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CANADA – CERTAIN MEASURES AFFECTING THE AUTOMOTIVE INDUSTRY

AB-2000-2

Report of the Appellate Body

(the "GATS")[4]; and with Article XVII of the GATS. The Panel Report was circulated to the Members of the World Trade Organization (the "WTO") on 11 February 2000.

3. The Panel concluded as follows: (a) that Canada acts inconsistently with Article I:1 of the GATT 1994; (b) that the inconsistency with Article I:1 of the GATT 1994 is not justified under Article XXIV of the GATT 1994; (c) that Canada acts inconsistently with Article III:4 of the GATT 1994, as a result of the application of the Canadian value added requirements; (d) that the European Communities and Japan failed to demonstrate that Canada acts inconsistently with Article III:4 of the GATT 1994, as a result of the application of the production-to-sales ratio requirements; (e) that Canada acts inconsistently with Article 3.1(a) of the *SCM Agreement*; (f) that the European Communities and Japan failed to demonstrate that Canada acts inconsistently with its obligations under Article 3.1(b) of the *SCM Agreement*; (g) that Canada acts inconsistently with Article II of the GATS; (h) that the inconsistency with Article II of the GATS is not justified by Article

5. On 2 March 2000, Canada notified the DSB of its intention to appeal certain issues of law covered in the Panel Report and certain legal interpretations developed by the Panel, pursuant to paragraph 4 of Article 16 of the *Understanding on Rules and Procedures Governing the Settlement of Disputes* (the "DSU"), and filed a Notice of Appeal pursuant to Rule 20 of the *Working Procedures for Appellate Review* (the "*Working Procedures* "). On 13 March 2000, Canada filed its appellant's submission.[7] On 17 March 2000, the European Communities and Japan each filed its own appellant's submission.[8] On 27 March 2000, Canada[9], the European Communities and Japan[10] all filed appellees' submissions. On the same day, Korea and the United States each filed a third participant's submission.[11]

6. The oral hearing in the appeal was held on 6 and 7 April 2000. In the oral hearing, the participants and third participants presented oral arguments and responded to questions put to them by the Members of the Division hearing the appeal.

II. The Measure and Its Background

7. The Canadian measure[12]

8. The MVTO 1998 has its origins in the Agreement Concerning Automotive Products Between the Government of Canada and the Government of the United States of America (the "Auto Pact")[17], which was implemented domestically in Canada by the MVTO 1965 and the Tariff Item 950 Regulations. These legal instruments were replaced by the MVTO 1988 and later by the MVTO 1998. The MVTO 1998 is in effect today.[18]

9. Under the MVTO 1998, the import duty exemption is available to manufacturers of motor vehicles on imports "from any country entitled to the Most-Favoured-Nation Tariff"[19], if the manufacturer meets the following three conditions: (1) it must have produced in Canada, during the designated "base year", motor vehicles of the class imported; (2) the ratio of the net sales value of the vehicles *produced in Canada* to the net sales value of all vehicles of that class *sold* for consumption *in Canada* in the period of importation must be "equal to or higher than" the ratio in the "base year", and the ratio shall not in any case be lower than 75:100 (the "ratio requirements"); and (3) the amount of Canadian value added in the manufacturer's local production of motor vehicles must be "equal to or greater than" the amount of Canadian value added in the local production of motor vehicles of that class during the "base year" (the "CVA requirements").[20]

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[17]See 4 International Legal Materials, p. 302. The Auto Pact was concluded in 1965. Under Article II(a) of the Auto Pact, Canada agreed to accord an import duty exemption to imports from the United States of certain products listed in Annex A of the Auto Pact. In order to receive the import duty exemption, a company had to meet three conditions set out in paragraph 2(5) of Annex A: (1) it must have produced in Canada, during the "base year", motor vehicles of the class it was importing; (2) the ratio of the net sales value of its production in Canada to the net sales value of motor vehicles of that class sold for consumption in Canada must have been "equal to or higher than" the ratio during the "base year", and could in no case be lower than 75:100; and (3) the Canadian value added in the company's local production in Canada of motor vehicles must

10. The Panel found that, as a matter of fact, the average ratio requirements applicable to the MVTO 1998 beneficiaries are "as a general rule" 95:100 for automobiles, and "at least" 75:100 for buses and specified commercial vehicles.[21]

11. The MVTO 1998 states that the CVA used by a particular manufacturer shall be calculated based on the "aggregate" of certain listed costs of production, which are, broadly speaking:

- the cost of parts produced in Canada and of materials of Canadian origin that are incorporated in the motor vehicles;
- transportation costs;
- labour costs incurred in Canada;
- manufacturing overhead expenses incurred in Canada;
- general and administrative expenses incurred in Canada that are attributable to the production of motor vehicles;
-

13. With respect to the actual ratio and CVA requirements under the SROs, each SRO sets out specific ratio and CVA requirements to be met by the company receiving the SRO. For ratio requirements, the SROs issued before 1977 set the production-to-sales ratios at 75:100. Since then, almost all SROs have set ratios at 100:100.[25] For CVA, requirements under the SROs range from 40 to 60 per cent, as follows: SROs issued before 1984 stipulate that, during an initial period of one or two years, the CVA must be at least 40 per cent of the cost of production. After that initial period, the CVA should be at least the same (in dollar terms) as in the last 12 months of the initial period; however, the CVA must not, in any case, be less than 40 per cent of the cost of production. For SROs issued after 1984, the CVA shall be no less than 40 per cent of the cost of sales of vehicles sold in Canada, with the exception of the manufacturer CAMI Automotive Inc. ("CAMI"), for which the CVA level is set at 60 per cent.[26]

14. In accordance with its obligations under the CUSFTA, since 1989, Canada has not designated any additional manufacturers to be eligible for the import duty exemption under the MVTO 1998, nor has Canada promulgated any new SROs. Also, the MVTO 1998 specifically excludes vehicles imported by a manufacturer which did not qualify before 1 January 1988.[27] Thus, the list of manufacturers eligible for the import duty exemption is closed.

III. Arguments of the Participants and Third Participants

A. *Claims of Error by Canada – Appellant*

1. Article I:1 of the GATT 1994

15. Canada argues that the Panel erred in finding that the Canadian measure is inconsistent with the most-favoured-nation ("MFN") provisions of Article I:1 of the GATT 1994. By its terms, Article I:1 prohibits discrimination in the according of advantages based on the origin of products. In Canada's view, the Canadian measure at issue is "origin-neutral"[28] in this sense, and is therefore consistent with Article I:1.

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[25]Panel Report, para. 2.34.

[26]*Ibid*., para. 2.33.

[27]MVTO 1998, Schedule, Part 1, para. 3.

[28]Canada's appellant's submission, para. 163.

16. Canada submits that none of the previous panel reports addressing the issue of MFN treatment under Article I:1 supports the Panel's concept of a *de facto* violation of Article I:1. The

3. Article I:1 and Article II:1 of the GATS

(a) *Article I:1 of the GATS*

20. According to Canada, the Panel erred in finding that the scope of the GATS extends to the measure at issue. Canada argues that the scope of the GATS is established in Article I of that Agreement, which states that the Agreement applies to "measures…affecting trade in services." Canada submits that the measure at issue does not affect trade in services. In this case, Canada contends, the measure does not affect the supply of distribution services and does not affect wholesale distribution service suppliers in their capacity as service suppliers. It is true that the import duty exemption "may affect"

27. In the view of the European Communities, production-to-sales ratio requirements of both one to one or greater, and of less than one to one, result in export contingency "in law". Where the ratio requirements are one to one or greater, the manufacturer concerned cannot sell any value of motor vehicles brought into Canada under the import duty exemption unless it exports an equivalent value. Where the ratio requirements are less than one to one, the European Communities agrees with Canada that the manufacturer concerned is entitled to sell a certain value of motor vehicles imported under the import duty exemption without exporting. However, the European Communities points out that, if the manufacturer does export, the value of imports made under the import duty exemption will increase by an amount equal to the value of the exports. Therefore, the measure is contingent "in law" upon export performance as a result of the ratio requirements, in contravention of Article 3.1(a) of the *SCM Agreement.*

3. Article I:1 and Article II:1 of the GATS

(a) *Article I:1 of the GATS*

28. According to the European Communities, the Panel's finding that the Canadian measure affects trade in services under Article I of the GATS was correct. While it is true that the measure in this case can affect both goods and services, this does not mean that the measure cannot be examined under the GATS. The European Communities maintains that the proper test under Article I:1 of the GATS is simply whether the measure at issue affects the supply of services and that the Panel's examination of the measure under Article II of the GATS implicitly included an assessment of whether the measure affects trade in services under Article I of the GATS.

(b) *Article II:1 of the GATS*

29. In the view of the European Communities, Article II of the GATS applies to *de facto* as well as *de jure* discrimination. When examining a claim of *de facto* discrimination, any inconsistency must be inferred from the total configuration of the facts surrounding the measure. In this case, the Panel properly examined these facts, and these facts support its finding that *de facto* discrimination exists.

30. The European Communities submits that the Panel correctly found that the Canadian measure accords less favourable treatment to services and service suppliers of some Members than it accords to like services and service suppliers of other Members. The European Communities argues that, contrary to Canada's claim, vertical integration in the automotive industry does not preclude the

possibility that competitive conditions for the provision of wholesale trade services would be affected by the measure. The Panel's finding that vertical integration did not exclude potential competition in wholesaler-manufacturer relationships nor actual competition in wholesaler-retailer relationships was correct. This finding is confirmed by the fact that the vast majority of the service suppliers receiving the import duty exemption under the measure are from the United States. Furthermore, eligibility for the import duty exemption has been closed, since 1989, to any additional service suppliers.

C. *Arguments by Japan – Appellee*

1. Article I:1 of the GATT 1994

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(b) *Whether the Measure is "Contingent…in Law…upon Export Performance"*

34. Japan considers that the measure is contingent "in law" upon export performance under Article 3.1(a) of the *SCM Agreement*. As a result of the ratio requirements, there is a clear relationship of conditionality between the import duty exemption and exportation. Japan argues that where the ratio requirement is set at one to one or higher, there is a requirement to export in order to receive the import duty exemption. The only "economically viable"[32] way for a manufacturer to comply with the ratio requirements when it imports motor vehicles is to export vehicles that it has produced in Canada. Where the ratio requirement is less than one to one, the requirement to export also arises, even though, Japan concedes, the "pressure" to export is of a "lesser degree"[33] in this situation. Japan has provided mathematical expressions of these arguments.

35. According to Japan, the Panel's finding that the ratio requirements, as a condition for receiving the import duty exemption, are contingent "in law" upon export performance was correct, since contingency can be established based on the words of the relevant legal instruments. Those instruments create a "construct"[34] under which the import duty exemption under the measure is contingent upon export performance. Therefore, the measure is contingent "in law" upon export performance under Article 3.1(a) of the *SCM Agreement*.

3. Article I:1 and Article II:1 of the GATS

(a) *Article I:1 of the GATS*

36. In Japan's view, the Panel's approach in determining whether the application of the measure affects trade in services within the meaning of Article I of the GATS is correct. The Panel did not err in its substantive finding that the measure affects trade in services under Article I of the GATS. The term "affecting" in Article I has a broad reach. The measure affects trade in services, as it has an effect on the "cost and/or profitability"[35] of the related wholesale trade services.

(b) *Article II:1 of the GATS*

37. Japan argues that the measure is inconsistent with the MFN obligation in Article II of the GATS. The Panel's finding in this regard is correct. The Panel relied, in part, on the fact that the measure put some service providers at an economic or competitive disadvantage. The Panel

[32]Japan's appellee's submission, para. 71.

[33]*Ibid*., para. 73.

[34]*Ibid*., para. 85.

[35]*Ibid*., para. 113.

recognized that two elements of the provision of wholesale services must be examined: wholesale services provided to manufacturers, and wholesale services provided to retailers. In Japan's view, the Panel made the correct finding under Article II of the GATS, that the import duty exemption is only available to certain wholesale service suppliers, and is therefore not made available to like service suppliers of all WTO Members.

D. *Claims of Error by the European Communities – Appellant*

1. Article 3.1(a) of the *SCM Agreement* – European Communities' Claim Regarding CVA Requirements

38. According to the European Communities, the Panel failed to address the European Communities' claim that the CVA requirements operate as an export performance condition prohibited by Article 3.1(a) of the *SCM Agreement.* The European Communities claimed before the Panel that the CVA requirements make the subsidy contingent "in law" and, alternatively, "in fact" upon the use of domestic over imported goods or, as the sole alternative, upon export performance.[36] Therefore, the CVA requirements are inconsistent with the prohibition of Article 3.1(a). The Panel's failure to address the alternative condition of export performance was an error. The European Communities requests the Appellate Body to find that certain of the CVA requirements are contingent upon export performance.

2. Article 3.1(b) of the *SCM Agreement*

(a) *Whether the Measure is Contingent "in Law" upon the Use of Domestic over Imported Goods*

39. The European Communities argues that Article 3.1(b) of the *SCM Agreement* prohibits subsidies contingent upon a condition that "gives preference" [37] to the use of domestic over imported goods. The Panel's narrow finding that Article 3.1(b) only prohibits the granting of subsidies that "require" the beneficiary to "actually use" domestic goods constitutes legal error.[38] In the European Communities' view, the Panel's interpretation would allow circumvention of Article 3.1(b).

40. The European Communities notes that Article 3.1(b) prohibits the granting of subsidies that are contingent upon the use of domestic over imported goods "whether solely or as one of several conditions". These terms cover the situation where a subsidy is simultaneously subject to two or more "cumulative conditions". However, the European Communities argues that these terms may also apply where a subsidy is subject to two or more "alternative" conditions, where compliance with any one or more of them gives a right to obtain the subsidy.[39] According to the European Communities, the use of domestic over imported goods through the CVA requirements is an alternative condition for receiving the import duty exemption under the measure. This alternative condition is a condition "in law" for receiving the import duty exemption, and is, therefore, inconsistent with Article 3.1(b) of the *SCM Agreement.*

(b) *Whether the Measure is Contingent "in Fact" upon the Use of Domestic over Imported Goods*

41. In the alternative, the European Communities argues that the CVA requirements constitute a subsidy contingent "in fact" upon the use of domestic over imported goods. In making this claim, the European Communities contends that the Panel's finding that Article 3.1(b) does not apply to "in fact" contingency is erroneous.

contingent "in law" upon export performance, Japan submits that the Panel's use of judicial economy was in error, and the issue of whether the subsidy is contingent "in fact" upon export performance should be considered by the Appellate Body.

44. According to Japan, the Panel made certain findings relevant to the issue of whether the import duty exemption is contingent "in fact" upon export performance. The Panel's examination of the ratio requirements demonstrates that the "facts" of those requirements lead to the conclusion that the import duty exemption is contingent upon export performance.

2. Article 3.1(b) of the *SCM Agreement*

(a) *Whether the Measure is Contingent "in Law" upon the Use of Domestic over Imported Goods*

45. Japan argues that the measure is contingent "in law" upon the use of domestic over imported goods, in contravention of Article 3.1(b) of the *SCM Agreement*. The plain language of this provision demonstrates that a "key component" of the applicable legal standard is whether the use of domestic over imported goods "would lead to" the granting or maintenance of a subsidy.[40] This interpretation is supported by the object and purpose of the *SCM Agreement* as a whole and of Article 3.1(b) in particular.

46. Japan submits that, in this case, the use of CVA is one of several conditions that, if fulfilled, results in the receipt of the import duty exemption. One way to meet the CVA requirements is to use domestic parts and materials. According to Japan, it has *not* been demonstrated that the CVA requirements can be met without using domestic parts and materials. The Panel has referred to the *hypothetical* possibility to do so, but Canada has not provided sufficient evidence to rebut the fact that the CVA requirements mandate the use of domestic parts and materials. The Panel's finding that a subsidy is not contingent on the use of domestic over imported goods if it can be obtained through other means, although the use of domestic over imported goods is one way actually to obtain the subsidy, is problematic. If this finding is upheld, it will be possible for WTO Members to escape their Article 3.1(b) obligations by including additional conditions that are unrelated to the use of domestic over imported goods.

[40]Japan's appellant's submission, para. 7.

(b) *Whether the Measure is Contingent "in Fact" upon the Use of Domestic over Imported Goods*

47. Japan argues that Article 3.1(b) of the *SCM Agreement* prohibits both subsidies contingent "in law" and subsidies contingent "in fact" upon the use of domestic over imported goods. The Panel's finding restricting the scope of application of Article 3.1(b) to subsidies contingent "in law" was erroneous. The Panel found that the inclusion of the words "in law or in fact" in paragraph (a) of Article 3.1 of the *SCM Agreement* and the absence of the same words in paragraph (b) of the same Article means that the drafters of Article 3.1(b) intended to limit that provision to contingency "in law". In Japan's view, the Panel's reasoning ignores the ordinary meaning of the words of Article 3.1(b). Article 3.1(b) prohibits subsidies "contingent … upon the use of domestic over imported goods." These words do not expressly limit the scope of coverage of Article 3.1(b) to contingency "in law". In the absence of an express limitation, Article 3.1(b) must be interpreted to apply to both contingency "in law" and "in fact". The inclusion of the words "in law or in fact" in Article 3.1(a) is most likely intended to "anchor"[41] footnote 4 of the *SCM Agreement*, which sets forth an explanation of subsidies contingent "in fact" upon export performance. In addition, the Panel's finding that Article 3.1(b) prohibits only subsidies contingent "in law" upon the use of domestic over imported goods does not take into account the object and purpose of the *WTO Agreement* as a whole and of Article 3.1(b) of the *SCM Agreement.*

48. According to Japan, when determining whether a subsidy is contingent "in fact" upon the use of domestic over imported goods, the issue is whether the configuration of the facts surrounding the granting of the subsidy is such that, "in fact", the subsidy will be granted if the recipient used domestic over imported goods. In the case of the measure at issue here, the relevant facts establish that it is impossible for manufacturers to satisfy the CVA requirements without purchasing at least a certain proportion of Canadian parts and components.

F. *Arguments by Canada – Appellee*

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

(a) *Whether the Measure is "Contingent…in Fact…upon Export Performance"*

49. According to Canada, the Panel correctly applied the principle of judicial economy when it declined to examine whether the measure was contingent "in fact" upon export performance under Article 3.1(a) of the *SCM Agreement.* Since the Panel found that contingency "in law" existed, the

[41] Japan's appellant's submission, para. 29.

Panel was entitled to stop its analysis there. This is a legitimate application of judicial economy, which Canada's appeal does not change. However, if the Appellate Body agrees with Canada's

subsidy would, by definition, not be "contingent" upon the use of domestic over imported goods, since it could be received without using domestic over imported goods.

(b) *Whether the Measure is Contingent "in Fact" upon the Use of Domestic over Imported Goods*

54. Canada considers, moreover, that Article 3.1(b) does not extend to measures that are "in fact" contingent upon the use of domestic over imported goods. The Panel's finding on this issue was correct. In Canada's view, the context provided by Article 3.1(a) is determinative. As the words "in law or in fact" are included in Article 3.1(a), the fact that they are not found in Article 3.1(b) indicates that Article 3.1(b) does not apply to contingency "in fact".

55. In any event, Canada argues, Japan and the European Communities have failed to establish that the measure is contingent "in fact" upon the use of domestic over imported goods. As evidence provided by Canada to the Panel demonstrates, it is not impossible to meet the CVA requirements without using Canadian goods.

G. *Third Participants*

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revenue foregone which is "otherwise due", under Article 1.1(a)(1)(ii). Since a benefit is conferred as a result, the measure is a "subsidy" within the meaning of Article 1.1 of the

(ii) Article II:1 of the GATS

61. Korea submits that the Panel was correct in finding that the measure is inconsistent with Article II:1 of the GATS because it does not accord treatment no less favourable to like services and service suppliers of other WTO Members. Through its effect on the conditions of competition, the measure results in *de facto* discrimination based on the origin of the service or service supplier. In fact, the closed category of service suppliers is comprised almost exclusively of service suppliers of the United States and Canada. As a result, some motor vehicle service suppliers of some Members can receive the import duty exemption, while those of other Members cannot, and, consequently,

(c) whether the Panel erred in failing to address the European Communities' alternative claim that the import duty exemption, as a result of the application of the CVA requirements as one of the conditions for the import duty exemption, is a subsidy contingent upon export performance within the meaning of Article 3.1(a) of the *SCM Agreement*;

(d) whether the Panel erred in concluding that the European Communities and Japan have failed to demonstrate that Canada acts inconsistently with its obligations under Article 3.1(b) of the *SCM Agreement* by granting a subsidy which is contingent upon the use of domestic over imported goods, as a result of the application of the CVA requirements as one of the conditions determining eligibility for the import duty

68. 2.2471

71. Although the measure on its face imposes no formal restriction on the *origin* of the imported motor vehicle, the Panel found that, in practice, major automotive firms in Canada import only their own make of motor vehicle and those of related companies.[62] Thus, according to the Panel,

> …General Motors in Canada imports only GM motor vehicles and those of its affiliates; Ford in Canada imports only Ford motor vehicles and those of its affiliates; the same is true of Chrysler and of Volvo. These four companies all have qualified as beneficiaries of the import duty exemption. In contrast, other motor vehicle companies in Canada, such as Toyota, Nissan, Honda, Mazda, Subaru, Hyundai, Volkswagen and BMW, all of which also import motor vehicles only from related companies, do not benefit from the import duty exemption.[63]

72. Therefore, the Panel considered that, in practice, a motor vehicle imported into Canada is granted the "advantage" of the import duty exemption only if it originates in one of a small number of countries in which an exporter of motor vehicles is affiliated with a manufacturer/importer in Canada that has been designated as eligible to import motor vehicles duty-free under the MVTO 1998 or under an SRO.

73. Since 1989, no manufacturer not already benefiting from the import duty exemption on motor vehicles has been able to qualify under the MVTO 1998[64] or under an SRO. The list of manufacturers eligible for the import duty exemption was closed by Canada in 1989 in fulfilment of Canada's obligations under the CUSFTA.[65]

74. Thus, in sum, while the Canadian Customs Tariff normally allows a motor vehicle to enter Canada at the MFN duty rate of 6.1 per cent, the same motor vehicle has the "advantage" of entering Canada duty-free when imported by a designated manufacturer under the MVTO 1998 or under the SROs.[66]

75. In determining whether this measure is consistent with Article I:1 of the GATT 1994, we begin our analysis, as always, by examining the words of the treaty. Article I:1 states, in pertinent part:

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[62]Panel Report, para. 10.43.

[63]*Ibid.*

[64]MVTO 1998, Schedule, Part 1, para. 3.

[65]*Supra*, footnote 17 and para. 14.

[66]Assuming, as above, that that country benefits from Canada's MFN rate.

cannot accept Canada's argument that Article I:1 does not apply to measures which, on their face, are "origin-neutral".[71]

79. We note next that Article I:1 requires that *"any advantage*, favour, privilege or immunity granted by any Member to *any product* originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of *all other Members*." (emphasis added) The words of Article

customs unions and free trade areas under Article XXIV. This justification was rejected by the Panel, and the Panel's findings on Article XXIV were not appealed by Canada. Canada has invoked no other provision of the GATT 1994, or of any other covered agreement, that would justify the inconsistency of the import duty exemption with Article I:1 of the GATT 1994.

84. The object and purpose of Article I:1 supports our interpretation. That object and purpose is to prohibit discrimination among like products originating in or destined for different countries. The prohibition of discrimination in Article I:1 also serves as an incentive for concessions, negotiated reciprocally, to be extended to all other Members on an MFN basis.

85. The measure maintained by Canada accords the import duty exemption to certain motor vehicles entering Canada from certain countries. These privileged motor vehicles are imported by a limited number of designated manufacturers who are required to meet certain performance conditions. In practice, this measure does not accord the same import duty exemption immediately and unconditionally to like motor vehicles of *all* other Members, as required under Article I:1 of the GATT 1994. The advantage of the import duty exemption is accorded to some motor vehicles originating in certain countries without being accorded to like motor vehicles from *all* other Members. Accordingly, we find that this measure is not consistent with Canada's obligations under Article I:1 of the GATT 1994.

86. We, therefore, uphold the Panel's conclusion that Canada acts inconsistently with Article I:1 of the GATT 1994 by according the advantage of the import duty exemption to motor vehicles originating in certain countries, pursuant to the MVTO 1998 and the SROs, which advantage is not accorded immediately and unconditionally to like products originating in the territories of all other WTO Members.

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

A. *Whether the Measure Constitutes a "Subsidy"*

87. Canada appeals the Panel's finding that the measure is a "subsidy" within the meaning of Article 1.1 of the *SCM Agreement*.[74] For Canada, the measure does not, in the language of Article 1.1, forego "government revenue that is otherwise due".[75] Canada argues that the import duty exemption at issue here cannot be equated mechanically with a tax exemption, such as the one at issue

[74]Canada's appellant's submission, para. 57.

[75]*Ibid.*, para. 60.

in *United States – Tax Treatment for "Foreign Sales Corporations"* ("*United States – FSC*

93. In our view, it is also not relevant that motor vehicles benefiting from the import duty exemption may enter Canada duty-free if imported under the provisions of the NAFTA. Duty-free treatment under the NAFTA is not at issue in this case. The measure at issue in this case is the import duty exemption set out in the MVTO 1998 and the SROs.

94. For these reasons, we uphold the Panel's finding that "government revenue that is otherwise due is foregone" and that the measure constitutes a "subsidy" under Article 1.1 of the *SCM Agreement*.[87]

B. *Whether the Measure is "Contingent…in Law…upon Export Performance"*

95. Canada appeals the Panel's finding that the measure is a subsidy which is "contingent …in law…upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*. Canada argues that the Panel erred in law by misinterpreting the definition of "contingent", and alleges that the Panel did not "even attempt to demonstrate contingency 'on the basis of the words of the relevant legislation…'; instead, it resorted to hypothetical 'facts'."[88] Thus, Canada maintains that the Panel erroneously found the measure contingent "in law" upon export performance because it conducted a "hypothetical" analysis of certain factual elements.[89] Canada submits, furthermore, that the facts relating to the measure do not demonstrate that it is *de facto* contingent upon export performance.[90]

96. The Panel concluded that the subsidy provided by the measure is "contingent…in law…upon export performance" within the meaning of Article 3.1(a) of the *SCM Agreement*.[91] In its analysis, the Panel examined the ratio requirements, but not the CVA requirements[92], of the measure under the MVTO 1998 and the SROs. The Panel found that "the MVTO 1998 and the SROs demonstrate, on their face, that the import duty exemption is contingent upon export performance…".[93]

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[87]Panel Report, para. 10.170.

[88]

97. Article 3.1 of the *SCM Agreement* provides, in pertinent part:

> Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> (a) subsidies contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;
>
> …
>
> (footnotes omitted)

98. In *Canada – Measures Affecting the Export of Civilian Aircraft* ("*Canada – Aircraft* "), we noted that the key word in Article 3.1(a) is "contingent":

> …the ordinary connotation of "contingent" is "conditional" or "dependent for its existence on something else". This common understanding of the word "contingent" is borne out by the text of Article 3.1(a), which makes an explicit link between "contingency" and "conditionality" in stating that export contingency can be the sole or "one of several other *conditions*".[94] (footnote omitted)

99. Although in *Canada – Aircraft* we were dealing with a subsidy that was contingent "in fact" upon export performance, we stated in that case that "the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency."[95] We stated, furthermore, that:

> There is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent. *De jure* export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument. Proving *de facto* export contingency is a much more difficult task. There is no single legal document which will demonstrate, on its face, that a subsidy is "contingent…in fact…upon export performance". Instead, the existence of this relationship of contingency, between the subsidy and export performance, must be *inferred* from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.[96]
>
> (emphasis in italics in the original; emphasis in underlining added)

100. We start with what we have held previously. In our view, a subsidy is contingent "in law" upon export performance when the existence of that condition can be demonstrated on the basis of the very words of the relevant legislation, regulation or other legal instrument constituting the measure.

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The simplest, and hence, perhaps, the uncommon, case is one in which the condition of exportation is set out expressly, in so many words, on the face of the law, regulation or other legal instrument. We believe, however, that a subsidy is also properly held to be *de jure* export contingent where the condition to export is clearly, though implicitly, in the instrument comprising the measure. Thus, for

> "[M]anufacturer" means a manufacturer of a class of vehicles who
>
> …
>
> (b) produced vehicles of a class in Canada in the 12-month period ending on July 31 in which the importation is made where
>
> > (i) the ratio of the net sales value of the vehicles produced to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in that period is equal to or higher than the ratio of the net sales value of all vehicles of that class produced in Canada by the manufacturer in the base year to the net sales value of all vehicles of that class sold for consumption in Canada by the manufacturer in the base year, and is not in any case lower than 75 to 100…[100]

104. We agree with the Panel that "[i]n cases where the production-to-sales ratio is 100:100, the only way to import any motor vehicles duty-free is to export, and the amount of import duty exemption allowed is directly dependent upon the amount of exports achieved."[101] Like the Panel, we fail to see how a manufacturer with a production-to-sales ratio of 100:100 could obtain access to the import duty exemption – and still maintain its required production-to-sales ratio – without exporting. A manufacturer producing motor vehicles in Canada with a sales value of 100 that does not export must sell all those motor vehicles in Canada. That manufacturer's production-to-sales ratio becomes 100:100, but without the benefit of importing duty-free one single motor vehicle. Only if that manufacturer exports motor vehicles produced in Canada does it become entitled to import motor vehicles free of duty. The value of motor vehicles which can be imported duty-free is strictly limited to the value of motor vehicles exported. In our view, as the import duty exemption is simply not available to a manufacturer unless it exports motor vehicles, the import duty exemption is clearly conditional, or dependent upon, exportation and, therefore, is contrary to Article 3.1(a) of the SCM Agreement.

105. Where the ratio requirements are set at less than 100:100 (for example, we know that the four MVTO automobile manufacturer beneficiaries have, on average, ratio requirements of approximately 95:100)[102], the relationship between exports and the ability to import duty-free is less straightforward. With a ratio requirement of 95:100, a manufacturer producing motor vehicles in Canada with a sales value of 95 that does not export is nevertheless entitled to import, duty-free, additional motor vehicles with a sales value of 5. If that manufacturer doubles its Canadian production to 190, then the amount of the duty-free "allowance" also doubles, to 10; that is, the

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[100]MVTO 1998, Schedule, Part 1, para. 1(1), definition of "manufacturer".

[101]Panel Report, para. 10.184.

[102]*Ibid*., para. 10.182.

"allowance" increases in direct proportion to the increase in production. The Panel considered that, up to this amount, the import duty exemption is not contingent upon export performance.[103] However, should a manufacturer wish to import on a duty-free basis any motor vehicles above its "allowance", that manufacturer must export motor vehicles. As in the case of a 100:100 ratio requirement, for a manufacturer with a ratio requirement less than 100:100, for any amount above this duty-free "allowance", the value of vehicles which can be imported duty-free is strictly limited, and tied to, the value of vehicles exported. The Panel found that for the amount exceeding the duty-free "allowance" there is, therefore, a clear relationship of contingency between the import duty exemption and export performance.[104]

106. We share the Panel's view. Regardless of the actual ratio specified for a particular

> …a panel should make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of and conformity with the relevant covered agreements, and *make such other findings as will assist the DSB* in making the recommendations or in giving the rulings provided for in the covered agreements. (emphasis added)

113. The standard terms of reference of a panel, set out in Article 7.1 of the DSU, speak in very similar terms. A panel should make "such findings as will assist the DSB" in making recommendations or rulings. Under Article 7.2 of the DSU, a panel "shall address the relevant provisions in any covered agreement or agreements cited by the parties to the dispute."

114. In discharging its functions under Articles 7 and 11 of the DSU, a panel is not, however, required to examine *all* legal claims made before it. A panel may exercise judicial economy. In *United States – Measure Affecting Imports of Woven Wool Shirts and Blouses from India*, we said:

> Nothing in [Article 11 of the DSU] or in previous GATT practice requires a panel to examine all legal claims made by the complaining party. Previous GATT 1947 and WTO panels have frequently addressed only those issues that such panels considered necessary for the resolution of the matter between the parties, and have declined to decide other issues. Thus, if a panel found that a measure was inconsistent with a particular provision of the GATT 1947, it generally did not go on to examine whether the measure was also inconsistent with other GATT provisions that a complaining party may have argued were violated.[113]

115. We refined this notion in *Australia – Measures Affecting the Importation of Salmon* ("*Australia – Salmon*"), where we said:

> The principle of judicial economy has to be applied keeping in mind the aim of the dispute settlement system. This aim is to resolve the matter at issue and "to secure a positive solution to a dispute". To provide only a partial resolution of the matter at issue would be false judicial economy. *A panel has to address those claims on which a finding is necessary in order to enable the DSB to make sufficiently precise recommendations and rulings so as to allow for prompt compliance by a Member* with those recommendations and rulings "in order *to ensure effective resolution of disputes* to the benefit of all 113ed.

116. In our view, it was not necessary for the Panel to make a determination on the European Communities' *alternative* claim relating to the CVA requirements under Article 3.1(a) of the *SCM Agreement* in order "to secure a positive solution" to this dispute. The Panel had already found that the CVA requirements violated both Article III:4 of the GATT 1994 and Article XVII of the GATS. Having made these findings, the Panel, in our view, exercising the discretion implicit in the principle of judicial economy, could properly decide not to examine the *alternative* claim of the European Communities that the CVA requirements are inconsistent with Article 3.1(a) of the *SCM Agreement.*

117. We are bound to add that, for purposes of transparency and fairness to the parties, a panel should, however, in all cases, address expressly those claims which it declines to examine and rule upon for reasons of judicial economy. Silence does not suffice for these purposes.

VIII. Article 3.1(b) of the *SCM Agreement*

118. The European Communities and Japan appeal the Panel's finding that they failed to demonstrate that the import duty exemption is a subsidy which is "contingent…upon the use of domestic over imported goods" under Article 3.1(b) of the *SCM Agreement.* They maintain that the Panel erred in concluding that the measure is not contingent "in law" upon the use of domestic over imported goods.[115] In the alternative, the European Communities and Japan claim that the Panel erred in concluding that Article 3.1(b) does not extend to contingency "in fact", and they assert that the import duty exemption is contingent "in fact" upon the use of domestic over imported goods.[116] We address each of these issues in turn.

A. *Whether the Measure is Contingent "in Law" Upon the Use of Domestic over Imported Goods*

119. In appealing the Panel's conclusion regarding contingency "in law", the European Communities argues that Article 3.1(b) of the *SCM Agreement* prohibits subsidies contingent upon a condition that "gives preference to" the use of domestic over imported goods.[117] On the other hand, Japan submits that Article 3.1(b) prohibits subsidies where the use of domestic over imported goods "would lead to" the granting or maintaining of the subsidy.[118] In their view, the Panel's interpretation is incompatible with the object and purpose of Article 3.1(b), and would allow circumvention of this

[115]European Communities' appellant's submission, para. 5; Japan's appellant's submission, para. 2.

[116]*Ibid*.

[117]European Communities' appellant's submission, para. 23.

[118]Japan's appellant's submission, para. 7.

provision.[119] Furthermore, the European Communities and Japan argue that, applying the test used by the Panel, the CVA requirements, in certain circumstances, do require the "actual use of domestic goods"[120] as a matter of law.[121] Finally, according to the European Communities and Japan, the use of domestic over imported goods as a result of the CVA requirements is an "alternative" condition "in law" for receiving the import duty exemption, and is, therefore, inconsistent with Article 3.1(b) of the *SCM Agreement*.[122]

120. In examining the CVA requirements under Article 3.1(b), the Panel stated:

> As we noted in the section of our report relating to claims under Article 3.1(a) of the SCM Agreement, the word "contingent" has been defined, *inter alia*, as "conditional, dependent". It is in light of this ordinary meaning of the word "contingent" that we must examine whether, under the CVA requirements outlined above, access to the import duty exemption is conditional or dependent upon the use of domestic over imported goods.[123]

121. The Panel found that:

> …while under the MVTO 1998 and SROs access to the import duty exemption is contingent upon satisfying certain CVA requirements, a value-added requirement is in no sense synonymous with a condition to use domestic over imported goods. In this regard, we recall that the definition of "CVA" in the MVTO 1998 includes, in addition to parts and materials of Canadian origin, such other elements as direct labour costs, manufacturing overheads, general and administrative expenses and depreciation. Thus, and depending upon the factual circumstances, a manufacturer might well be willing and able to satisfy a CVA requirement without using any domestic goods whatsoever. *Under these circumstances, it would be difficult for us to conclude that access to the import duty exemption is contingent, i.e. conditional or dependent, in law on the use of domestic over imported goods within the meaning of the SCM Agreement.*[124] (emphasis added)

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[119]European Communities' appellant's submission, para. 25; Japan's appellant's submission, paras. 8 and 14.

[120]European Communities' appellant's submission, para. 28.

[121]See Japan's appellant's submission, para. 11.

[122]European Communities' appellant's submission, paras. 43-50; Japan's appellant's submission, paras. 9 and 17.

[123]Panel Report, para. 10.213.

[124]*Ibid*., para. 10.216.

122. Article 3.1(b) provides as follows:

> Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
>
> …
>
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

As we have already found that the import duty exemption constitutes a "subsidy" within the meaning of Article 1 of the *SCM Agreement*, we turn to whether this subsidy is contingent "in law" upon the use of domestic over imported goods.

123. In our discussion of Article 3.1(a) in Section VI of this Report, we recalled that in *Canada – Aircraft* we stated that "the ordinary connotation of 'contingent' is 'conditional' or 'dependent for its existence on something else'."[125] Thus, a subsidy is prohibited under Article 3.1(a) if it is "conditional" upon export performance, that is, if it is "dependent for its existence on" export performance. In addition, in *Canada – Aircraft*, we stated that contingency "in law" is demonstrated "on the basis of the *words* of the relevant legislation, regulation or other legal instrument."[126] (emphasis added) As we have already explained, such conditionality can be derived by necessary implication from the words actually used in the measure.[127] We believe that this legal standard applies not only to "contingency" under Article 3.1(a), but also to "contingency" under Article 3.1(b) of the *SCM Agreement.*

124. As we are considering a claim of "in law" contingency under Article 3.1(b), it is important to 53rforman2be derivevalue As we"oTj 0s8.75 TD -5 Tc -0 Tw (.) Tj -10 -0.5638 12 0 Tc 0.1875 Tw ( ) Tj 3 0 TD /F3

> (i) *the cost of parts produced in Canada, and the cost of materials to the extent that they are of Canadian origin*, that are incorporated in vehicles in the factory of the manufacturer in Canada, but not including parts produced in Canada, or materials to the extent that

125. The import duty exemption at issue in this appeal is contingent on the satisfaction of three requirements: (1) manufacturing presence in Canada, (2) the ratio requirements, and (3) the CVA requirements. The Panel found that each of these requirements was a "condition" for receiving the import duty exemption.[129] Under the measure, a manufacturer applying for the import duty exemption in a particular period is required to disclose to the Government of Canada the *aggregate* of the costs, listed in the definition of "Canadian value added" in the MVTO 1998, of producing vehicles in Canada, so as to demonstrate that the manufacturer has satisfied the CVA requirements. One of these costs – indeed, the first one listed – is Canadian parts and materials incorporated in motor vehicles in the factory of the manufacturer in Canada, that is, "domestic goods".

126. The precise issue under Article 3.1(b) is whether the *use* of domestic over imported goods is a "condition" for satisfying the CVA requirements, and, therefore, for receiving the import duty exemption.

127. In examining this issue, the Panel first set out the CVA requirements, as contained in three separate legal instruments: the MVTO 1998, the SROs, and the Letters of Undertaking.[130] With respect to the MVTO 1998, the Panel did not make any specific findings regarding the actual percentages of CVA required for individual manufacturer beneficiaries. The Panel simply noted that "there are the CVA requirements under the MVTO 1998 itself".[131] For the SROs, the Panel discussed "typical" levels of CVA required for companies operating under SROs issued before 1984 and those issued from 1984 onwards. For one manufacturer, CAMI Automotive Inc. ("CAMI"), the Panel stated that it "must meet a requirement that the total CVA of its vehicles and original equipment manufacturing parts produced in Canada in a given year must be at least 60 per cent of the cost of

cent of it itself

factor in determining the eligibility for the import duty exemption."[134] Apparently, the Panel found that the CVA requirements in the Letters are not "conditions" additional to those in the MVTO 1998 for the MVTO manufacturers.

128. The Panel then examined whether the import duty exemption is contingent "in law" upon the use of domestic over imported goods. In its examination, however, the Panel did not conduct an analysis of how the CVA requirements under the MVTO

130. The Panel's reasoning implies that under no circumstances could *any* value-added requirement result in a finding of contingency "in law" upon the use of domestic over imported goods. We do not agree. We noted that the definition of "Canadian value added" in the MVTO 1998 *requires* a manufacturer to report to the G do 3 Ti,I TCanada the *aggregate* of certain listed costs of its production of motor vehicles, and that the first such cost item specified is the cost I TCanadian parts and materials *used* in the production of motor vehicles in its factory in Canada.[137] It seems to us that whether or not a particular manufacturer is able to satisfy its specific CVA requirements without using anyTCanadian parts and materials in its production depends very much on the *level* of the applicable CVA requirements. For example, if the level of the CVA requirements is very high, we can see that the use of domestic goods may well be a necessity and thus be, in practice, required as a *condition* for eligibility for the import duty exemption. By contrast, if the level of the CVA requirements is very low, it would be much easier to satisfy those requirements *without* actually using domestic goods; for example, where the CVA requirements are set at 40 per cent, it might be possible to satisfy that level simply with the aggregate of other elements I TCanadian value added, in particular, labour costs. The multiplicity I T*possibilities* for compliance with the CVA requirements, when these requirements are set at low levels, may, depending on the specific level applicable to a particular manufacturer, make the use of domestic goods only one *possible* means (means which might not, in fact, be utilized) of satisfying the CVA requirements.

131. In our view, the Panel's examination of the CVA requirements for specific manufacturers was insuffici Ti,for a reasoned determination of whether contingency "in law" on the use of domestic do imported goods exists. For the MVTO 1998 manufacturers and most SRO manufacturers, the Panel did not make findings as to what the actual CVA requirements are and how they operate for individual manufacturers. Without this vital information, we do not believe the Panel knew enough about the measure to determine whether the CVA requirements were contingent "in law" upon the use of domestic do imported goods. We recall that the Panel did make a finding as to the level of the CVA requirements for one company, CAMI. The Panel stated that the CVA requirements for CAMI are 60 per cent of the cost of sales I Tvehicles sold in Canada.[138] At this level, it may well be that the CVA requirements operate as a condition for using domestic do imported goods. However, the Panel did *not* examine how the CVA requirements would actually operate at a level of 60 per cent.

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[137]*Supra*, para. 125.

[138]Panel Report, para. 10.205.

132. The Panel's failure to examine fully the legal instruments at issue here and their implications for individual manufacturers vitiates its conclusion that the CVA requirements do not make the import duty exemption contingent "in law" upon the use of domestic over imported goods. In the absence of an examination of the operation of the applicable CVA requirements for individual manufacturers, the Panel simply did not have a sufficient basis for its finding on the issue of "in law" contingency. Thus, we conclude that the Panel erred in conducting its "in law" contingency analysis.

133. In *Australia – Salmon*, we stated that where we have reversed a finding of a panel, we should attempt to complete a panel's legal analysis "to the extent possible on the basis of the factual findings of the Panel and/or of undisputed facts in the Panel record".[139] Here, as we have stated, the Panel did not identify the precise levels of the CVA requirements applicable to specific manufacturers. In addition, there are not sufficient undisputed facts in the Panel record that would enable us to examine this issue ourselves. As a result, it is impossible for us to assess whether the use of domestic over imported goods is a condition "in law" for satisfying the CVA requirements, and, therefore, is a condition for receiving the import duty exemption.

134. In light of these considerations, we are unable to complete the legal analysis necessary to determine whether the import duty exemption, through the application of the CVA requirements, is contingent "in law" upon the use of domestic over imported goods. Therefore, we make no finding and reserve our judgment on whether the import duty exemption at issue is contingent "in law" upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the *SCM Agreement.*

B. *Whether the Measure is Contingent "in Fact" Upon the Use of Domestic over Imported Goods*

135. On appeal, the European Communities and Japan have maintained that if we find that the measure is not contingent "in law" upon the use of domestic over imported goods, then they appeal, in the alternative, the Panel's finding that Article 3.1(b) of the *SCM Agreement* does not apply to subsidies contingent "in fact" upon the use of domestic over imported goods.[140] The European Communities and Japan contend that Article 3.1(b) applies to subsidies contingent "in fact" upon the

[139]*Supra*, footnote 114, para. 118.

[140]European Communities' appellant's submission, paras. 53-54; Japan's appellant's submission, para. 19.

use of domestic over imported goods[141], and argue that the import duty exemption is precisely such a prohibited subsidy.[142]

136.

139. We look first to the text of Article 3.1(b). In doing so, we observe that the ordinary meaning of the phrase "contingent…upon the use of domestic over imported goods" is not conclusive as to whether Article 3.1(b) covers both subsidies contingent "in law" and subsidies contingent "in fact" upon the use of domestic over imported goods. Just as there is nothing in the language of Article 3.1(b) that specifically *includes* subsidies contingent "in fact", so, too, is there nothing in that language that specifically *excludes* subsidies contingent "in fact" from the scope of coverage of this provision. As the text of the provision is not conclusive on this point, we must turn to additional

We believe the same reasoning is applicable here. The fact that Article 3.1(a) refers to "in law or in fact", while those words are absent from Article 3.1(b), does not necessarily mean that Article 3.1(b) extends only to *de jure* contingency.

142. Finally, we believe that a finding that Article 3.1(b) extends only to contingency "in law" upon the use of domestic over imported goods would be contrary to the object and purpose of the *SCM Agreement* because it would make circumvention of obligations by Members too easy. We expressed a similar concern with respect to the GATS in *European Communities – Bananas* when we said:

> Moreover, if Article II was not applicable to *de facto* discrimination, it would not be difficult -- and, indeed, it would be a good deal easier in the case of trade in services, than in the case of trade in goods -- to devise discriminatory measures aimed at circumventing the basic purpose of that Article.[148]

143. For all these reasons, we believe that the Panel erred in finding that Article 3.1(b) does not extend to subsidies contingent "in fact" upon the use of domestic over imported goods. We, therefore, reverse the Panel's broad conclusion that "Article 3.1(b) extends only to contingency in law."[149]

144. Having reached this conclusion, we must now consider whether the import duty exemption, as a result of the application of the CVA reicl1m (devi 0 TD /F3183 Twpean C) Tj 0.on, ass a.5.25 TTv33e

is "in fact" a condition for satisfying the CVA requirements, and, therefore, is a condition for receiving the import duty exemption.

146. We are thus unable to complete the legal analysis necessary to determine whether the import duty exemption, through the application of the CVA requirements, is contingent "in fact" upon the use of domestic over imported goods. Accordingly, we make no finding and reserve our judgment on whether the import duty exemption at issue is contingent "in fact" upon the use of domestic over imported goods within the meaning of Article 3.1(b) of the *SCM Agreement.*

IX. Article I:1 and Article II:1 of the GATS

147. Canada appeals the Panel's conclusion that the import duty exemption is inconsistent with Article II:1 of the GATS. Canada first appeals the Panel's finding that the measure is one "affecting trade in services" within the scope of Article I:1 of the GATS.[151] It then appeals the finding that Canada does not accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country contrary to its obligations under Article II:1 of the GATS.[152]

A. *Article I:1 of the GATS*

148. Canada maintains that the Panel erred in finding that the import duty exemption falls within the scope of the GATS. In the view of Canada, the Panel mistakenly concluded that whether a measure is within the scope of the GATS is determined by whether that measure is consistent with certain substantive obligations, such as Article II, and not by whether the measure falls within Article I of the GATS.[153]

149. The Panel first examined the general issue of whether the import duty exemption constitutes a measure "affecting trade in services" within the meaning of Article I of the GATS. The Panel then referred to the reports of the panel and the Appellate Body in *European Communities – Bananas* for the proposition that "the term 'affecting' in Article I of the GATS has a broad scope of application and that accordingly no measures are *a priori* excluded from the scope of application of the GATS."[154]

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[151]Canada's appellant's submission, para. 102.

[152]*Ibid*., para. 145.

[153]*Ibid*., para. 102.

[154]Panel Report, para. 10.231.

153. We proceed to the threshold analysis of Article I of the GATS. Article I:1 of the GATS states, in pertinent part:

> ***Article I***
>
> *Scope and Definition*
>
> 1. This Agreement applies to measures by Members *affecting trade in services*.
> 2. For the purposes of this Agreement, *trade in services* is defined as *the supply of a service*:
>
> (a) from the territory of one Member into the territory of any other Member;
>
> (b) in the territory of one Member to the service consumer of any other Member;
>
> (c) *by a service supplier of one Member, through commercial presence in the territory of any other Member*;
>
> (d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.
>
> (emphasis added)

154. Article XXVIII defines certain terms used in the GATS. We refer, in particular, to the following:

> (a) "measure" means any measure by a Member, whether in the form of a law, regulation, rule, procedure, decision, administrative action, or any other form;
>
> (b) "supply of a service" includes

> (f) "service of another Member" means a service which is supplied,
>
> …
>
> (ii) in the case of the supply of a service through commercial presence or through the presence of natural persons, by a service supplier of that other Member;
>
> (g) "service supplier" means any person that supplies a service;
>
> …

155. With these treaty provisions in mind, we believe that at least two key legal issues must be examined to determine whether a measure is one "affecting trade in services": first, whether there is "trade in services" in the sense of Article I:2; and, second, whether the measure in issue "affects" such trade in services within the meaning of Article I:1.

156. We look first at whether there is "trade in services" in this case. For the purposes of the GATS, "trade in services" is defined in Article I:2 as the "supply of a service" in any one of four listed modes of supply. At issue here is the supply of a service under mode (c) of Article I:2, that is, the supply of a service "by a service supplier of one Member, through *commercial presence* in the territory of any other Member". (emphasis added) "Commercial presence" is, in turn, defined in Article XXVII21.7344 Ta9mercupp6s supplirticle

158. Having concluded that there is, in fact, "trade in services" in this case, we consider next whether the measure at issue "affects" trade in services. In *European Communities – Bananas*, we said:

> In our view, the use of the term "affecting" reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word "affecting" implies a measure that has "an effect on", which indicates a broad scope of application. This interpretation is further reinforced by the conclusions of previous panels that the term "affecting" in the context of Article III of the GATT is wider in scope than such terms as "regulating" or "governing".[159]

159. We also found in that case that, although the subject matter of the GATT 1994 and that of the GATS are different, particular measures "could be found to fall within the scope of both the GATT 1994 and the GATS", and that such measures include those "that involve a service relating to a particular good or a service supplied in conjunction with a particular good."[160] We further stated, in that case, that:

> Whether a certain measure affecting the supply of a service related to a particular good is scrutinized under the GATT 1994 or the GATS, or both, is a matter that can only be determined on a case-by-case basis.[161]

160. In cases where the same measure can be scrutinized under *both* the GATT 1994 and the GATS, however, the focus of the inquiry, and the specific aspects of the measure to be scrutinized, under each agreement, will be different because the subjects of the two agreements are different. Under the GATS, as we stated in *European Communities – Bananas*, "the focus is on how the measure affects the supply of the service or the service suppliers involved."[162]

161. We note that Canada argues that the import duty exemption is not a measure "affecting trade in services" within the meaning of Article I of the GATS, because it is a tariff measure that affects the *goods* themselves and not the supply of distribution services.[163] As such, Canada maintains, the measure at issue does not "affect" a service supplier in its *capacity as a service supplier* and in its *supply of a service.*[164] Canada relies on our report in *European Communities – Bananas* to support

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[159]*Supra*, footnote 146, para. 220.

[160]*Ibid.*, para. 221.

[161]*Ibid.*; see also Appellate Body Report, *Canada – Certain Measures Concerning Periodicals*, WT/DS31/AB/R, adopted 30 July 1997, p. 19.

[162]*Supra*, footnote 146, para. 221.

[163]Canada's appellant's submission, para. 115.

[164]*Ibid.*

its argument that the import duty exemption falls exclusively within the scope of the GATT 1994,

examined whether or how the import duty exemption affects *wholesale trade service suppliers in their capacity as service suppliers*. Rather, the Panel simply stated:

> Like the measures at issue in the *EC – Bananas III* case, the import duty exemption granted only to *manufacturer beneficiaries* bears upon conditions of competition in the supply of distribution services, regardless of whether it directly governs or indirectly affects the supply of such services.[170] (emphasis added)

165. We do not consider this statement of the Panel to be a sufficient basis for a legal finding that the import duty exemption "affects" wholesale trade services of motor vehicles *as services*, or wholesale trade service suppliers *in their capacity as service suppliers*. The Panel failed to analyze the evidence on the record relating to the provision of wholesale trade services of motor vehicles in the Canadian market. It also failed to articulate what it understood Article I:1 to require by the use of the term "affecting". Having interpreted Article I:1, the Panel should then have examined all the relevant facts, including *who* supplies wholesale trade services of motor vehicles through commercial presence in Canada, and *how* such services are supplied. It is not enough to make assumptions. Finally, the Panel should have applied its interpretation of "affecting trade in services" to the facts it should have found.

166. The European Communities and Japan may well be correct in their assertions that the availability of the import duty exemption to certain manufacturer beneficiaries of the United States established in Canada, and the corresponding unavailability of this exemption to manufacturer beneficiaries of Europe and of Japan established in Canada, has an effect on the operations in Canada of wholesale trade service suppliers of motor vehicles and, therefore, "affects" those wholesale trade service suppliers in their capacity as service suppliers. However, the Panel did not examine this issue. The Panel merely asserted its conclusion, without explaining how or why it came to its conclusion. This is not good enough.

167. For these reasons, we believe that the Panel has failed to examine whether the measure is one "affecting trade in services" as required under Article I:1 of the GATS. The Panel did not show that the measure at issue affects wholesale trade services of motor vehicles, as services, or wholesale trade service suppliers of motor vehicles, in their *capacity as service suppliers*. Nonetheless, we continue our analysis of the issues raised on appeal under Article II:1, and examine whether, in the terms of that provision, the measure accords treatment "no less favourable" to like services and service suppliers of other Members.

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[170]Panel Report, para. 10.239.

B. *Article II:1 of the GATS*

168. Canada argues that even if the GATS was held applicable to the measure at issue, the Panel is still in error in finding that this measure accords less favourable treatment to services and service suppliers of any other Member under Article II:1.[171] Canada states that neither the European Communities nor Japan contended that the import duty exemption discriminates "in law"; rather, they argue that the import duty exemption discriminates "in fact" by according less favourable treatment in practice to certain services and service suppliers.[172] In Canada's view, the Panel "was required to set out the basis on which the measures accord less favourable treatment to certain services and service suppliers and to show how such less favourable treatment is accorded, either in fact or in law, to the services or service suppliers of certain Members."[173]

169. In examining Canada's appeal under Article II:1 of the GATS, we begin with the text of that provision:

> ***Article II***
>
> *Most-Favoured-Nation Treatment*
>
> 1. With respect to any measure covered by this Agreement, each Member shall accord immediately and unconditionally to services and service suppliers of any other Member treatment no less favourable than that it accords to like services and service suppliers of any other country.

170. The wording of this provision suggests that analysis of the consistency of a measure with Article II:1 should proceed in several steps. First, as we have seen, a threshold determination must be

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171. If the threshold determination is that the measure *is* covered by the GATS, appraisal of the consistency of the measure with the requirements of Article II:1 is the next step. The text of Article II:1 requires, in essence, that treatment by one Member of "services and services suppliers" of any other Member be compared with treatment of "like" services and service suppliers of "any other country". Based on these core legal elements, the Panel should first have rendered its interpretation of Article II:1. It should then have made factual findings as to treatment of wholesale trade services and service suppliers of motor vehicles of different Members commercially present in Canada. Finally, the Panel should have applied its interpretation of Article II:1 to the facts as it found them.

172. The Panel did none of this. The Panel did not inquire into how the market for wholesale trade services of motor vehicles in Canada is structured. Nor did it explain how less favourable treatment resulted from the measure at issue. Instead, it engaged in speculation about the "possibility" of certain relationships.[176] In response to Canada's argument that there is no competition between service suppliers at the wholesale level because of vertical integration and exclusive distribution arrangements in the motor vehicle industry, the Panel stated that vertical integration:

> …neither rules out potential competition in the wholesaler-manufacturer relationship, nor actual competition in the wholesaler-retailer relationship. Although due to the existing structure of the market, wholesale trade service suppliers procure their vehicles from the same manufacturers, no government measure prevents even a vertically integrated wholesale distributor from approaching different manufacturers for the procurement of motor vehicles.[177]

173. Based on this speculative analysis, the Panel proceeded to make the following "findings":

> We therefore

> Although none of the criteria for granting the import duty exemption is expressly based on nationality, the manufacturing presence requirement, referring to the period 1 August 1963 – 31 July 1964 in the MVTO 1998, has allowed only three service suppliers of the United States (Chrysler Canada Ltd., General Motors of Canada Ltd. and Ford Motor Company of Canada Ltd.) and one service supplier of Sweden (Volvo Canada Ltd.) to qualify for the import duty exemption. It was noted above that Volvo Canada Ltd. recently passed under the control of a juridical person of the United States (Ford Motor Co.). SROs have been used to expand the category of manufacturer beneficiaries by allowing two other manufacturers/wholesalers of automobiles (Intermeccanica of Canada and CAMI, a 50/50 joint venture between Suzuki Motor Co. of Japan and General Motors Corp. of the United States) and several manufacturers/wholesalers of buses and specified commercial vehicles to qualify for the import duty exemption.[182] (footnote omitted)

177. Having determined which manufacturer beneficiaries are "of " which Me

183. In coming to this conclusion, we do not suggest that the import duty exemption does *not* affect wholesale trade services of motor vehicles in Canada. Nor do we conclude that Canada accords no less favourable treatment to services and service suppliers of any Member than that which it accords to like services and service suppliers of another country consistently with Article II:1 of the GATS. We make no such conclusion. We mean only to say that the Panel, in this case, failed to substantiate its conclusion that the import duty exemption is inconsistent with Article II:1 of the GATS. As such, we have no choice but to reverse the findings and conclusions of the Panel relating to Article II:1 of the GATS.

184. In reaching this conclusion, we are mindful of the importance of the GATS as a new multilateral trade agreement covered by the *WTO Agreement*. This appeal is only the second case in which we have been asked to review a panel's findings on provisions of the GATS. Given the complexity of the subject-matter of trade in services, as well as the newness of the obligations under the GATS, we believe that claims made under the GATS deserve close attention and serious analysis. We leave interpretation of Article II of the GATS to another case and another day.

X. Findings and Conclusions

185. For the reasons set out in this Report, the Appellate Body:

(a) upholds the Panel's conclusion that Canada acts inconsistently with Article I:1 [illegible] lea

(d) is unable to come to a conclusion, and hence reserves judgment, on whether or not the import duty exemption is, as a result of the application of the CVA requirements, contingent "in law" upon the use of domestic over imported goods under Article 3.1(b) of the *SCM Agreement*; reverses the Panel's conclusion that Article 3.1(b) does not extend to contingency "in fact"; and is unable to come to a conclusion, and hence reserves judgment, on whether or not the measure is contingent "in fact" upon the use of domestic over imported goods under Article 3.1(b) of the *SCM Agreement*, as a result of insufficient factual findings and undisputed facts in the Panel record;

(e) finds that the Panel has failed to examine whether the measure is one "affecting trade in services" as required under Article I:1 of the GATS; reverses the Panel's

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Signed in the original at Geneva this 18th day of May 2000 by:

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Claus-Dieter Ehlermann
Presiding Member

_____ _____

James Bacchus
Member

Florentino Feliciano
Member