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Canada – Dairy
Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk*

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1 Introduction

This paper summarizes and critically reviews the dispute brought before the World Trade Organization (WTO) concerning Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk, euphemistically referred to herein as Canada – Dairy. This dispute is centered on the WTO Agricultural Agreement, though it also involves the WTO Subsidies and Countervailing Measures (SCM) Agreement and GATT – 1994.

Many analysts have argued that a significant accomplishment of the Uruguay Round of negotiations was the development of a set of rules on agricultural supports, that covered the three main policy instruments of such support: border measures, domestic supports, and export subsidies. The national commitments made as part of the Agreement on Agriculture clearly represented just the beginning of agricultural reform, reflected by the fact that agriculture was earmarked as part of the built-in agenda going forward. It is widely recognized that the agricultural sector is one of the most highly subsidized sectors in the world. Liberalization of trade in agriculture was deemed the "lighthouse" of the Uruguay Round for the United States and a number of other jurisdictions. It remains controversial today. Hence, this political and economic backdrop adds a special importance to this dispute.

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Contextually the dispute is also significant because it brings to light the systemic question of whether the Agriculture Agreement and the SCM Agreement are structured and drafted to strike the proper balance among the support measures, especially when there are spillover consequences of domestic support measures on export markets. Although the domestic price-setting mechanism is a distinct instrument from the export-pricing instrument, these instruments cannot be evaluated in isolation. Hence, in an environment of regulated prices and other domestic support measures, distortions introduced in one area (e.g. domestic supports) may have an impact on prices in another area, even if somewhat less regulated (e.g. export prices).

From a legal perspective, an important systemic feature of the case has to do with the relationship between the SCM Agreement and the Agriculture Agreement. The question of how the SCM Agreement should inform the Agriculture Agreement was raised but not answered in this dispute.

The discussion that follows undertakes a three-step analysis. In each step, we begin with the most general and turn in sequence to the more specific legal and economic issues raised by the Canada – Dairy dispute.

First, we consider the economic basis for the WTO provisions that are at the heart of this dispute. We ask: What are the underlying goals of the various WTO provisions touched upon in the Canada – Dairy case, and are the goals themselves sensible from an economic perspective?

Second, we present and evaluate the key factual and legal elements of the case, focusing primarily on the legal issues raised by the case in its final disposition (e.g. whether at the Panel or the Appellate Body level) that seem particularly important to understanding the stated legal and economic logic of the case. More specifically we ask: Have the reviewing panels and the AB applied the law consistently, mindful of WTO precedent? Are the panelists and the AB doing what they state they are doing? Are the judgments well grounded in legal argument? Is there ambiguity in the applicable law, as drafted? If so, how is it resolved — e.g. with deference to national measures, or through judicial license?

And third, we consider and evaluate the particular legal and economic issues and methodologies raised by the dispute. More specifically we ask: In light of the underlying goals of the relevant WTO provisions, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles?
2 General economic analysis

The Canada – Dairy case raises several levels of questions from an economic perspective. A first-level question is: What are the goals of the various WTO provisions touched upon in this case, and are the goals themselves sensible from an economic perspective? This is the question that we review in this section. A second-level question is: In light of these goals, and taking them as given, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles? This second-level question will be taken up in section 4, after the legal aspects of the case have been presented and evaluated in section 3.

What, then, are the goals of the various WTO provisions touched upon in this case? This question centers on the question of whether Canada’s milk support schemes violated its export-subsidy-reduction commitments under Articles 3.3, 9, and 10 of Agriculture Agreement. Hence, we evaluate in this section the general economic basis for international commitments to reduce export subsidies on agricultural products such as those embodied in these Articles.

As a general matter, it is instructive to begin by considering the stated rationale for limiting export subsidies generally as contained in paragraph 2, section B of Article XVI GATT: "The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement." From an economic perspective, what is interesting about this statement is that the authors of the Agreement may have harmful effects for both importing and exporting governments.

By contrast, the Preamble of the Agreement on Agriculture and the Articles themselves suggest a more nuanced view of the impacts of agricultural export subsidies on importing and exporting governments. For instance, the Preamble lists as one of the four areas for achieving binding commitments the area of "export competition," and indeed Article 8 of the Agreement is entitled "Export Competition Commitments." This suggests that the commitments to reduce agricultural export subsidies are seen by WTO members as primarily serving the interests of competing exporters of agricultural products, but not necessarily the interests of exporting governments. This suggestion is made more explicit in the last paragraph of the Preamble, which states "... and taking into account the possible negative effects of the implementation of the reform programme on least-developed and net food-importing developing countries."

In fact, it might be said that the Preamble of the Agriculture Agreement reflects an underlying tension of interests between exporting and importing governments on the issue of export subsidies that is absent in the stance against export subsidies taken in the name of exporters and importers in section B of Article XVI GATT. As we explain below, tension between exporting and importing governments over the issue of export subsidies is more readily understood with standard economic arguments than is a unanimous stance against export subsidies. However, as we also explain below, standard economic analysis does not help us explain the way in which the tension between exporting and importing governments was resolved in the Agriculture Agreement. Thus, though for somewhat different reasons, the goals of the export subsidy provisions in both the Agricultural Agreement and section B of Article XVI GATT (and by implication, Article 3.1(c) of the SCM Agreement) are puzzling from an economic perspective.

2.1 The economic puzzle of international agreements to limit export subsidies

To appreciate the economic puzzle posed by international agreements to limit export subsidies, let us begin by trying to explain with standard economic arguments the interests of exporting and importing governments as expressed in Part B of Article XVI GATT. To this end, consider a hypothetical world in which export subsidies were not prohibited and where no government had yet imposed a tariff in a GATT negotiation. We might think of this hypothetical world as approximating in very broad terms the world as it might have existed during the early years of GATT, had Part B of Article XVI GATT not been introduced.

In this hypothetical world, with governments then free to respond to an export subsidy with tariffs and/or export subsidies of their own, it can be generally shown that one country’s export subsidy must be seen as harmful to the governments of competing exporting countries, but beneficial to the governments of importing countries (we explain this benefit below).

1 Part B of Article XVI GATT was introduced during the 1955 Review Session. We do not mean to suggest that there were in fact no tariff bindings in 1955, but only that at the time the Part B of Article XVI GATT was introduced the tariff choices of most GATT Contracting Parties remained largely unrestrictive by existing GATT tariff bindings.

2 See Bergwell and Staiger (2002), chapter 10.
Thus, the position can be achieved by importing goods to the domestic economy, the quantity of good X demanded by domestic consumers is decreasing in the domestic price of good X. The domestic supply curve, on the other hand, is positively sloped, indicating an increase in the quantity of good X supplied as the price of good X increases.

The domestic supply curve is depicted as a dashed line labeled S_d in Figure 10.1. The equilibrium price and quantity are determined at the point where the supply and demand curves intersect. At this equilibrium, the quantity demanded equals the quantity supplied, and the market is said to be in balance.

In the short run, changes in the price of foreign goods can affect the domestic economy. If the price of good Y, a foreign good, increases, it may make domestic producers more competitive, increasing the demand for domestic goods. Conversely, if the price of good Y decreases, it may reduce the demand for domestic goods.

The left-hand quadrant of Figure 10.1 depicts the impact on the domestic economy when the price of good Y is increased. An increase in the price of good Y shifts the supply curve for domestic goods to the right, indicating an increase in the quantity supplied. This, in turn, increases the equilibrium price of domestic goods. The right-hand quadrant of Figure 10.1 illustrates the impact on the domestic economy when the price of good Y is decreased. A decrease in the price of good Y shifts the supply curve for domestic goods to the left, indicating a decrease in the quantity supplied. This, in turn, decreases the equilibrium price of domestic goods.

The diagrams in Figure 10.1 are consistent with the principles of microeconomics, where changes in the price of one good affect the supply and demand for another good, leading to adjustments in the market equilibrium.
standard economic arguments imply that agreements that attempt to place limits on export subsidies are not serving the interests of importing governments.

It is thus that, in practice, due to a variety of possible "transaction costs," these escapes may indeed be quite costly to use, and the resulting inflexibility of tariff commitments might then serve as the basis for understanding why export subsidies could be viewed as harmful by the governments of importing countries who had bound their tariffs. At a general level, this observation would seem to suggest a promising direction for further consideration of the degree to which the conclusions of the standard economic arguments reviewed above are robust. But the economics literature has yet to develop a formal treatment of the transaction-cost position in this context.

Hence, we may articulate a first piece of the economic puzzle posed by international agreements to limit export subsidies: standard economic arguments predict a tension between the interests of exporter governments and importer governments in this context, and so these arguments cannot account for the mutuality of interests expressed by exporting and importing governments in Part B of Article XVI GATT.

As we observed above, while the tension between the interests of exporter governments and importer governments that is predicted by standard economic arguments is absent from Part B of Article XVI GATT, this tension can be seen in the preamble of the Agriculture Agreement. Nevertheless, it would be wrong to conclude from this observation that the export subsidy provisions of the Agriculture Agreement can find support from standard economic arguments. This is because, if followed to their logical conclusions, the standard economic arguments carry with them an even more provocative implication about the way in which this tension should be resolved. This is the second piece of the economic puzzle posed by international agreements to limit export subsidies: from a worldwide perspective, governments that choose to subsidize their exporters in the absence of international agreements should be encouraged to subsidize more under international agreements, not less.

The essential reason for this provocative implication of standard economic arguments is that, when the impacts on both competing exporter and importing governments are taken into account, an export subsidy can always be shown to confer a net benefit on the rest of the world. Through an international agreement, this net benefit can be "internalized" by the grantor of the export subsidy, resulting in an expansion of its export-subsidy program.
Why is it that an export subsidy can always be shown to confer a net benefit on the rest of the world? We may gain an intuitive understanding of this fact by returning to figure 10.1 above. Let us suppose that the foreign export supply of good y actually comes from two foreign countries, foreign country 1 and foreign country 2, whose exporters of good y are competing for sales in the domestic-country market. In the right-hand quadrant of figure 10.1, the horizontal line bordered E(\(p^*\)) then depicts the total export supply of good y from the foreign countries 1 and 2 as a function of the price, \(p^*\), offered by foreign exporters and in the absence of a foreign export subsidy.

Now suppose that foreign country 1 applies an export subsidy to good y. Suppose further that, in response to the export subsidy of foreign country 1, foreign country 2 introduces an export subsidy of its own that permits its exporters to continue to export the original volume of good y to the domestic country and receive (inclusive of its export subsidy payment to them) the original price for their export sales. Notice that, under this response, the entire impact on foreign country 2's foreign currency 1's decision to offer an export subsidy is reduced to the budgetary cost of foreign country 2's export subsidy program, since under this export-subsidy program foreign country 2's exporters are completely insulated from any effects of foreign country 1's export subsidy. Suppose, then, that the upshot of foreign country 1's export subsidy and foreign country 2's described response is reflected in the right-hand quadrant of figure 10.1 by the downward shift of the foreign export supply curve to that labeled E(\(p^*\)).

Figure 10.1 may now be used to develop an intuitive understanding of why an export subsidy can always be shown to confer a net benefit on the rest of the world. In the case under consideration, we may ask: How is it that we can be sure that foreign country 1's export subsidy confers a net benefit on the domestic importing country and the competing exporter foreign country 2? We can be sure of this fact for a simple reason: the extra tariff revenue collected by the domestic country under the tariff T in the presence of the foreign export subsidies, labeled as the box 356 in the left-hand quadrant of figure 10.1, is more than sufficient to pay for the budgetary cost of foreign country 2's described export subsidy program.4

4 This can be seen with the aid of figure 10.1 by observing that foreign country 2's described export subsidy must be at a (per-sales-unit) level equal to the difference between the original price received by foreign exporters, \(p^*\), and the new price received by foreign exporters (excluding their subsidy receipts), \(p_2\). This difference is the height of the box 3564 in the left-hand quadrant of figure 10.1. For foreign country 2, the budgetary cost of its described export-subsidy program is then the net sales-volume multiplied by the total export-volume of its good y-exporting firms. But the total export volume of foreign country 2's good y-exporting firms must be less than \(m_y \cdot \Delta \alpha = m_y \cdot (m_y - x_1)\) in figure 10.1, because foreign country 1's exporters are also supplying a portion of the trade volume \(m_y\). As \(m_y \cdot \Delta \alpha\) is the length of the box 3564, it then follows that the box 3564 is larger than the budgetary cost of foreign country 2's described export subsidy program.

As before, if in the present case under discussion the importing government or the competing exporter government chooses not to respond to the export subsidy of foreign country 1 in the described fashion, then it is presumably because an even better response has been found. Either way, the two governments can always be assured of a net benefit from foreign country 1's export subsidy.

5 See Bagwell and Staiger (2002), chapter 10. This conclusion follows provided that the goal of the WTO is to serve the interests of its member governments, and that those interests are represented at the WTO bargaining table.

Hence, it follows that the domestic importing government could fully compensate foreign country 2 for the harm done to it by foreign country 1's export subsidy (i.e., the domestic importing government could pay for the budgetary cost of foreign country 2's described export-subsidy program) and still enjoy some remainder of the box 3564 for itself.5

For the reasons described above, it is difficult to utilize standard economic reasoning to offer broad support for worldwide benefits from export-subsidy provisions which seek to place limits on export subsidies such as those touched upon in the Canada - Dairy case. Instead, standard economic reasoning leads to the conclusion that negotiated commitments to reduce the level of export subsidies from their unilateral levels represent an inefficient victory of exporter interests over importing - and world - welfare. The bottom line, then, is that the standard economic reasoning does not provide broad support for the position that facilitating agreements to restrain export subsidies is an activity that the WTO should be involved in.6

2.2 What is wrong with the standard argument against export subsidies?

At this point it would be reasonable to ask: What is wrong with the standard argument against export subsidies? After all, standard economic arguments imply that free trade is the efficient outcome for the world, and that international agreements that reduce the level of intervention toward free trade - such as those that reduce export subsidies - are therefore efficiency-enhancing. Why do these standard arguments not provide formal support for the position that international agreements to limit export subsidies make economic sense?

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5 See Bagwell and Staiger (2002), chapter 10. This conclusion follows provided that the goal of the WTO is to serve the interests of its member governments, and that those interests are represented at the WTO bargaining table.
The difficulty with this position is that the formal conditions that are necessary to make free trade efficient when the interests of all governments are accounted for rule out the possibility that these governments would also choose to subsidize exports in a unilateral policy setting. In fact, such formal models predict that governments would tax exports in the absence of an international agreement, and hence a negotiated movement to free trade, while efficiency-enhancing in these models implies an international agreement that eliminates export taxes and thereby expands trade volumes.

Once these formal models are augmented with ingredients such as political economy considerations or imperfect competition that are capable of converting the predicted government policy choices from export taxes to export subsidies, the augmented models themselves no longer imply that free trade is efficient when the interests of all governments are accounted for (see also note 6). Efficiency continues to require international agreements that expand trade volumes from the levels implied by unilateral policy choices in these augmented models, but this is now accomplished in these augmented models by international agreements to increase export subsidies.

As a consequence, the contention that agreements to reduce export subsidies serve the interests of WTO member governments because they represent a movement away from policy intervention and toward free trade does not stand up to formal scrutiny. We are thus left with the bottom line that formed the concluding observation of the previous subsection: the standard economic perspective does not provide broad support for the position that facilitating agreements to restrain export subsidies is an activity that the WTO should be involved in.

2.3 Interpretation 1: rethink economic explanations of export subsidy agreements

This observation invites at least two possible interpretations. A first interpretation emphasizes the limits of existing formal economic reasoning in this instance, and casts doubt on the ability of existing formal economic models to adequately capture the role that international agreements to limit export subsidies can play. According to this interpretation, it is important to seek and develop further alternative modeling approaches that might better reflect some critical feature associated with the issue of export subsidies that the standard models have failed to capture. We have already mentioned the possibly important role of transaction costs in this regard. It is also possible that modeling approaches which see international agreements as helping governments make commitments to their own private sectors—rather than to other governments—may point the way to a more complete understanding of the role that international agreements to limit export subsidies can play.

In the case of agricultural markets, the notion that governments might seek international agreements as a way to make commitments to their own private sectors—that is, to "tie their own hands" against intervention in the face of otherwise irresistible pressure from strong special interests—has a special appeal. Intuition would suggest that, given the extreme domestic-political forces at work in agricultural markets, national governments might well seek ways to stand up to these pressures, and international agreements are a likely tool in this regard. Indeed, at a general level there is some empirical evidence that GATT/WTO commitments do play this role.

Nevertheless, it is important to point out that, as yet, there is little formal understanding of the way in which international commitments might actually work toward this purpose. And there is even less formal understanding of the way that such international commitments might be structured to serve this purpose more effectively. A greater formal understanding of these issues could yield important dividends.

As one illustrative example, if governments seek to "tie their own hands" when it comes to resisting political pressures over domestic agricultural policies, then the ability to make commitments that afford very little discretion or ex-post flexibility can be very valuable in serving this purpose. But when it comes to international commitments, the realities of international enforcement may call for a fairly high degree of flexibility in these commitments. From this perspective, provisions of the Agriculture Agreement that give a government ex-post flexibility to "untie its hands," such as the special safeguard provisions contained in Article 5, would work…

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1 It is also interesting to observe that current efforts in the developed world to further restrict export subsidies in agriculture so as to help developing countries are driven by the interests of developing countries who are themselves competing exporters of agricultural products. The economic perspective outlined above would nevertheless predict that food-importing developing countries, food-importing countries more generally, and the world as a whole stand to lose if these efforts are successful.


10 See Bagwell and Staiger (1990).
the quantity demanded by the buyer will tend to be lower than the quantity supplied by the seller, as the quantity supplied by the seller is determined by the market-clearing price. This perspective might then in turn suggest that the flexibility afforded to governments under the WTO's dispute settlement procedures might, to the extent they apply to the EU-Agile Agreement, be further enhanced.

If any agreement is to prove effective, it is not only the agreed-tariff reductions that are important. So, for instance, the EU's efforts to restrain export subsidies through the use of export restrictions are not only a key feature of the agreement, but also serve to underline the importance of such policies. A second interpretation, which places more weight on the presumptions contained in the draft agreement, is that the agreement does not require the EU to impose any specific measures to reduce its export subsidies. Such an interpretation is consistent with the EU's announced intention to liberalize its export policies, and it raises questions about the EU's commitment to trade liberalization.

2.4 The interpretation of the draft agreement is also open to question, and it is not clear how the EU's commitment to trade liberalization will be reflected in the implementation of the agreement. However, the EU's announced willingness to liberalize its export policies is an important factor in determining whether the agreement will be effective. If the EU is willing to liberalize its export policies, it is likely that the agreement will be effective. If the EU is not willing to liberalize its export policies, it is unlikely that the agreement will be effective.

Under the first possibility for negotiation, both buyers and sellers are assumed to act in their own self-interest, and to pursue their own particular interests. Under the second possibility, the EU may agree to change its market-clearing price, and to reduce its export subsidies, in order to avoid the imposition of export duties by the US. Under the second possibility, the EU may agree to change its market-clearing price, and to reduce its export subsidies, in order to avoid the imposition of export duties by the US. Under the second possibility, the EU may agree to change its market-clearing price, and to reduce its export subsidies, in order to avoid the imposition of export duties by the US. Under the second possibility, the EU may agree to change its market-clearing price, and to reduce its export subsidies, in order to avoid the imposition of export duties by the US.
sellers and buyers are counted, because it moves joint supply farther from the competitive outcome.

We may conclude that, while trade-volume-expanding agreements are still needed to solve the inefficiency in this situation, negotiations that involve only sellers are likely to result in restrictions in trade and further worldwide inefficiency.

What does this have to do with the WTO and its export-subsidy provisions? We may think of typical market-access negotiations within the GATT/WTO as corresponding to the situation in which both the buyers and the sellers are each small players in a competitive market, but are represented at the international bargaining table by their respective governments, who in turn have the ability to affect (world) market-clearing prices with their trade policy choices.13

In a typical situation, sellers of good 1 in country 1 seek access to buyers of good 1 in country 2, while sellers of good 2 in country 2 seek access to buyers of good 2 in country 1, and the governments of countries 1 and 2 then come together to negotiate an exchange of market access commitments. Importantly, in these negotiations the interests of both the sellers of goods 1 and 2 (represented by the governments of countries 1 and 2, respectively) and the buyers of goods 1 and 2 (represented by the governments of countries 2 and 1, respectively) are represented. As a consequence of this representation, the negotiated market-access agreements are naturally trade-expanding in their effect, taking the form of various commitments to policy changes that increase trade volumes from the levels implied by unilateral policy choices.14

In the same way, we may think of negotiations over export subsidies within the GATT/WTO as corresponding to the situation in which only sellers are represented.15 As a consequence of this representation, the negotiated commitments are naturally trade-restricting in their effect, taking the form of various commitments to policy changes that reduce trade (export) volumes. From this advantage point, agreements by exporting governments to limit export subsidies can be interpreted as a "sellers' combination in restraint of trade," with the consequent implications for overall efficiency (i.e. good for the sellers, but not for the buyers, and not for the sellers and buyers on the whole).16

The simple point is that the standard economic rationale for the purpose of negotiations over trade policy is that trade volumes are inefficiently low when governments set their trade policies unilaterally. As a consequence, from this perspective, the central task of trade negotiations is to expand trade volumes beyond their unilateral levels to more efficient levels. Since agreements to restrict export subsidies are agreements to restrict trade volumes below unilateral levels, such agreements appear to run counter to efficiency. Any economic argument in support of international agreements to restrict export subsidies must overcome this basic dilemma.

3 Factual and legal claims

3.1 Introduction and overview

In this dispute, the United States and New Zealand challenged certain Canadian government domestic milk-production and export supports that were provided through Canada's Special Milk Classes Scheme as well as the Canadian government's application of its tariff rate quota for imports of fluid milk. The Canadian government has a comprehensive system of supply management for industrial milk that includes production quotas, administered price supports and border measures.

This dispute centered on allegations of excessive use of export subsidies and the Canadian government's misuse of its tariff rate quota. However, more broadly this case arises out of the tensions between the instruments of supply management. Indeed, it may not be possible to understand the 13 In fact, while we develop this argument in the context of trading economies with perfectly competitive export sectors, an identical logic applies if instead the export industry is characterized as an oligopoly (see Bagwell and Staiger, 2002, chapter 10).
14 Here the GATT/WTO negotiating norm of "reciprocity" can serve the role of forcing (world) market-clearing increases in trade volumes (see Bagwell and Staiger, 2002, chapter 6), completing the analog with the oligopoly/oligopoly/oligopoly negotations discussed above.
15 More accurately, those represented at the negotiating table are not sellers (i.e. exporters), and what is important is that the interests of the other side of the market, namely the net buyers (i.e. importers) are not being served by such negotiations.
16 We observe that the same logic is at work on the import-policy side. If, for example, importers of a product come together to negotiate a customs union, then as they harmonize their external tariffs on the products they jointly import from outside the customs union, they will have an incentive to agree to external tariffs that more effectively exert their combined oligopoly power, which is to say they will have incentives to negotiate higher external tariffs than restrict external trade volume. This incentive is inefficient from the point of view of world (buyer and seller) welfare, and if the exporters of these products from outside the customs union were also represented in these negotiations, trade volumes would presumably not be restricted in this way. In some ways, the provisions of Article X:4 GATT that specifically prohibit raising external tariffs in this circumstance may serve to give exporters outside of the customs union some representation in these negotiations, and thereby contribute toward ensuring that inefficiencies do not arise from this incentive.
nature of this dispute—export subsidies—without examining the government's intervention policies, the European Union's (EU) market-creating mechanisms, and the potential for the EU to establish a comprehensive system of indirect price intervention and price support that could counteract the impact of the dairy producer's support. The dispute is important in the context of the agricultural agreement, which is the most significant interpretative dispute in the WTO—agreement.

The discussion that follows breaks this history into two parts: the first phase, including the Panel and AB ruling, and the second phase, which includes the rulings of the 21.5 Panels and the AB.

3.2 Phase I: the Panel and the AB report

Article 9.1(a) of the Agreement on Agriculture. The complainants argued that Class 5(d) and (e) under the Scheme amount to export subsidies under Articles 9.1(a) of the Agricultural Agreement, which obliges govern-ments to reduce their direct export subsidies. This provision requires reductions of

[the provision by governments or their agencies of direct subsidies, in-cluding payments in kind, to a firm, to an industry, to producers of an agricultural product, to a cooperative or other association of such produc-ers, or to a marketing board, contingent on export performance.]

The Panel noted that under 9.1(a) an export subsidy comprised four different elements: (1) direct subsidies, including payments in kind (2) provided by governments or their agencies (3) to a firm, an industry, to producers of an agricultural cooperation or other association of produc-ers, or to a marketing board, contingent on export performance.19

The Panel examined the applicability of each of these elements in turn and concluded that the milk made available under Special Class 5(d) and (e) constituted export subsidy subject to reduction commitments. Summarizing this discussion in brief, the Panel noted that since processors and exporters obtain the milk and the milk is made available for exports, the facts support elements three and four above.20

The question of whether these facts support a finding of direct subsidies, including payments in kind, stand at the heart of the legal controversy. The Panel noted that this constitutes a "gratuitous act," and that a payment con-notes in turn the granting of a benefit. Payments in kind include the pro-vision of a good free of charge or at less than the normal price.21 Under the Scheme, the exporters and processors obtain the milk at less than the price for use on the domestic market. Indeed, the milk prices available under Classe: 5(d) and (e) were significantly lower than domestic prices or other prices and, given high tariffs on imports, they were also lower than the price of imported milk.22 Hence, these facts and others led the Panel to conclude that the elements of "payment in kind/ direct subsidy" as well as the "benefit" elements were met.

The remaining element was whether the payments were provided "by governments or their agencies."23 The Panel examined the character and operation of the Scheme and the role of the regulatory bodies. It empha-sized the decision-making roles played by the CDC, which is a Crown cor-poration under the Federal Government of Canada, the role of provincial marketing boards and the CMSCM. Considering the role of government involvement in the Scheme, the Panel identified the CDC as the ultimate decision maker on the question of whether or not domestic requirements were met and whether milk constituted surplus for export, among other variables. Since all elements of 9.1(a) were present, the Panel held that Special Class 5(d) and (e) milk amounted to an export subsidy that was subject to reduction commitments.

On appeal, the AB reversed on several of these elements. Specifically, it reversed on the availability of "direct subsidies" and "payments in kind" and therefore disagreed with the Panel's conclusion that the measures const-i tute an inconsistency under the Agricultural Agreement Article 9.1(a).24

While arguing that the Panel properly looked to the SCM Agreement for guidance on the general definition of a subsidy contained in its Article 1.1, the AB argued that the Panel applied this definition improperly. The AB did not agree with the concept of "benefit" being equated with the term "payment in kind" given that the latter was simply a form of payment. It was theoretically possible to receive full consideration for a payment in kind thereby failing to meet the requirement of "benefit" or a gratu-itous act.25 Further, the AB argued that the Panel had also "failed entirely to make any mention of the other integral aspect of a subsidy under Article 1.1 of the SCM Agreement, namely the need for a financial contribu-tion." Having reached a different finding on the meaning of the terms "direct subsidies" and "payment in kind," the AB therefore reversed the Panel's conclusion that the Canadian measures involved export subsidies under Article 9.1(a).

19 See para. 7.38.
20 See para. 7.39.
21 See para. 7.43.
22 See para. 7.38.
23 See para. 7.63.
24 The AB did, however, concur with the Panel that the provincial milk marketing boards constituted "agencies of Canada's Government" for purposes of Article 9.1(a).
25 See paras. 81-91.
Article 9.1(c): The complainants also alleged that certain classes of milk under the Scheme were a violation of Article 9.1(c) of the Agriculture Agreement. This provision covers "payments on the export of an agricultural product that are financed by virtue of governmental action." The Panel interpreted the latter provision that requires that the payment is "conditional or contingent on exports" to be analogous to the finding of export conditionality under Article 9.1(a). The Panel also considered and answered in the affirmative that the term "payments in kind" is covered by the terminology of "payment" in 9.1(c). Given the role of the provincial boards in paying milk producers a monthly income and the intermediary role of the boards, the functional government of governmental action was also deemed present. The Panel found that lower-priced milk provided to processors for export under the Scheme constituted a subsidy under Article 9.1(c) of the Agricultural Agreement. This issue was also appealed and the AB upheld the Panel findings.

Article 3.3 of the Agricultural Agreement Article 3.3 is designed to prohibit export subsidies, as defined in Article 9.1, that exceed a Member's commitment levels. The Panel held that the actions were inconsistent with Article 3.3 given that the total quantity of exports generated through subsidies provided to classes 3(d) and (e) under the Scheme were clearly in excess of Canada's quantity-reduction commitment levels identified in its Schedule.

Articles 10.1 and 8 of the Agriculture Agreement: Article 10.1 is an alternative basis for determining whether an export subsidy exists. It provides that "export subsidies not listed in paragraph 1 of Article 9 shall not be applied in a manner which results in, or which threatens or leads to, circumvention of export subsidy commitments; nor shall non-commercial transactions be used to circumvent such commitments." Focusing on the question of whether "other" export subsidies exist that are not listed in Article 9.1, the Panel looked particularly to 10.1(e) which "covers a wider range of export subsidies than the specified practices listed in Article 9.1." The Panel also looked to Article 1 of the SCM Agreement.

Noting the arguments under 9.1(a) and (c), the Panel held that assuming in the alternative that the treatment of Classes 3(d) and (e) did not constitute an export subsidy as listed in 9.1(a) or (c), it would come under the "other" category of export subsidy for purposes of Article 10.1. Since Article 8 requires Members' "not to provide export subsidies otherwise in conformity with this Agreement," the Panel held that Canada's measures were inconsistent with Article 8.

The United States also claimed that Article 3 of the SCM Agreement was violated by virtue of the provision of milk in Classes 3(d) and (e), but the Panel decided to apply the principle of judicial economy and did not examine US claims under Article 3.

The AB reversed the Panel's findings that Canada acted inconsistently with its obligations under Articles 3.3 and 8 of the Agriculture Agreement by providing export subsidies within the meaning of Article 9.1(a). However, it concurred that its scheme of Special Milk Classes 5(d) and 5(e) was inconsistent with 3.3 and 8 by providing export subsidies within the meaning of 9.1(c). It elected not to speak to coverage under Article 10.1.

Tariff Rate Quota: The final aspect of this case at the Panel level related to Canada's tariff rate quota for imports of fluid milk, which provided for a quota of 64,500 tons, with differential duties for in-quota imports of 17.5% and over-quota imports of 283.8%. Access to the lower in-quota rate was restricted to "cross-border imports by Canadians of consumer packaged milk for personal use, valued at less than $820 per entry." The United States argued that Canada's restrictions on access to its tariff rate quota for fluid milk amounted to treatment less favorable than imports of fluid milk than it had provided in its WTO schedule, which thereby constituted a violation of GATT Article II.(b).
Subsequently, the United States and New Zealand requested a second Article 3.1 Panel to examine the revised Canadian measures and the second Article 3.1 Panel Report was released in July 2002. As noted, Canada has issued a number of revisions to those measures since then.

Part II.3 Panel Rulings: As a result of the adverse ruling by the WTO in October 1996, the Canadian milk quota system continued to operate in substantially the same way as before.

Part II.3.1: The milk quota system is intended to maintain in basic milk supply management scheme, including an annual quota for milk and allocations to producers and regulated processors. The existing milk quota is used by the dairy farmers and processors to manage their production and sales.

Part II.3.2: Without government intervention, if quotas are set at current levels, the domestic market would be undersupplied. The Government of Canada has determined that the supply management system in Canada is consistent with the obligations under Article 11:1(b) of the Domestic Support Code of the GATT.

Part II.3.3: In May 1994, the Canadian milk quota system was considered by the World Trade Organization (WTO) in the case of Canada-GATT: Panel Report. The WTO Panel determined that the Canadian milk quota system was inconsistent with the obligations of the GATT under Article 11:1(b) of the GATT.

Part II.3.4: In response to the WTO Panel’s decision, the Canadian government liberalized the domestic market for milk and dairy products, and the revised system was found to be consistent with the GATT obligations. The Canadian government committed to phase out the milk quota system and to move towards a market-based system.

Part II.3.5: The milk quota system was gradually phased out and replaced by a market-based system. The transition occurred in stages, starting in 1995, with the introduction of a new milk pricing system that was designed to approximate real market prices.

Part II.3.6: The milk quota system was fully phased out in 2000. At the same time, the Canadian government introduced a new milk pricing system that was designed to approximate real market prices. The new system was developed in consultation with dairy farmers and processors.

Part II.3.7: The new milk pricing system was designed to be more responsive to market conditions, and to provide incentives for dairy farmers to produce the milk that the market demands.

Part II.3.8: The new milk pricing system has been successful in achieving its goals. The milk market in Canada is now more dynamic and responsive, and dairy farmers are better able to adapt to changes in market conditions.

Part II.3.9: The Canadian government has continued to monitor the milk market closely, and to adjust the milk pricing system as necessary to ensure its effectiveness.

Part II.3.10: In 2018, the Canadian government introduced a new milk pricing system that is designed to be even more responsive to market conditions, and to provide even stronger incentives for dairy farmers to produce the milk that the market demands.

Part II.3.11: The new milk pricing system is expected to be fully phased in by 2023. At that time, the Canadian dairy industry will have a fully market-based system that is designed to be responsive to market conditions, and to provide incentives for dairy farmers to produce the milk that the market demands.
Noted market prices, another commodity trade data is "below-market" and not included in the 21.5.3. Final
Looking at that price, however, does not answer the fundamental
question as to whether CMC can do "an effective price under the WTO jurisprudence". The
WTO member could easily defeat the export subsidy commitments that
they would have undertaken in the Agreement on Agriculture under
Article 6.1(a). (The implications of the Agreement on Agriculture
provided under Article 6.1(a) of the production of the milk and the total
cost of the producer must be paid in order to produce the milk, the total
amount that it must to be produced at a price, the long-term, were the
cost of the producer must be paid in order to produce the milk, the total
amount that it must to be produced at a price, the long-term, were the

* See All Report, para. 41.5.

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The Question of Financing by Government Action. As to the question of whether the payments are being “financed by virtue of government action,” the Panel formulated the issue as whether “milk processors for export have access to lower priced commercial export milk, but for governmental action.” The Panel considered that this standard would be met if it could demonstrate that de jure or de facto governmental action (i) prevents the Canadian milk producers from selling more milk on the regulated domestic market at a higher price than to the extent of the quota allocation to them; and (ii) obliges Canadian milk processors to export all milk contracted as lower-priced CEM and therefore penalizes the diversion of milk from the export market to the domestic market.

The Panel argued that “the choice left to the Canadian producer is not a real choice.” Since the government had taken away the first-best option, which was domestic sales, producers would rationally opt for the second-best possibility, export sales. The Panel found that CEM “would not be available to Canadian producers but for . . . the federal and provincial actions . . . obliging producers, at least de facto, to sell outside quota milk for export.”

The AB disagreed that producers are obliged or driven to produce additional milk for export sale. However, the AB acknowledged the logic of the Panel’s reasoning as a means of establishing a demonstrable link between governmental action and the financing of payments. Given its judgment to reverse on the issue of payments, the AB did not feel it necessary to consider the Panel’s findings on the phrase “financed by virtue of governmental action” with any further detail.

On the issue of Article 10.1 of the Agriculture Agreement, given that the AB was unable to speak of the legal character of the measure under Article 9.1, it was unwilling or unable to discuss the legal character of the measure under Article 10.

4 The second 21.5 Panel and AB rulings

New Zealand and the United States requested the establishment of a second 21.5 panel to evaluate the consistency of the Canadian measures with

the DSB rulings and Canada appealed. Given the rulings of the AB in response to the first 21.5 panel report, it is hardly surprising to see the complainants seeking additional consideration of the meaning of what the AB had stated to be the proper methodology for evaluating the existence of a subsidy – namely, the average total cost of production. The brief summary that follows focuses primarily on the evolving clarification of this concept.

4.1 The question of payments redux

The second 21.5 panel proceedings brought to the surface two alternative formulations of what constituted “average total cost of production.” The complainants argued that the cost of production should be interpreted to mean industry-wide average costs with industry-wide average CEM prices along with imputed costs. The objective would be to determine whether prices are below the average total cost of production. Canada, in contrast, argued that individual producer costs were the appropriate comparison, excluding imputed and certain other costs. The Panel appeared not to have confidence in the data presented by Canada as being complete and instead represented as “extrapolation” regarding individual producer prices. It expressed doubts that the individual producer’s costs should be the basis for the determination. The Panel also argued that the evidence did not support Canada’s position that payments were not made and it ultimately elected not to opine on which methodology was definitive.

It also disagreed with Canada on the exclusion of other costs. The AB ruling on this second 21.5 panel upheld the basic finding. On the methodology, however, the AB went further and suggested that the nature of the obligations imposed under the Agriculture Agreement speak to export subsidies provided through private party action. And the AB suggested that the question “is not whether one or more individual milk producers, efficient or not, are selling CEM at a price above or below their individual costs of production. The issue is whether Canada, on a national basis, has respected its WTO obligations.” As a result of this perception of the Agreement implicating a national obligation, the AB suggests that the benchmark should be a “single, industry wide cost of production figure rather than an indefinite number of cost of production...
figures for each individual producer.\textsuperscript{54} The AB further held that all costs should be included.

On the question of whether these payments were "financed by virtue of governmental action," the Panel focused on a number of attributes of the scheme and its incentives, and concluded that Canada had failed to establish that governmental action is not demonstrably linked to these payments.\textsuperscript{55} The AB upheld this finding and articulated for the first time a detailed interpretation of this provision. It reiterated the view that "payments" can be made by private parties and need not be made by the government, and the standard requires careful scrutiny of the factual and regulatory setting.\textsuperscript{60} Indeed, the AB argued that governmental action can be an act or an omission, and the scope of government action includes circumstances where non-tariff elements may be involved in the making of payments.\textsuperscript{57}

With respect to the terminology "by virtue of," the AB argued that simply enabling payments was insufficient, a "lighter nexus" between the mechanism or process by which the payments are financed being necessary.\textsuperscript{58} With respect to the question of financing, the AB accepted that it could encompass situations where significant aspects of financing might not involve the government, but the government "must pay a sufficiently important part in the process by which a private party funds payments, such that the requisite nexus exists between governmental action and financing."\textsuperscript{60}

On the facts of this case, the AB focused on the issue that milk was produced "using a single line of production, but sold in two different markets," and the fixed costs of production are shared. Moreover, the AB stressed that the price of milk is fixed by a governmental agency that has a statutory mandate to ensure a "fair return" for "efficient producers."\textsuperscript{59} It also emphasized that "governmental action" controls virtually every aspect of domestic milk supply management, a fact which ensures a highly remunerative system for domestic milk producers which covers their fixed costs and permits them "to sell export milk at prices that are below the costs of production."\textsuperscript{60}

4.1.1 Comments and questions on legal and policy matters

As noted at the beginning of this study, the Agricultural Agreement has been seen as an accomplishment in no small measure because it set up a framework of rules for evaluating agricultural supports and because countries committed to phased reductions or improvements in the three core areas of domestic supports, export subsidies, and market access commitments. Of these, legal experts are often inclined to see the rules on export subsidies as representing the clearest improvement made by the Agricultural Agreement as compared with the GATT rules, particularly when reflected in numerical commitments in countries schedules.\textsuperscript{61}

Yet neither the Agriculture Agreement nor the SCM Agreement provides a complete methodology for interpreting core concepts — e.g., what constitutes a "subsidy," whether there is a "payment," and what is meant an empirically sound and consistent basis for a judgment on that point. And it remains to be seen whether the definitions will prove workable. With respect to the second example, on payments, the 21.5 Panel elected to focus on domestic and world market prices as a means of arriving at a judgment on this question, in an environment of a price floor and production ceilings. That Panel’s approach seems to be founded, in part, on the AB’s response to the first Panel methodology, and in the full review by the AB it stressed that "below market rates" was decisive. Given that guidance by the AB, the 21.5 Panel’s decision to focus on internal (domestic) and external (world) prices is understandable. But then the AB went a step further and identified another standard, "total cost of production," because it argued that an "objective benchmark" was necessary, which implied the price methodology was not.

The AB’s formulation in response to the 21.5 Panel Report appears to be an altogether new methodology for determining the existence of a "payment." Putting aside for the moment whether it represents an improved economic rationale, as a matter of legal methodology this approach does not seem grounded in a strict legal interpretation of the applicable agreements. In other words, neither the Agricultural Agreement nor the SCM Agreement explicated the use of this methodology. Moreover, since this methodology was not delineated in the covered agreements, not surprisingly the parties had generated a factual report that permitted neither the Panel nor the Appellate Body to complete the analysis. Having called certain pertinent facts and the applicable methodology into question, the AB was unable to reach a judgment on the law, and the case was sent back to be re-reviewed by a second 21.5 Panel. In a word, it appears that the
AB developed its own methodology because it was dissatisfied with that employed by the Panel. The second Panel was in turn understandably hesitant to be conclusive with respect to the methodology that might be used as a reliable basis for determining the average production cost. At a minimum, the AB had not spoken on this point in sufficient detail to guide the Panel. As between industry averages and firm specific information, the Panel leaned in the direction of industry averages, partly owing to the nature of the data that was presented to it in this instance. The AB took this a step further and affirmatively supported the notion of industry averages under the stated logic that WTO obligations flowed to the nation as a whole and hence this aggregate data was more appropriate.

We shall turn presently to an overall economic assessment of this case. The legal reasoning and stated logic on this single methodological point, however, also warrants further consideration. The AB introduced whole cloth the concept of "average total cost of production" because it was thought to offer a more precise basis for determining whether a payment is present. In the following section, we question the reliability of that measurement. Nevertheless, using the logic articulated, would it not make more sense to lean toward the methodology that delivers the most rigorous and precise assessment possible of actual costs? If so, that would lead one toward developing detailed firm-specific data and then aggregating and averaging that data. If such detailed micro-economic data is not available then other methodologies might need to be utilized so it may not be the only choice available.

Hence, the AB could have attempted to delineate or articulate some hierarchy of possible approaches, leaning to the most rigorous method available in the first place. Instead, it chose to reject the microeconomic methodology because it considered this analysis as firm-oriented while WTO obligations occur at the level of the nation-state. Given that this provision is attempting to assess the impact of government action on private costs, it is curious not to see an aggregation of such firm-level data as a more precise starting point than some general averages.

From a legal and policy perspective, this case is also noteworthy for its treatment of State responsibility and attribution. The issue of public versus private conduct and the scope of governmental measures that can come under the GATT/WTO system has surfaced periodically for many years. There have been several GATT/WTO cases that considered the extent of government responsibility over the actions of private parties and the outer limits of what constitutes a government measure. Canada—Dairy reviewed that issue in the context of a particular covered agreement. In Japan—Semiconductor, the GATT panel held that even non-binding administrative guidance by the Government of Japan could constitute a "government measure" if certain criteria were met. Later, in Japan—Film, the WTO held against the US complainant on the facts of the case but on the general question of actionable government measures, the panel built upon the semiconductor case to support an expansive view of government-covered measures. That Panel noted that "past GATT cases demonstrate that the fact that action is taken by private parties does not rule out the possibility that it may be deemed to be governmental if there is sufficient government involvement with it..." Within the context of Article 9.1(c) of the Agricultural Agreement, we see in Canada—Dairy even more detailed consideration of the extent of government responsibility over private practices, which the respondent had asserted were fully deregulated private sector decisions. As discussed above, the 21.5 Panel's interpretation of the extent of government involvement the "question depends on the source of funds and the extent of government action; if any, in their collection" (Report on Review Pursuant to Article XVI:5, adopted on May 24, 1960 BISD 85/182).

46 See Report of the GATT Panel (adopted) Japan—Trade in Semiconductors, BISD 3rd Supp. 116, at 155 (1988). In that case, "which involved extractions on exports of semiconductors by the Government of Japan, the specific criteria identified by the panel included: (1) that reasonable grounds—exist for believing that the government measures created sufficient incentives to persuade private parties to conform their conduct to the non-mandatory measure, and (2) that the effectiveness of the private conduct was 'essentially dependent,' on the non-mandatory actions taken by the government."

47 See WTO/DS464/R (Japan—Film). The Panel found that "government policy or action need not necessarily have a substantially binding or compulsory nature for it to entail a likelihood of compliance by private actors in a way so as to nullify or impair legitimately expected benefits within the preview of Article XXIII:1(b). Indeed, it is clear that non-binding actions, which include sufficient incentives or disincentives for private parties to act in a particular manner can potentially have adverse effects on competitive conditions of market access." Another case that involved private activities was Restrictions on Imports of Desert Apples, which involved market withdrawal of fruits by consumer organizations. That Panel found that the formal system for apples was a hybrid one, and the buy-in and withdrawal systems could be considered a government measure. See, Restrictions on Imports of Desert Apples adopted on June 22, 1989, 36th Supp BISD 93, 1990 BISD 93, 1990.

48 See Japan—film (WTO/DS464/R), para. 10.56. That panel also looked to the semiconductor panel report for the proposition that "where administrative guidance creates incentives or disincentives largely dependent upon government action for private parties to act in a particular manner, it may be considered a government measure." See para. 10.44–10.46.
responsibility hinged on a "but for" standard. The AB held that there had to be a "demonstrable link" between the government action and the financing of payments. The final articulation of that link by the AB goes quite some distance into the deconstruction of what constitutes "payments: financed by virtue of governmental action." In making its evaluation, the AB has indicated a willingness to consider the entire regulatory scheme and its consequences for private entities. In this case, private activities were seen as having lost (or never having had) their private character, operating as they were under the comprehensive supply management scheme.

5 Specific economic analysis

We now consider and evaluate the particular legal and economic issues and methodologies raised by the dispute. More specifically we ask: in light of the underlying goals of the relevant WTO provisions, and taking them as given, was the resolution of the substantive economic issues around which the case revolved based on sound economic principles? The central substantive economic issue of this case concerns the identification of export subsidies, and more specifically the methodology for detecting the presence of "payments" to exporters within the meaning of Article 9.1(c) of the Agriculture Agreement.

The AB report in response to the first 21.5 Panel determination (especially paragraphs 89–92) provides the rationale for the measure of "payments" to exporters of processed dairy products that was proposed by the AB, namely, the difference between the average total cost of domestic milk production and the milk price paid by exporters of processed dairy products. In essence, the AB suggests that the milk's "proper value" is its average total cost of production; and further the AB suggests that, measuring proper value in this way, its methodology for measuring payments strikes a balance between, on the one hand, permitting domestic supports for milk producers even when these supports may have some "spillover" economic benefits for exporters of processed dairy products, and on the other, not going so far as to permit the provision of unlimited support for exporters of processed dairy products so long as this support is generated by the domestic support provisions for milk producers.

This raises a key question: Does the suggested comparison of the average total cost of milk production with the milk price paid by exporters of processed dairy products provide a reliable measure of how much support exporters of processed dairy products are receiving? By way of the following hypothetical scenarios, we suggest that the reliability of the measure suggested by the AB is problematic. We then reconsider an alternative measure of proper value which the AB considered and rejected, namely world market prices.

5.1 What is wrong with average total cost as a measure of proper value?

Consider the following hypothetical scenario. Suppose that a government wishes to redistribute income from its general population toward its dairy farmers, who are currently earning a below-normal economic rate of return on their sunk investments (e.g., dairy cattle, land improvements tailored toward dairy farming, physical and human capital specific to the dairy industry) but, due to the "market" nature of these investments, do not find it in their economic interest to exit from dairy farming. Suppose further for the sake of argument that this country is initially a textbook laissez-faire perfectly competitive market economy, and that it is an exporter of processed dairy products ("cheese") on world markets (and for simplicity, let us assume for now that unprocessed milk is not directly tradable internationally, due perhaps to high costs of transport).

To accomplish the desired redistribution, suppose that the government imposes a tax on all milk that is consumed by domestic households — whether consumed directly, or rather indirectly in the form of cheese — and uses the revenue generated by this tax to pay for direct "bump-sum" transfers to its dairy farmers. Should this program be viewed as providing an export subsidy to cheese exporters? The immediate reaction to this question would probably be a puzzled look and the answer "Of course not." However, a little reflection reveals that the country's exports of cheese on world markets would likely rise as a result of this program, and so the answer may not be quite as obvious as it first appears. Still, upon further reflection, most observers would probably agree that the answer to this question is "No." It is true that, under typical economic conditions, the impact of this program would be to increase the country's cheese exports. But the increased exports would not come about as a result of "payments" made to domestic producers of cheese as a reward for exporting. Instead exports, which we now recall are simply the difference between a country's domestic production and its domestic demand.
consumption, would increase with the introduction of this program only because domestic consumption of cheese would be reduced.

In fact, total domestic production of cheese at given world prices would not be altered at all with the introduction of this program: each domestic cheese producer can always export all of its production to world markets and receive the given world price for its foreign sales, and so the domestic production of cheese continues to occur at the point where this (unchanged) world price equals the (unchanged) domestic marginal cost of cheese production. Moreover, these producers would be willing to sell cheese to domestic consumers only if the producers receive this same (i.e., world) price for domestic sales. This means that the full incidence of the milk tax will be passed on to domestic consumers of cheese, who will see the price they pay for cheese rise by the full cost implications of the milk tax.

As a consequence, the total quantity of cheese produced in the domestic country at a given world price is unchanged with the introduction of this program. And the increased exports at a given world price associated with the introduction of this program would come about as a result of the diminished domestic consumption of cheese, which in turn results from the tax-induced price increase for cheese faced by domestic consumers. For these reasons, any export effects of the program will be dependent upon features of domestic demand for cheese (such as how "price elastic" this demand is).

Figure 10.2 illustrates the main idea. In the left-hand quadrant of Figure 10.2, the price of cheese charged by domestic cheese producers is measured on the vertical axis while the quantity of cheese is measured on the horizontal axis. As there are assumed to be no impediments to the export of cheese, the price of cheese charged by domestic producers does not change for domestic sales, which we denote by \( p \); the same is true of the price these producers could charge for sales on the world market, which we denote by \( p^* \) (but is, we must have \( p = p^* \)). The quantity of cheese supplied by domestic producers at any given producer price \( p \) is then depicted as the upward-sloping curve in the left-hand quadrant of Figure 10.2, which we label \( S(p) \). In the absence of a tax on the domestic consumption of milk and the milk content of cheese, domestic demand for cheese is depicted by the downward-sloping curve in the left-hand quadrant, which we label \( D(p) \).

At any given world-market price \( p^* \), we may use the fact that \( p = p^* \) to determine the export supply of cheese from the domestic country as

The difference between domestic supply and demand in the left-hand quadrant. This difference is plotted in the right-hand quadrant of Figure 10.2, which measures \( p^* \) on the vertical axis and the quantity of cheese on the horizontal axis, and the associated domestic export supply curve for cheese is labeled \( E(p^*) \). The foreign import demand for cheese can be plotted in the right-hand quadrant of Figure 10.2 as well, and it is depicted as the horizontal line labeled \( M(p^*) \). As shown in the two quadrants of Figure 10.2, in the absence of a tax on the domestic consumption of milk and the milk content of cheese, domestic cheese producers make domestic and foreign sales at a common price equal to \( p^* \) and supply a quantity of cheese equal to \( s_0 \), while domestic cheese consumers pay the price \( p^* = p^* \) and demand a quantity of cheese equal to \( d_0 \), with the difference between \( s_0 \) and \( d_0 \) corresponding to the volume of cheese exported to world markets by the domestic country, \( e_0 \).

Now consider the impact of the cheese market of a tax on the domestic consumption of milk and the milk content of cheese. Since domestic cheese producers can continue to sell all the cheese they want on world markets and receive the world price \( p^* \) (this is reflected in the horizontal foreign import demand curve \( M(p^*) \), in the right-hand quadrant of Figure 10.2), these domestic cheese producers will only sell cheese to Canada—Dairy
Consider now an alternative price setting program, in which the government<br>domestic consumers who continue to receive P<sub>1</sub> for each unit of<br>cheese sold on the domestic market. This implies that domestic cheese<br>consumers bear the entire incidence of the tax and therefore must<br>import additional cheese to satisfy the demand. The resulting higher<br>price P<sub>2</sub> for domestic cheese, however, will tend to reduce the<br>quantity of cheese demanded by domestic consumers and<br>increase the quantity demanded by domestic producers. The result is a<br>shift in domestic cheese demand from Q<sub>1</sub> to Q<sub>2</sub>, and a corresponding<br>shift in domestic cheese supply from Q<sub>1</sub> to Q<sub>2</sub>. As the<br>price rises, the quantity demanded by domestic consumers decreases,<br>while the quantity supplied by domestic producers increases. The<br>result is a change in the equilibrium price and quantity of cheese.<br><br>The implications of this program for the behavior of domestic<br>producers and consumers are as follows: domestic producers will<br>be induced to increase their production of cheese, and domestic<br>consumers will be induced to reduce their consumption of cheese. The<br>program will also have a number of other implications, including<br>changes in the distribution of income and wealth, and changes in<br>the pattern of trade. In general, the program will tend to shift<br>domestic consumption away from cheese and toward other goods.<br><br>In summary, the domestic price-setting program will<br>have a number of important implications for the behavior of domestic<br>producers and consumers. It will tend to increase the production of<br>cheese and reduce its consumption, and it will have a number of<br>other implications as well. The program will be an important<br>factor in determining the demand and supply of cheese in the<br>domestic market.
for cheese unaffected, with the consequent outward shift of the domestic export supply curve for cheese.

Hence, if it is agreed that the first program described above does not qualify as an export-subsidy program, then the second program logically cannot either. And, under the methodology suggested by the AB for calculating "payments" to cheese exporters, we would find that the payments are positive, provided that preyr account were taken of the impact of the regulations in the program out of profit rate for milk producers. 48

The simple point is, under this second program, domestic milk producers will receive the high domestic regulated price for milk sales that ultimately find their way to domestic consumers, while these producers will receive a lower unregulated price for milk sales that are used to produce exports: there is now a degree of "cross-subsidization" implied by the pattern of domestic-milk sale prices. As a consequence, the milk price received by a domestic milk producer will be higher in relation to its average total cost when this milk is sold for domestic consumption than when it is sold to a processor for export. And since the average price across all milk sales must equal the average total cost (again, provided that the costs of the sunk factors are calculated appropriately, i.e., they are imputed as a lower unregulated price for milk sales that are used to produce exports), there is a degree of positive payments to exporters of processed dairy products—i.e., assured.

Hence, the pattern of domestic milk sale prices under this second program will appear as "cross-subsidization" of cheese exporters, even though the program itself has identical economic implications to the first program described above, and therefore has no impact whatsoever on the domestic production of cheese whether destined for the domestic or export markets. Moreover, in this case the second step of the AB's methodology for determining the presence of export subsidies will be met as well: the payments so defined will be "financed by virtue of government action," since it is true that without the government's regulatory program this "cross-subsidization" would not occur.

This suggests a basic and fundamental problem with the methodology for identifying the presence of export subsidies as suggested by the AB. In effect, whenever sunk investments earning a below-market rate of return are present—a condition that is likely to be met in "declining" industries that are also the most likely to be receiving domestic support—the measurement of average total cost for use in the AB's suggested methodology becomes problematic. If the rental costs of the sunk investments are imputed as their residual returns in the industry, then the measured average total cost must equal the industry average price. This "endogeneity" between the prices charged in the industry and the measured average total costs implies in turn that the AB's methodology will find that payments are being received by any purchaser of the products of that industry that pays a price below the industry average price. As the hypothetical scenario considered above illustrates, this does not provide a reliable guide for identifying the presence of export subsidies.

An alternative measurement procedure would be to exclude fixed costs that are also sunk from the calculation of average total cost for the purposes of the AB's methodology. This alternative procedure would solve the "endogeneity" problem described above, but it would lead to other problems. For example, this alternative procedure would overlook a government subsidy program that induced suppliers to offer low prices to some buyers when they would not have done to absent the government program, but where the low prices are not so low as to fall below the measured average total cost. A related, though perhaps less relevant, flaw in the AB methodology is that, by basing its proposed calculation of average total cost on the assumption of an "ordinary profit" rate (paragraph 95), the methodology could overlook subsidy payments in an industry where profits were extraordinarily high.

Finally, it is interesting to observe that in the second 2.1.5 Panel Report, a central part of the dispute revolved around whether imputed costs should be included in the average total cost calculation or not. The US and New Zealand (complainants) argued for including these imputed costs, much as we have done in our hypothetical scenario above, while Canada argued for excluding them. The Panel chose not to rule on which procedure for measuring the average total cost was correct, stating that "... we have
6 Concluding observations on the legal texts and economic analysis

5.2 What is wrong with world market prices as a measure of proper value?

In light of the difficulties in the AB's suggested methodology as pointed out in section 5.1 above, we suggest briefly here that the AB might consider a different approach to the measurement of proper value that would avoid the problems associated with the calculation of CERs. Specifically, we suggest that the AB could adopt a term competitive with world market prices as a measure of proper value, which we have termed the "price of parity". This approach would involve comparing commercial export milk prices and world market prices at parity with the participation of domestic supply in the production of output. The implicit assumption here is that the world market prices are the proper measure of value for the purposes of the Agreement.

The implication of this approach is that the world market prices are the proper measure of value for the purposes of the Agreement. This is consistent with the principles of GATT/WTO and the obligations of Canada under the Agreement. It is also consistent with the practice of other countries that have adopted a similar approach. This approach would also avoid the issues related to the calculation of CERs, which have been raised by the AB and others in the context of the Agreement.
this instance, and casts doubt on the ability of existing formal economic models to adequately capture the role that international agreements to limit export subsidies can play. According to this interpretation, it is important to seek and develop further alternative modeling approaches that might better reflect the critical feature associated with the issue of export subsidies that the standard models have failed to capture. A second interpretation would place more weight on the presumptions implied by the standard economic arguments reviewed above, and this second interpretation would cast doubt on the rationale for international agreements to limit export subsidies.70

At the least, the conclusion we report in section 2.1 reflects the need for further articulation of the rationale for the treatment of export subsidies within the GATT/WTO. At most, the GATT/WTO’s approach to export subsidies might benefit from a fundamental overhaul.

Second, our analysis points to a basic and fundamental problem with the methodology for identifying the presence of export subsidies as suggested by the AB in the Canada—Dairy case. We appreciate the systemic tension faced by the AB and the Panels, in that the Agriculture Agreement permits domestic supports and prohibits export subsidies in excess of reduction commitments, and the adjudicators are then faced with a dilemma as to how to give both effect when the domestic subsidy fosters the export subsidy. However, the particular methodology developed by the AB, as we argued, does not isolate the presence of export subsidies.

In effect, whenever sunk investments earning a below-market rate of return are present—a condition that is likely to be met in industries receiving domestic support—the measurement of average total cost for use in the AB’s suggested methodology becomes problematic. If the rental costs of the sunk investments are imputed as their residual returns in the industry, then as an accounting matter the measured average total cost must equal the industry average price. This implies in turn that the AB’s methodology will find that payments are being received by any purchaser of the products of that industry that pays a price below the industry average price. As the hypothetical scenario considered in our analysis above illustrates, this does not provide a reliable guide for identifying

70 In this regard, the conclusion we report in section 2.1 may be difficult to accept for those who put emphasis on other, less analyzed or proven factors such as transaction costs, the size of economic development of the importing country, the perceptions that export subsidies are particularly aimed at transferring the costs of adjustment abroad, etc. The lawyer-co-author here is not fully convinced, although appreciative, of the force of overall economic observation on the effects of export subsidies.
This dispute between the European Communities and the United States originated when the United States amended its copyright law in a way that limited and impaired certain benefits promised to the European Communities under the Agreement on Trade-Related Aspects of Intellectual Property Rights (BTPR). Article 21 of the BTPR provides that the TRIPS Agreement shall not apply to "any national treatment or any restriction on the use of intellectual property, or any national rule of law or administrative action that would be sufficient, if applied to the same effect in the absence of the Agreement, to constitute a violation of the Agreement."

As of the date of this writing, the exact relationship between the SCM Agreement and the BTPR remains unclear. The parties have not yet reached a settlement, and the dispute is currently before the World Trade Organization. The outcome of this dispute will have significant implications for international intellectual property law and will likely shape the future of trade relations between the United States and the European Union.