UNITED STATES - TAX TREATMENT FOR "FOREIGN SALES CORPORATIONS" - RECOURSE BY THE UNITED STATES TO ARTICLE 22.6 OF THE DSU AND ARTICLE 4.11 OF THE SCM AGREEMENT

WT/DS108

ORAL STATEMENT OF THE

UNITED STATES OF AMERICA

March 7, 2002

I. INTRODUCTION

1. Mr. Chairman, Members of the Arbitrator, on behalf of the U.S. delegation, I would like to express our gratitude for your continued service in trying to resolve this dispute and advance the aims of the multilateral system.

2. There are many issues to discuss today, but the most important issue is this: Do the WTO rules permit trade sanctions that are disproportionate to the trade impact on the complaining Member of a WTO-inconsistent measure? To our knowledge, no WTO Member has ever claimed sanctions that are disproportionate to the trade impact it has allegedly suffered. Even in *Brazil Aircraft*, Canada did not claim an amount in excess of the trade harm it alleged it had suffered.

3. Yet, that is what the EC is claiming in this proceeding. Of course, the EC has claimed that this is not so, because, according to its calculations, the amount of sanctions it seeks are not in excess of the trade impact on the EC of the U.S. subsidy. However, as the United States has demonstrated in its written submissions, the EC's figures have no basis in fact. When the trade impact of the U.S. subsidy is properly calculated, one finds that the amount of sanctions claimed by the EC is roughly four times greater than the amount of the estimated trade impact on the EC. In the view of the United States, the amount claimed by the EC is "punitive" under any definition of that term.

4. In today's statement, the United States will begin by addressing this fundamental issue, focusing on the arguments contained in the *EC Second Submission*. Because that submission is devoted largely to a discussion of Article 4.10 of the SCM Agreement, the bulk of our comments today will address the proper interpretation of that provision. However, we will touch on certain methodological issues regarding the measurement of the trade impact on the EC. This discussion

will be brief, as the *US Second Submission* demonstrates the numerous flaws in the new methodologies contained in the *EC First Submission*.

II. COUNTERMEASURES UNDER ARTICLE 4.10 OF THE SCM AGREEMENT ARE NOT "APPROPRIATE" IF THEY ARE DISPROPORTIONATE TO THE TRADE IMPACT OF A SUBSIDY ON THE COMPLAINING MEMBER

5. Turning to the issue of the correct standard under Article 4.10 of the SCM Agreement, we need to clarify some things at the outset. In its second submission, the EC mischaracterizes the U.S. argument, with the EC repeatedly accusing the United States of attempting to apply the standard of Article 22.4 of the DSU to Article 4.10 of the SCM Agreement.[1] However, the United States has not argued that the standard under Article 4.10 is the same as the standard under Article 22.4. The United States, like prior arbitrators, recognizes that the word "appropriate" and "equivalent" are different.

6. What the United States has argued, though, is that the standard under Article 4.10 cannot be applied as if it existed in clinical isolation from the DSU, and in a manner which is inconsistent with the object and purpose of the DSU.

7. Instead, the issue is this: The United States asserts that in determining the appropriateness of countermeasures under Article 4.10, the trade impact of a subsidy on the complaining Member must be taken into account. Countermeasures that are disproportionate to that trade impact are not appropriate. The EC, on the other hand, argues that the trade impact on the complaining Member can be ignored.

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[1] *See EC Second Submission*, paras. 10, 22, 36, 41, 53.

8. Before turning to the specifics of the EC's second submission, the United States must comment on one fundamental assertion in that submission which is absolutely astonishing. In discussing the negotiating history of the SCM Agreement and the Swiss and Australian proposals, the EC concedes that these proposals required a consideration of the negative effects of a subsidy, but the EC then opines that these proposals did not answer the question: "negative effects *on whom*?"[2] The EC then states as follows: "No indication is given that countermeasures should be limited to the effect on the complaining parties."[3]

9. In the view of the United States, this statement reveals the crux of the EC's argument, which is that because Article 4.10 does not expressly state that countermeasures should be assessed in terms of the trade impact on the complaining Member, the trade impact on the complaining Member is irrelevant.

10. Think, however, of the implications of this assertion if it were accepted. If one looks closely at the DSU, one finds nothing in Article 22 that expressly states that nullification or impairment must be assessed in terms of the nullification or impairment *on the complaining Member*. In the EC's words, Article 22.4 of the DSU does not answer the question: nullification or impairment with respect *to whom*? Yet in every arbitration to date, the parties – including the EC – and the arbitrators have assumed that nullification or impairment must be assessed in terms of the impact of a WTO-inconsistent measure on the complaining Member.

11. WTO Members would be astonished to learn that a single Member is entitled to suspend concessions or other obligations based on an amount equivalent to the global nullification or

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[2] *EC Second Submission*, para. 68.
[3] *Id.*

impairment caused by a WTO-inconsistent measure. Is the EC actually asserting that, for example, in *EC Bananas* the United States would have been entitled to suspend concessions based on an amount equivalent to the nullification or impairment inflicted by the EC measures on banana-exporting Members? Could the United States challenge other WTO-inconsistent measures maintained by the EC that exclusively affect other Members, and then claim an entitlement to suspend concessions based on the nullification or impairment suffered by those Members?

12. Indeed, if *EC Bananas* had been a dispute under Article 4.10 of the SCM Agreement and the approach suggested by the EC in this case had been applied in the first arbitration (involving the United States), what would the arbitrator have done in the arbitration proceeding involving Ecuador's request to suspend concessions? Because the arbitrator would have already awarded the global amount of the subsidy to the United States, there would have been nothing left to award to Ecuador. Is the EC then advocating a race to the arbitrator with the winner of the race taking all?

13. The absurd consequences that would flow from the EC's approach demonstrate its lack of validity. Fortunately, WTO Members and WTO dispute settlement bodies have taken a different approach, and have interpreted Article 22.4 of the DSU as referring to the nullification or impairment suffered by the complaining Member. There is no basis for concluding that this same approach was not intended to apply with respect to Article 4.10 of the SCM Agreement. Put differently, it would be wrong to conclude that, through the use of the terms "appropriate"

and "disproportionate", the drafters intended a radical departure from WTO dispute settlement norms. However, this is precisely the conclusion that the EC would have the Arbitrator draw.

14. Having demonstrated the fallacy in the basic EC approach, let us turn to the EC's second submission and the details of its arguments. What we find is that the EC's interpretation of Article 4.10 is based solely on the following four allegations: (1) the word "countermeasures" has a special meaning; (2) countermeasures, so defined, have only one unique objective, which is to induce compliance; (3) the *Brazil Aircraft* precedent justifies ignoring the trade impact of a subsidy on the complaining Member; and (4) Article 4.10 is a special or additional rule or procedure. However, none of these allegations withstands scrutiny or justifies an approach which ignores the trade impact of a subsidy on the complaining Member. Let us consider each of these allegations, in turn.

A. The Term "Countermeasures", as Used in the SCM Agreement, Does Not Have a Special Meaning

15. The ordinary meaning of "countermeasure" is "An action taken to counteract a danger, threat, etc."[4] "Counteract", in turn, is defined as "hinder or defeat by contrary action; neutralize the action or effect of."[5] Another definition of "countermeasure" is "A measure or action taken in opposition to another."[6] Neither of these definitions precludes a standard for countermeasures that is linked to the trade impact of a subsidy on the complaining Member.

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[4] *New Shorter Oxford English Dictionary* (1993).
[5] *Id.*
[6] *The American Heritage Dictionary of the English Language* (New College Ed. 1976).

16. Ignoring the ordinary meaning, however, the EC asserts that the term "countermeasures" has a special meaning that sets it apart from other related WTO dispute settlement provisions.[7] The EC claims that this special meaning can be found in general principles of international law and, in particular, in the International Law Commission's Draft Articles on State Responsibility ("Draft Articles").

17. The EC makes no attempt to explain how its approach is consistent with customary rules of interpretation of public international law. Those rules require a consideration of the ordinary meaning of treaty language in its context and in light of the object and purpose of the treaty. The EC is not relying on the ordinary meaning of "countermeasures" in its context in the SCM Agreement.

18. Moreover, under customary rules of interpretation, as reflected in Article 31(4) of the *Vienna Convention on the Law of Treaties*, "[a] special meaning shall be given to a term if it is established that the parties so intended." The EC offers no evidence that the drafters intended that the term "countermeasures" have a special meaning. Instead, it merely cites to *Brazil Aircraft*, a case in which the arbitrator itself did not provide any justification as to why the term "countermeasures" should be accorded a special meaning under Article 31(4) of the *Vienna Convention*.

19. The absence of any justification or explanation is understandable, given that WTO bodies have used the term "countermeasures" interchangeably with other terms relating to WTO-authorized remedies. For example, the arbitrator in *EC Bananas* referred to the suspension of

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[7] *EC Second Submission*, para. 17.

concessions as "countermeasures".[8] Similarly, in *US Line Pipe*, the Appellate Body characterized antidumping and countervailing duties and safeguard measures as "countermeasures".[9] Indeed, even the report of the International Law Commission on which the EC relies describes compensation under the DSU as "a form of countermeasure."[10] All of this has led one scholar to conclude that "compensation and suspension of concessions is WTO parlance for countermeasures."[11]

20. In this regard, even the EC appears to feel constrained to rely on standards that comport with those reflected in the DSU. The EC has asked for the authority to suspend concessions, the standard DSU remedy. The EC has not, for example, asked the DSB to authorize financial penalties, something which might be proper under the EC's expansive definition of "countermeasures."

21. Thus, to the extent that this first allegation of the EC has any relevance, it is simply that Article 4.10 may allow for countermeasures other than the countermeasures specifically provided for in the DSU. However, that is not an issue here, because the parties agree that the suspension of concessions sought by the EC is a countermeasure. What is significant is that because the

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[8] *European Communities - Regime for the Importation, Sale and Distribution of Bananas - Recourse to Arbitration by the European Communities Under Article 22.6 of the DSU* ("*EC Bananas*"), WT/DS27/ARB, Decision by the Arbitrators circulated 9 April 1999, para. 6.3; *see also European Communities - Measures Concerning Meat and Meat Products (Hormones) - Original Complaint by the United States - Recourse to Arbitration by the European Communities Under Article 22.6 of the DSU*, WT/DS26/ARB, Decision by the Arbitrators circulated 12 July 1999, para. 40, quoting *id.*

[9] *United States - Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea*, WT/DS202/AB/R, Report of the Appellate Body circulated 15 February 2002, para. 257.

[10] *Report of the International Law Commission*, Fifty-third session (23 April-1 June and 2 July-10 August 2001), A/56/10, page 357, note 863 ("*Draft Articles*").

[11] Peter C. Mavroidis, *Remedies in the WTO Legal System: Between a Rock and a Hard Place*, 11 Eur. J. Int'l L. #4 (2000), downloaded from <www.ejil.org/journal/Vol11/No4/index.htm/>, page 39.

remedies set forth in the DSU constitute countermeasures, there is no basis for interpreting Article 4.10 in the radical manner suggested by the EC.

B. "Countermeasures" Under Article 4.10 Do Not Have a Unique Purpose

22. Proceeding from the misguided assumption that the term "countermeasures" has a special meaning, the EC then argues that "countermeasures" under Article 4.10 have a unique purpose, which is to induce compliance. The problem with this argument is that this purpose is not unique to Article 4.10. Instead, as the United States has previously noted, inducing compliance is a purpose of the DSU in general.[12] This is not surprising given that the remedies in the DSU constitute countermeasures. Moreover, if inducing compliance were the only standard, there would be no limit on the amount of countermeasures that could be authorized, because one could always argue that an amount in excess of the amount of the subsidy or the amount of the trade impact would be necessary or better able to induce compliance.

23. The EC tries to distinguish Article 4 of the SCM Agreement by asserting that its purpose is to achieve the withdrawal of the subsidy.[13] However, as the United States previously has explained,[14] this purpose is shared by Article 3.7 of the DSU, which states 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 concerned ... ."

24. The EC then asserts that Article 4 of the SCM Agreement has nothing to do with the other objective of the DSU, which is to preserve the balance of rights and obligations between

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[12] *See, e.g., US First Submission*, para. 43.
[13] *EC Second Submission*, para. 59.
[14] *See US Second Submission*, para. 55.

Members.[15] However, Article 3.3 of the DSU clearly indicates that one of the objectives of the WTO dispute settlement system is "the maintenance of a proper balance between the rights and obligations of Members." Article 4 of the SCM Agreement is part of the WTO dispute settlement system, and, therefore, must be interpreted in light of the objectives of that system. It cannot be interpreted as if the DSU did not exist.

25. As the United States has explained, an application of Article 4.10 that takes into account the trade impact of a subsidy on the complaining Member is the only approach that is consistent with both of these objectives of the dispute settlement system.[16]

C. *Brazil Aircraft* Does Not Justify the EC's Approach

26. The EC's third justification for its approach is that the arbitrator in *Brazil Aircraft* used the total amount of the subsidy as the basis for determining the amount of countermeasures to award to Canada. In its second submission, the United States discussed how *Brazil Aircraft* is distinguishable on its facts from the present case, as well as the flaws in the arbitrator's reasoning. We will not repeat that discussion here.

27. Today, we simply wish to emphasize two things. First, in the instant case, the EC is asking the Arbitrator to award it countermeasures *in excess of* the trade impact on the EC of the U.S. subsidy. That is *not* what the arbitrator did in *Brazil Aircraft*. In that case, the arbitrator awarded Canada an amount of countermeasures that was *less than* the amount of trade harm alleged by Canada. Second, in *Brazil Aircraft*, the arbitrator recognized that there may be cases

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[15] *EC Second Submission*, para. 59.
[16] *US First Submission*, para. 46.

where it would be appropriate to base the amount of countermeasures on the trade impact of a subsidy.

D. The Fact that Article 4.10 of the SCM Agreement Is a Special or Additional Rule or Procedure Does Not Justify the EC's Approach

28. The EC's final argument is that Article 4.10 is a special or additional rule or procedure within the meaning of Article 1.2 of the DSU.[17] Essentially, the EC argues that this fact warrants reading into Article 4.10 an approach to remedies that is radically different from the approach of other WTO dispute settlement provisions.

29. This argument is totally at odds with the teachings of the Appellate Body, as set forth in *Guatemala Cement*. In that case, the Appellate Body described the relationship between the general provisions of the DSU and special or additional rules as follows:[18]

> The special or additional provisions listed in Appendix 2 of the DSU are designed to deal with the particularities of dispute settlement relating to obligations arising under a specific covered agreement, while Article 1 of the DSU seeks to establish an integrated and comprehensive dispute settlement system for all of the covered agreements of the *WTO Agreement* as a whole. It is, therefore, only in the specific circumstance where a provision of the DSU and a special or additional provision of another covered agreement are mutually inconsistent that the special or additional provision may be read to *prevail* over the provision of the DSU.

30. Article 4.10 does not, by its terms, preclude a consideration of the trade impact of a subsidy on the complaining Member. As the United States has explained, Article 4.10 does not expressly answer the question: "disproportionate" with respect to what? However, every other relevant dispute settlement provision in the WTO agreements refers, in one form or another, to

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[17] *See EC Second Submission*, paras. 12-14.

[18] *Guatemala - Anti-Dumping Investigation Regarding Portland Cement from Mexico*, WT/DS60/AB/R, Report of the Appellate Body adopted 25 November 1998, para. 66 (underscoring added; italics in original).

the trade impact of a measure on the complaining Member. In light of this, an interpretation of Article 4.10 that precludes a consideration of trade impact creates the very conflict with the DSU that the Appellate Body has cautioned against.

E. The EC's Criticisms of the U.S. Arguments Are Without Merit

31. Having dispensed with the main EC arguments, we now will turn to that portion of the *EC Second Submission* that responds to the U.S. arguments contained in the *US First Submission*. As will be seen, the EC's criticisms of the U.S. arguments are without merit.

1. The *Netherlands Working Party Report*

32. With respect to the United States' discussion of the *Netherlands Working Party Report*, the EC once again mischaracterizes the U.S. argument by falsely asserting that the United States claimed that this report supported an alleged U.S. view that the standard under Article XXIII was one of "equivalency".[19] Of course, that is not what the United States has argued. Instead, the United States has argued that this report stands for the proposition that "the appropriateness of countermeasures had to be assessed *in regard to* the impairment suffered by the complaining party" and that the report "went so far as to say that a countermeasure has to be assessed *in regard to* its 'equivalence' to the impairment suffered."[20] "In regard to its 'equivalence'" is not the same thing as "equivalent", and the United States acknowledged elsewhere that "appropriate" and "equivalent" have different meanings.[21]

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[19] *EC Second Submission*, para. 30.
[20] *US First Submission*, para. 27 (emphasis added).
[21] *Id.*, para. 41.

33. The EC then attempts to discount the precedential value of the report by observing that the Working Party's terms of reference required it to consider the impairment suffered by the Netherlands.[22] The United States fails to see the relevance of this observation, because the passage from the report quoted by the EC says on its face that the instructions to the Working Party came from the CONTRACTING PARTIES. The parties to the dispute likely proposed the Working Party's instructions, but it was the CONTRACTING PARTIES that issued them.

2. Other GATT Documents Related to Article XXIII

34. The EC next proceeds to quote from several GATT documents relating to the interpretation of Article XXIII for the proposition that the standard under Article XXIII was not one of equivalence.[23] That is all well and good, but the United States has not argued that the standard under Article XXIII was one of equivalence. What is significant about these documents is that none of them even hint at the proposition that the trade impact on the complaining Member is a factor that should be ignored.

3. Articles 7.9 and 9.4 of the SCM Agreement

35. Now let us turn to the EC's discussion of Articles 7.9 and 9.4 of the SCM Agreement. It is interesting that after having first asserted (incorrectly) that the term "countermeasures" carries with it a unique purpose and a unique standard that sets it apart from all other types of remedies under the WTO dispute settlement system, the EC glosses over the fact that Articles 7.9 and 9.4 require an assessment of the trade impact of a subsidy on the complaining Member. The notion

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[22] *EC Second Submission*, para. 32.
[23] *Id.*, paras. 33-35.

of "adverse effects" may or may not be broader than the notion of "nullification or impairment", as posited by the EC,[24] but the United States can agree that they are worded differently.

36. The important point is that Part III of the SCM Agreement requires that adverse effects be assessed with reference to the trade impact on the complaining Member. For example, Article 5(c) refers to "serious prejudice to the interests of another Member", not "Members". Article 7.2 requires that a request for consultations include a statement of available evidence with regard to the adverse effects caused "to the interests of the Member requesting consultations." Most significantly, Article 6.8 provides a series of defenses that focus on actions taken by, or events that happen to, "the complaining Member".

37. With respect to the EC's discussion of "nullification or impairment" as used in Article 5(b) of the SCM Agreement,[25] the EC's point is irrelevant, because, again, the United States is not arguing that the standard in Article 22.4 of the DSU applies to Article 4.10. Instead, the United States is arguing only that the trade impact of a subsidy on the complaining Member has to be taken into account in determining whether countermeasures are disproportionate.

38. Nevertheless, the United States notes that the EC makes the same mistake as did the arbitrator in *Brazil Aircraft*. Specifically, the EC assumes that Article 5(b) refers to nullification or impairment attributable to a violation of WTO rules, such as that described in Article 3.8 of the DSU and Article XXIII:(1)(a) of the GATT 1994.

39. In the view of the United States, Article 5(b) is referring to non-violation nullification or impairment of the type described in Article 26.1 of the DSU and Article XXIII:1(b) of the GATT

[24] *Id.*, para. 38.
[25] *EC Second Submission*, para. 40.

1994. The example in the text of Article 5(b) – the use of a subsidy to nullify or impair benefits of bound concessions under Article II of GATT 1994 – is the classic example of non-violation nullification or impairment first articulated in the 1950 Working Party Report on *The Australian Subsidy on Ammonium Sulphate.*[26] This example suggests that the drafters were thinking in terms of non-violation nullification or impairment. If this were not the case, then Article 5(b) would improperly blur the distinction between prohibited subsidies under Article 3 – for which nullification or impairment is presumed under Article 3.8 of the DSU – and actionable subsidies – for which a complaining party must demonstrate adverse effects.

40. Finally, with respect to the EC's invocation of *Brazil Aircraft*, the United States has previously explained that the conclusion that the arbitrator drew in that case from a comparison of Article 4.10 and Article 7.9 was illogical and begged the question of what "disproportionate" means.[27]

41. As for Article 9.4 of the SCM Agreement, the EC glosses over the fact that the first sentence of Article 9.4 refers to "the effects referred to in paragraph 1." Paragraph 1, in turn, refers to "serious adverse effects to the domestic industry" of the Member requesting consultations. Thus, in Article 9.4, too, the focus is on the effects of a subsidy on the complaining Member.

4. *Canada Autos*

42. With respect to the U.S. discussion of the Appellate Body report in *Canada Autos*, the EC does not dispute the U.S. point that the omission of language is not necessarily dispositive.

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[26] GATT/CP.4/39, adopted 3 April 1950, BISD II/188.
[27] *US Second Submission*, paras. 61-62.

Continuing to falsely assert that the United States is arguing that the standard in Article 4.10 is the same as the standard in Article 22.4 of the DSU, the EC says that the only factor that an arbitrator must consider under Article 4.10 of the SCM Agreement is the fact that the subsidy in question is prohibited.[28]

43. In the view of the United States, the fact that the subsidy is prohibited is not the only factor to be considered in determining whether a countermeasure is disproportionate. The text of Article 4.10 certainly does not compel that conclusion. Indeed, if one were to take this literalist approach, then, as we already have noted, suspension of concessions under Article 22.4 of the DSU would not have to be equivalent to the nullification or impairment suffered by the complaining Member because, literally, Article 22.4 does not impose such a requirement.

44. The real point of *Canada Autos* – and one that the EC ignores – is that when a treaty interpreter is considering context, he or she should not automatically assume that the omission of language is dispositive. In the context of this case, given that every other relevant WTO dispute settlement provision, either expressly or as interpreted, calls for a consideration of the trade impact of a measure on the complaining Member, it is implausible to conclude that the drafters intended that trade impact on the complaining Member be ignored for purposes of Article 4.10.

5. Object and Purpose

45. With respect to the U.S. arguments regarding the object and purpose of Article 4.10, we already have addressed the EC's counter-arguments in connection with our discussion of the EC's basic arguments. Simply to reiterate, the EC's assertions that Article 4.10 exists in

[28] *EC Second Submission*, paras. 49-50.

isolation from the DSU, and that Article 4.10 has only a single, unique purpose, are not tenable. Article 4.10 is part of the WTO dispute settlement system, and, as such, shares the dual objectives of that system, as reflected in the DSU.

6. Negotiating History

46. With respect to the negotiating history of the SCM Agreement, we also have dealt with this topic, in part, in our discussion of the EC's remarkable interpretation of the Swiss and Australian statements. Here, we will limit ourselves to a few observations.

47. First, the EC says that in the portions of the negotiating history cited by the United States, no reference was made "to nullification or impairment as the benchmark for countermeasures."[29] True enough; the United States never claimed that there was such a reference. However, the EC does not really deny that the statements the United States cited in its first submission reflected the view that countermeasures under what eventually became Article 4.10 would have to be based upon a consideration of trade impact. The best the EC can do is respond that the negotiating history does not specify trade impact *on whom*. However, we already have disposed of that particular EC argument.

48. The EC then quotes at length a passage from the Swiss proposal.[30] The United States is not sure what point the EC is trying to make. The quoted passage explains that prohibited subsidies would be treated like other WTO rules violations; they would be presumed to nullify or impair benefits. Indeed, the United States cited to – but did not quote – this very paragraph in its

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[29] *EC Second Submission*, para. 70.
[30] *Id.*, para. 71.

first submission.[31] However, what the EC conveniently omits is a discussion of the additional aspects of the Swiss proposal, which are discussed in the United States' first submission. A subsequent Swiss communication made clear that under its proposal, "countermeasures must not go beyond what is necessary to offset the negative effect."[32]

7. Scholarly Opinion

49. Finally, the EC makes only a feeble attempt to explain away the fact that, to date, scholarly opinion is consistent with the position advanced by the United States. The EC does not even dare address Mr. Mavroidis' observation that under Article 4.10 "the benchmark must be the damages suffered."[33] Similarly, Mr. Rosas' observation that Article 4.10 "only requires that the countermeasures are not disproportionate to the injury suffered" speaks for itself.[34]

F. Conclusion

50. To summarize, the United States is not arguing that the standard of Article 22.4 of the DSU applies to Article 4.10. What the United States *is* arguing is that Article 4.10, when interpreted in accordance with the customary rules of interpretation reflected in Articles 31 and 32 of the *Vienna Convention*, requires that the appropriateness of countermeasures be assessed by reference to the impact of a subsidy on the complaining Member.

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[31] *US First Submission*, para. 48, note 50, *citing to Communication from Switzerland*, MTN.GNG/NG10/W/17 (1 February 1988), page 4.

[32] *Id.*, para. 49, *quoting Elements of the Negotiating Framework; Communication from Switzerland*, MTN.GNG/NG10/W/26 (13 September 1989), page 3, note 1.

[33] *US First Submission*, para. 56, *quoting* Petros C. Mavroidis, *Remedies in the WTO Legal System: Between a Rock and a Hard Place*, 11 Eur. J. Int'l L. #4 (2000), downloaded from <www.ejil.org/journal/Vol11/No4/index.htm/>, page 45.

[34] *Id.*, *quoting* Allan Rosas, *Implementation and Enforcement of WTO Dispute Settlement Findings: An EU Perspective*, J. Int'l Econ. L. 131 (2001), page 142, note 45.

III. MEASURING THE TRADE IMPACT OF THE SUBSIDY ON THE EC

51. The United States would now like to make some brief comments regarding the measurement of the trade impact of the U.S. subsidy on the EC.

A. Economic Modeling

52. In its second submission, the United States responded to the EC's arguments regarding the alleged trade effects of the U.S. subsidy. As noted in that submission, as well as in the first U.S. submission, in many cases model-based calculations of the trade effects of a subsidy may well be appropriate.

53. In this case, however, the United States believes that the results of any attempt at empirical measurement are necessarily so uncertain as to give any objective observer concern about the use of such results as the basis for determining whether countermeasures are disproportionate to the trade impact on the complaining Member. Therefore, the United States has recommended to the Arbitrator that it use the amount of an accurately estimated subsidy in 2000 (or 2001) as a proxy for the global trade effects of the subsidy, and that the EC be awarded its proportionate share of that amount.

54. In support of this recommendation, the United States has provided citations to the economic literature on estimated parameters of economic responsiveness relevant to the measurement of trade effects. Employing these elasticities, the United States has demonstrated that the endpoints of the range of results from such modeling for export effects fall well below the level of the subsidy on one end and well above on the other. In choosing the level of the subsidy as a proxy for trade effects, the Arbitrator would be determining a level within the

possible range of effects and following in the path of the arbitrator in *Brazil Aircraft*, which faced a similar, but less difficult, analytical issue.

55. The reason the United States views the potential estimation of trade effects as less difficult in *Brazil Aircraft* is because that case dealt with the subsidization of a single product. This case is very different. Most recent estimates suggest that as much as half of all U.S. goods exports benefit from a FSC/ETI tax exemption whose value is in the order of only one percent of the export value of these products or one-half of one percent of all exports. Thus, the U.S. subsidy at issue here covers hundreds or thousands of products by providing a *de minimis* level of subsidy related to each export transaction. In *Brazil Aircraft*, which involved an industry dominated by two companies, the type of industry information needed to conduct a trade effects estimate could be reasonably gathered. By contrast, in this case, the necessary information could not be reasonably gathered by the Arbitrator or either of the parties due to the detailed knowledge required for a large number of sectors.

56. An additional problem is that of the "pass-through" of the tax subsidy. This issue is crucial to any consideration of trade effects. Indeed, 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 U.S. exports and the quantification of the trade impact would be zero.

57. There are a number of reasons why the Arbitrator should be concerned about pass-through if a trade modeling approach were to be undertaken. To the best of U.S. knowledge, there is no empirical literature estimating the elasticity of export supply, the technical measure

for determining the degree of pass-through. Use of an infinite elasticity of export supply (the condition of full subsidy pass-through to export prices) is more a convention in economic modeling than the reflection of actual empirical knowledge concerning the degree of pass-through. As the United States has noted,[35] many U.S. export products are by nature complex and knowledge-based. Such conditions effectively confer on producers a degree of pricing power. Such conditions of imperfect competition greatly complicate the pass-through issue. Given that the U.S. subsidy is so small relative to each individual export transaction, it is difficult to argue persuasively that all or even most of the subsidy is passed through to export prices rather than simply going to the firms as additional profits.

58. Indeed, the EC itself appears to have taken an ambiguous position on the crucial issue of pass-through. In paragraph 2 of its first submission the EC states as follows: "Also, the FSC/ETI scheme operates by increasing the profitability of export sales by between 5 and 10% - evidently a very efficient means of stimulating exports." This is not some isolated statement, but instead is an assertion that the EC has consistently made throughout the course of this dispute.[36] Is the EC saying that U.S. firms absorb all or most of the subsidy into company profits, thereby raising profitability rather than passing the subsidy through to purchasers in the form of lower export prices? Certainly the magnitude of the increase and the reference to profitability suggest that the EC did not have in mind simply the increase in normal accounting profits accruing from the additions to U.S. exports from a fully passed-through subsidy. However, if the subsidy is not

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[35] *US Second Submission*, para. 115.

[36] *See Oral Statement of the EC at the First Meeting of the Panel* (9-10 February 1999), para. 71; *Second Submission of the European Communities*, 2 March 1999, paras. 36, 39; and *EC Second Submission*, 26 February 2002, para. 89.

being fully passed-through, as the EC seems to assert, why does the EC assume in its economic model that it is?

59. In this regard, while the EC has relied on a modified version of the 1997 U.S. Treasury study for an estimation of trade effects, the EC has failed to note to the Arbitrator the statement in that study that the use of full pass-through will "tend to overstate the loss in exports that would accompany the removal of FSC benefits."[37] In addition, in annex 7 to Exhibit EC-8, the EC provided a study of the trade effects of the FSC by Thomas A. Pugel and Paul Wachtel in which the researchers adopted the methodology of the 1997 Treasury study, while extending it in an attempt to identify a "direct effect" free of the subsidy's impact on the U.S. dollar exchange rate. The appendix table B-1 of this study by Pugel and Wachtel clearly shows that an infinite U.S. export supply elasticity was used for all non-agricultural goods exports. Yet, in an earlier study of the predecessor to the FSC – the Domestic International Sales Corporation, or DISC – Thomas Pugel and Thomas Horst argue for less than full pass-through of the subsidy.[38] They note that,

> In a competitive industry marked by low barriers to entry, producers are forced to pass tax savings on to buyers through lower prices. Although wheat, soybeans and other agricultural commodities might satisfy this competitive requirement, most manufactured exports do not. Airplanes, computers and other office machinery, industrial equipment, drugs and other chemicals – the usual type of manufactured exports – are differentiated products of industries with high barriers to new competition. Although such manufacturers may lower their prices when income taxes are reduced, they are not compelled by competition to do so.[39]

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[37] Exhibit EC-1, page 12.

[38] Thomas Horst and Thomas Pugel, *The Impact of DISC on the Prices and Profitability of U.S. Exports*, Journal of Public Economics 7 (1977) pages 73-87. This article is cited in Exhibit EC-8 as part of Mr. Pugel's resume.

[39] *Id.*, page 77.

More specifically, Pugel and Horst conclude that it is not "plausible" to assume that "all tax savings are shifted forward through lower export prices ... ."[40]

60. In their empirical work for the year 1974, Pugel and Horst estimated that roughly three quarters of the tax savings from DISC were reflected in lower export prices and one quarter in boosting after-tax income.[41] In other words, they did not take the position that 100 percent of the tax savings was passed through.

61. In light of this information, the extent to which the U.S. subsidy at issue here is passed-through in the form of lower export prices is uncertain. What we do know from the work of both the U.S. Department of the Treasury and Pugel and Horst is that the assumption of full pass-through in the EC study overestimates the trade impact.

62. For empirical work, however, the problem does not end here. In addition to knowledge of the subsidy's impact on the price of U.S. exports, economic modeling also must incorporate estimates of the responsiveness of foreign demand to changes in U.S. export prices. As noted in the second U.S. submission, one way to capture the demand side of the equation is through empirically estimated values for U.S. demand elasticities. An alternative approach is to employ empirically estimated price elasticities of substitution between U.S. exports and EC products. For both export demand elasticities and substitution elasticities, the economic literature contains a variety of estimates of their values.

63. The U.S. modeling exercises described in the second U.S. submission employed both types of elasticities. In one exercise, the United States reran the EC/Treasury model using export

[40] *Id.*
[41] *Id.*, pages 84-85.

demand elasticities from the literature ranging from negative 1.13 to negative 2.53. Relative to a net U.S. global subsidy of $4.13 billion, the model reports increases in U.S. exports globally in a range between $830 million and $9.8 billion. For the EC, at a 26.8% share, the share of U.S. exports affecting the EC could range from $222 million to $2.6 billion.

64. The U.S. subsidy level in this exercise clearly lies within the range of the possible trade effects. Even at that, however, the trade effects of the subsidy are likely to be over-estimates, because the EC/Treasury model assumes full pass-through of the subsidy to export prices, an assumption that the EC's own expert has acknowledged as being implausible.

65. The U.S. modeling exercise based on the degree of substitution of U.S. for EC products used a range of substitution elasticities from the literature of between 1.5 and 2.5. The range effect of the $4.13 billion dollar subsidy in this model is an increase in global U.S. exports of between $2.4 billion and $7.3 billion, and a corresponding decrease in EC production of between $656 million and $2.0 billion. The U.S. export supply elasticity in the exercise with the smaller effect is 10 and in the exercise with the larger effect, 20. Export supply elasticities of 10 to 20 are commonly assumed in such modeling exercises as an approximation for infinite supply elasticity. Thus, as in the rerun of the EC/Treasury model, the results reported here from the imperfect substitution model are likely to be over-estimates.

66. While the United States certainly is not, as a general proposition, opposed to the use of formal economic analysis for the purposes of quantifying trade effects, we do not believe that such an approach is advisable in this case. To conduct this approach accurately would require detailed disaggregated information covering many different product sectors. It would have to

relax assumptions of perfect competition in many cases. It would have to deal with the problem of lack of empirical evidence on export supply elasticities. The results would be highly sensitive to assumptions about uncertain parameters. Our own simple exercise based on aggregated U.S. exports show trade effects of the FSC/ETI subsidy that range from below to above the level of the subsidy value. In light of this situation, and in line with the approach taken in *Brazil Aircraft*, the United States recommends that the Arbitrator adopt the value of the subsidy – properly calculated – as a proxy for the global trade effect of the subsidy, awarding to the EC a 26.8 percent share of this amount.

67. Finally, while we are on the topic of economic modeling, it is appropriate to note that the United States does not agree with the EC's unsubstantiated assertion that export subsidies must be assumed to increase exports by much more than the amount of the subsidy.[42] As we have just explained, the extent to which a particular subsidy increases exports – or whether it increases exports at all – is an empirical question, the answer to which depends on the facts. Indeed, the simple modeling exercise described in the *US Second Submission* shows that, depending on the parameters used, the U.S. subsidy at issue here could have an effect that is less than or greater than the amount of the subsidy. Put differently, depending on the facts, the provision of a subsidy by a government can, indeed, constitute a waste of taxpayers' money.

B. The EC's Extrapolated Growth Rates for the Subsidy Are Incorrect

68. In paragraph 92 of its second submission, the EC projects further into the future its estimates of the amount of the subsidy. The United States has previously explained why it would

[42] *See, e.g., EC Second Submission*, para. 89.

be impermissible for the Arbitrator to consider the year 2002.[43] However, putting that issue aside, the EC's numbers simply are not credible.

69. The EC continues to presume a straight extrapolation of the FSC growth rate from the earlier period 1987 to 1996, with the rate of subsidization increasing in line with the rate of covered exports. At an annual compound rate of 16.7 percent, the EC projects that covered exports will amount to $722.2 billion in 2002.

70. The United States has explained why the EC's 16.7 percent growth rate is incorrect.[44] Here, we simply will note that the calculations in the *EC Second Submission* further demonstrate the absence of any relationship between the EC's figures and reality. Based on its 16.7 percent growth rate, the EC projects covered exports for 2002 in the amount of $722.2 billion.[45] However, in 2001, U.S. total goods exports, at $730.9 billion, were barely over this amount. At the EC's projected growth rates, U.S. exports benefitting from the subsidy likely would exceed the actual total of all U.S. goods exports in 2003. Such a result confirms the fact that the EC's extrapolations are not correct, as illustrated in Exhibits US-7 and US-8.

C. The EC's Calculation of Its Share of the Subsidy Amount Is Incorrect

71. In Section VI.C. of its second submission, the EC challenges the method used by the United States to determine the EC's share of the subsidy under the U.S. proxy approach. The EC's challenge is incorrect as a conceptual matter, and its calculation of the EC share under its methodology is inaccurate.

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[43] *US Second Submission*, paras. 98-100.
[44] *Id.*, paras. 69-86.
[45] *EC Second Submission*, para. 92.

72. Turning to the conceptual issue first, the EC argues that an appropriate share should be based on trade flows rather than production. However, one cannot ignore EC domestic shipments in calculating the EC's share of the global subsidy. EC-produced products are a potential substitute for U.S. exports, and are affected by any increased exports resulting from the U.S. subsidy. As the United States explained at paragraph 64 of its first submission, an export subsidy potentially increases exports and, as a result, potentially affects both domestic sales of domestically-produced products in the country receiving the subsidized exports and the exports of that country to the rest of the world.

73. The United States also presented a graphical representation of the impact of an export subsidy in Exhibit US-10. The only proper conclusion is that if the Arbitrator should accept the U.S. suggestion to use the amount of the subsidy as a proxy for the trade impact, the impact on the EC should be based on an allocation method that includes domestic shipments of goods. The U.S. calculation of the EC's share was 26.8 percent, and, while the EC has contested the concepts underlying the U.S. methodology, the EC has not disputed the accuracy of the calculation itself.

74. However, in addition to the conceptual errors underlying the EC's alternative approach, the EC has made a glaring calculation error in applying its own methodology. When this error is corrected, the share for the EC is *less than* the share calculated under the U.S. methodology.

75. Basically, what the EC did is to overstate total EC goods exports by claiming that EC exports to the world (excluding intra-EC trade) was $1.08 trillion in 2000. In fact, the EC

exported only $859 billion to the world according to WTO statistics,[46] and only $879 billion according to IMF statistics.[47]

76. To correct the EC error, the United States has used the IMF statistics, because WTO statistics do not report EC goods exports to the United States. According to the IMF, EC goods exports to the world totaled $2,269 billion in 2000. To obtain the amount of EC goods exports to the world exclusive of exports to the United States and intra-EC trade, the United States simply subtracted the IMF figures of $1,390 billion for intra-EC goods exports and $210 billion for EC goods exports to the United States. This results in a figure of $669 billion for EC goods exports to the world.

77. In Exhibit EC-10, the EC overstated its goods exports to the rest of the world (excluding intra-EC exports and exports to the United States) by approximately 30 percent. Specifically, the EC used a figure of $866.6 billion instead of the correct figure of $669 billion. Using the correct figure of $669 billion, the EC's share of exports to the rest of the world is 31.9 percent, not the 37.7 percent figure reported in Exhibit EC-10.

78. In other words, using the EC methodology, but with accurate numbers, the EC's share of the negative effects of the U.S. subsidy in world trade would then be equivalent to 31.9 percent of the share of U.S. goods exports to the world excluding the EC. The EC said that the U.S. share of goods exports to the world excluding the EC was 78.7 percent. Applying the correct figure of 31.9 percent, the EC's share of the negative effects of the U.S. subsidy amounts to

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[46] World Trade Organization, *World Trade in 2000 – Overview*, Table 1-6, page 22.
[47] *Direction of Trade Statistics Quarterly*, IMF (September 2001).

25.1 percent (78.7 x 31.9). This share is lower than the 26.8 percent figure calculated under the U.S. methodology.

79. If, on the other hand, the EC should wish to use its share of U.S. exports as the appropriate allocation, this would result in an EC percentage share of the subsidy equal to 21 percent ($165.1 billion of U.S. goods exports to the EC in 2000 divided by $781.9 billion in total U.S. goods exports in 2000). This, too, is lower than the 26.8 percent figure calculated by the United States.

80. In summary, while the United States does not agree with the assumptions underlying the EC's alternative approach, this alternative approach – when correct figures are used – generates a lower amount of countermeasures than the U.S. approach.

IV. CONCLUSION

81. Mr. Chairman, that concludes the opening statement of the United States. The U.S. delegation will be pleased to answer any questions you may have.