree of confidence.

6.50

5 17.25w ( ) Tj 17.25 0 TD245 -12.7581T* -0.15 s onxt, we a pdinwe rough r Tc 0.1669305 17.

6.51 Secondly, with respect to the issue of pass through, the economic reasoning provided by the United States for adjusting the rate to a lower figure was no more inherently compelling than that which was used for its own study (US Treasury). The EC estimate of the trade impact assumes a full pass through effect of the subsidy onto the price of US products.[97] The United States argues that such an assumption is not necessarily supported by the empirical facts and hence would bias the results upward.[98] It argues that two factors could act in concert to result in a less than 100 per cent pass through of the subsidy onto the price of world products.[99] First, if firms are operating on the positively sloped segment of their average cost curve, an increase in production could result in an increase in costs that may not be compensated by the subsidy.[100] Second, if firms in an industry have market power, they would not necessarily have an incentive to lower prices.[101]

6.52 However, empirical evidence shows that the pass through effect of a similar programme was 75 per cent in the 1970s.[102] Today, more than 25 years later it is not unreasonable to suggest that the

---

provided by the United States were justified on the grounds that they were more recent and could be calculated at a disaggregate level. The process by which the elasticities are imputed, however, was never clearly specified by the United States. The original estimates from which the imputed estimates are done were sourced from two academic studies (Gallaway et al. (2001); Shiells and Reinert (1993)). Both studies relate to the United States. We note that these estimates are derived from demand functions for US consumers. Therefore, these estimates relate to the degree of substitution between imported products into the United States and domestically produced products for US consumers. The United States did not establish why measures of elasticities of imports into the United States could be used as estimates of elasticities of exports. In our view, the United States failed to effectively respond to three reasons identified by the EC as a cause for concern about the procedure used by the United States:

> "The Armington elasticity estimates used by the United States are for substitution between imports into the United States and domestically produced US products. These are not the same as substitution elasticities between US exports and domestically produced products in foreign countries. First, the foreign countries will have different policies towards imports. Second, foreign consumers will have tastes and preferences that are different from US consumers. Third, it is likely that the set of trade goods in an industry is not the same as the set of domestically produced goods offered for local sale. Therefore, the set of US exported goods is not the same as the set of domestically produced goods offered for sale in the United States, and the set of goods imported into the United states is not the same as the set of foreign produced goods offered for sale in foreign countries." (EC comments on US Responses to Additional Questions from the Arbitrator, para 5).

[97] The issue of pass through relates to the degree to which a company uses a subsidy it receives to lower the price of the product that it exports. At one extreme the company may choose to apply the full amount of the subsidy to the price of its products, thereby lowering its price. At the other, it may choose not to lower the price of the product. The concept of pass through is further explained in paragraph 89 of US Answers to Questions from the Arbitrator:

> "An exporter presented with the FSC/ETI tax savings can do one of two things. One the one hand, it can lower the price of its exports by the amount of the tax savings. If it does this, its net profit per transaction will remain the same, although its overall profits may increase because – other factors being held constant – the volume of its exports will increase. This is the "full pass through" scenario.
>
> Alternatively, the exporter can leave the price of its exports unchanged. If it does this, the volume of its exports will remain unchanged – other factors being held constant – but its net profit per transaction will increase by the amount of the tax savings. This is the "no pass-through scenario".

[98] The United States asserts that "pass-through is so critical that if it were determined that firms completely absorbed the tax subsidy rather than reflecting it in export prices, the subsidy would have no effect on US exports and the quantification of the trade impact would be zero." (US Oral Statement, para. 56).

[99] US Answers to Questions from the Arbitrator, para 94.

[100] US Answers to Questions from the Arbitrator, paras 95-97.

[101] US Answers to Questions from the Arbitrator, para 98-99.

[102] EC Answers to Questions from the Arbitrator, para 134.

world market is now more competitive, thereby increasing the pass through effect.[103]

withdrawal of the subsidy. That would be entirely contrary to the direction of footnote 9. Thus, the objective of the requirement must be to ensure that the incentive is more likely to ensure respect for the objective of withdrawal of a prohibited export subsidy as the sole way to restore the preexisting balance of rights and obligations.[106]

6.62 That is not how we see the matter before us. First, to the extent that there was any suggestion that entitlement to countermeasures to the level we have determined was reflecting "trade effects" on parties other than the European Communities, this would have no foundation. To repeat, we consider that our finding is warranted, based on the equivalence in the breach of the original rights and obligations taking into account the gravity of the breach. Where we addressed the issue of trade effects, we have in any case done so only in respect of those relating to the European Communities.

6.63 Second, the conclusion we have reached is not in any sense, a matter of "entitling" the European Communities to act "on behalf" of Members other than itself. As we have underlined in our reasoning above, it is proposing countermeasures relating to the redress of rights and obligations as

ANNEX A - CALCULATION OF THE AMOUNT OF THE SUBSIDY

A.1 The purpose of this annex is to present the arguments and methodologies for the estimation of the value of the subsidy for the year 2000.

A.2 There is no actual data available for the year 2000.[110] The starting-point for the analysis is, therefore, the revenue cost of the FSC scheme for 1996, the latest year for which data is available.[111] The parties differ in their views about the methodology to be used to project the 1996 figure forward to the year 2000.[112]

A. ARGUMENTS OF THE PARTIES

1. Calculation of the unadjusted value

A.3 The first submission of **the European Communities** states that the actual revenue cost of the programme (subsidy) is known only for 1996. In this year the cost of the programme was $2,972 million.[113] They propose two alternative methodologies in order to estimate the value for later years. First, one based on a US Treasury approach that assumes a growth rate of 8 per cent. In this scenario the value of the subsidy is $4,043 million in the year 2000. Second, actual exempt income under the FSC programme grew at an average annual rate of 16.7 per cent from 1987 to 1996.[114] If this growth rate were applied the value of the subsidy in 2000 would be $5,512 million.[115]

A.4 In its comments on the European Communities Methodology, **the United States** proposed the use of the US Dept. of Treasury published tax expenditure estimate of the subsidy for that year.[116] This figure is stated in the United States first submission as the figure used in the Budget of the United States government as $3,890 million for 2000.[117] Since the programme is applied across the board an adjustment is required to take services trade into account. The United States argues that this adjustment should be 8.3 per cent to deduct agricultural, computer, motion picture, engineering and architectural services.[118] The value of the subsidy in 2000 according to the United States is, therefore,

past rates.[128] The United States further amplified on these points in a response to a specific question on this issue from the Arbitrator.[129]

A.11 The European Communities has maintained its position that they view the approach of the Treasury as arbitrary and that the US Treasury has consistently underestimated the value.[130] It argues that, based on the new methodology proposed by the United States, the growth rate from 1996 to 2000 should be based on the 1992 to 1996 growth rate[131], since the United States approach "lacks any solid basis".[132]

A.12 The European Communities also criticises the use of unreferenced data by the United States. They cite tabulations 1 and 2 from the United States Answers to additional questions from the Arbitrator that are "done by the Office of Tax analysis, US Department of Treasury".[133] They also specifically address the determinants proposed by the United States. For example, they argue that there is a difference between the profitability of the overall manufacturing industry and the profitability that can be attributed to export sales.[134] With respect to the figures on profits, the European Communities produced data from the Economic Report of the President that challenge the United States data on profitability, and cited a study that showed that the major FSC beneficiaries has increased their FSC benefits in absolute amounts during the period 1996-2000.[135]

A.13 Taken together, if the 1992-1996 usage rate is applied, the European Communities estimate of the unadjusted subsidy for 2000 is $5,577 million (table A.1).[136] In contrast, the estimate of the unadjusted subsidy using the United States methodology is $3,869 million.

2.

B. ASSESSMENT BY THE ARBITRATORS

1.

therefore agree that, for the purposes of fulfilling our mandate concerning the level of countermeasures in relation to the violation of Article 3.1(a) of the *SCM Agreement*, the adjustment to the subsidy amount for exports of services should account for this category of engineering and architectural services.[148]

A.22 Since there are differences of view between the parties regarding the growth of the FSC usage rate and adjustments to the gross estimate of the subsidy, there are necessarily differences in the estimates. Nevertheless, if the subsidy is adjusted downwards by 0.57 per cent and upwards by 7.2 per cent, the overall adjustment would be upwards by 6.63 per cent, which is the difference between the two adjustment values. In this case, the estimate of the adjusted subsidy provided by the United States is $4,125 million, while that of the European Communities is $5,988 million.

3. Allocating agriculture

(a) Introduction

A.23 The United States initially considered that the amount of subsidies attributable to exports of agricultural products should be deducted for the purposes of determining the amount of "appropriate countermeasures" under Article 4.10 of the *SCM Agreement.* Upon further reflection, it considered that such adjustment was not necessary, because the same proxy approach is necessary. The European Communities argues that the obligation of the United States is to withdraw the whole subsidy, and that the amount of exports of agricultural products under the FSC/ETI scheme is in any case very small.[149] The European Communities has also argued that the existence of a separate violation under the Agriculture Agreement cannot lead to a reduction of the amount of countermeasures below the amount of the subsidy.

A.24 We turn to an examination of the amount of the subsidy for the purposes of the SCM Agreement.[150] In order to identify the agricultural component of the FSC subsidy, we will refer to the product coverage of the WTO *Agreement on Agriculture*. The principal technical challenge involved is that the WTO definition is commodity-based, whereas the industry definitions are a mix of manufacturing and services industries. For example, in the USSIC fishing is included in 090, but so is the operation of fish hatcheries and preserves (table A.2).

(b) Coverage of the *Agreement on Agriculture*

A.25 The *Agreement on Agriculture* covers HS Chapters 1-24, less fish and fish products, plus a number of headings in chapters, 33, 35, 38, 41, 43, and 51-53.[151] Fish and fish products are defined as chapter 03, 0509, 1504, 1603-05, 2301.[152]

(c) US Standard Industrial Categories

A.26 The 13 sectors that are used in the European Communities study are aggregated using United States SIC classification. Since these are industry categories they are a mix of both service and

[148] See US first submission, para. 73; US Second Submission, para. 88; EC first submission, para. 93.

[149] First Submission para. 88.

[150] We recall that the 21.5 panel in this case made a separate ruling that the FSC/ETI scheme was in violation of the *Agreement on Agriculture*, in addition to the *SCM Agreement*. The Appellate Body upheld this finding (Article 21.5 Appellate Body Report, para. 256(d)). We also note, in respect of the deduction for agricultural products discussed here, that if a separate assessment were made to evaluate the level of nullification or impairment resulting from the violation of the *Agreement on Agriculture*, this could provide a separate basis for suspension of concessions which would in any event not lower the entitlement to countermeasures under the *SCM Agreement*.

[151] See *Agreement on Agriculture, Annex 1*.

[152] From WTO, *Unfinished Business*.

calculated on the basis of the parties' respective methodologies, can be considered to be a reasonable approximation of the actual value of the subsidy for the year 2000.

Table A.1 - Calculating the value of the subsidy for the year 2000

	United States	**European Communities**
FSC Usage growth rate	.01 per annum	.106886 per annum
FSC Exempt Income in 2000		
Total US Exports*	$781,918 million	$781,918 million
Unadjusted subsidy value in 2000	$3,869 million	$5,577 million
Adjustment		
Services (-0.57 %)	$22 million	
ETI Adjustment (+7.2%)	$278 million	$401 million
Estimated value with agriculture	**$4,125 million**	**$5, 988 million**
Estimated value without agriculture	**$3,739 million**	**$ 5,332million**

* Source: WTO (2002), www.wto.org

Table A.2 – United States Standard Industrial Classification

Agriculture	
010	Agricultural production – crops
020	Agricultural production – livestock and animal specialties
070	Agricultural services
Forestry, and Fishing	
080	Forestry
090	Fishing, hunting and trapping
Food and Kindred Products	
201	Meat products
202	Dairy products
203	Preserved fruit and vegetables
204	Grain mill products
205	Bakery products
208	Beverages
209	Other food and kindred products
210	Tobacco

Table A.3 - Pre -tax exempt income (millions of dollars)

	1996	US 2000	EC 2000
Agriculture	118.7	165.3	222.9
Other non-manufactured	435.6	644.8	818.3
Food	153.3	214.2	287.9
Tobacco	153.6	214.2	288.5
Lumber	30.3	42.1	56.9
Paper	74.5	103.7	139.9
Chemical	729.8	1018.2	1370.9
Rubber	24.4	33.8	45.8
Primary metal	44.2	61.6	83.0
Fabricated metal	59.9	83.4	112.5
Non-electrical machinery	742.5	1036.3	1394.8
Electrical machinery	911.7	1272.2	1712.6
Transport equipment	644.3	898.8	1210.3
Scientific instruments	254.4	355.4	478.0
Other manufactured	137.0	202.1	257.3
TOTAL	4513.9	6346.1	8479.5
Total non –agriculture	4088.4	5752.4	7680.2

Source: WTO, based on submissions by the parties.