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SUMMARY:

Decision: A WTO Arbitrator has ruled that Brazil is entitled to impose retaliatory trade sanctions on U.S. imports in the amount of U.S. $294.7 million. The award granted fell significantly short of the total amount of U.S. $2.681 billion sought by Brazil.

Significance of Decision / Commentary:

The rulings adopted by the Arbitrator in this case impose substantial constraints on the ability of complaining parties to seek compliance through the use of so-called “cross-retaliation.”

The current arbitration arose from a request by Brazil to take “countermeasures” against the United States for its failure to comply with the rulings of the WTO Dispute Settlement Body (DSB) in *US – Upland Cotton*. The Arbitrator issued two reports, one on Brazil’s claims related to the U.S. prohibited subsidies, and the other on the U.S. “actionable” subsidies.

When a WTO Member fails to implement the rulings of the DSB, the Dispute Settlement Understanding (DSU) provides for the use of retaliation as a “last resort” to induce compliance. The DSU sets out “principles and procedures” that govern the use of retaliation. The “general principle” is that “the complaining party should first seek to suspend concessions or other obligations with respect to the same sector(s)” as that in which the violation occurred. In other words, if the violation related to trade in goods, then the general principle is that the complainant “should first seek” to retaliate on goods, usually in the form of additional (and in some case, punitive) tariffs.

However, the drafters of the DSU recognized that same-sector retaliation could be insufficient to induce compliance. They therefore included in the DSU the concept of “cross retaliation”, *i.e.*, retaliation in a different sector. If the violation related to trade in goods, then cross-retaliation would permit the suspension of obligations under the General Agreement on Trade in Services (GATS) or the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

The ability to impose cross-retaliation can play an important role in the effort to induce compliance. For example, the application of additional tariffs on goods can impose as much if not more pain on the economy of the complaining party than on the non-compliant Member. Higher tariffs on consumer goods or intermediate goods will mean higher prices for consumers and businesses, respectively, in the complaining country. The ability to cross-retaliate was included in the DSU to provide an additional tool to complainants to seek compliance.

The DSU is drafted in a manner that should provide considerable flexibility to complainants if they wish to move to cross-retaliation. It states “if that party [the complainant] considers” that it is “not practicable or effective” to retaliate in the same sector, and if “the circumstances are serious enough”, it may seek to retaliate under another agreement. This wording clearly vests considerable discretion in the complainant as to when “that party considers” cross-retaliation is necessary. The discretion is not unlimited, as an arbitrator will need to determine whether these principles have been followed. In the present case, the Arbitrator interpreted the rules in a very restrictive manner.

First, the Arbitrator rejected the approach taken in the 2000 case of *EC – Bananas III (Ecuador) (Article 22.6 – EC)*, which ruled that a consideration by the complainant of the sector that was "least harmful to itself" was sufficient to be consistent with the applicable principles of the DSU. The Arbitrator in the present case stated that "[w]e do not share the view of the arbitrator on *EC – Bananas III (Ecuador) (Article 22.6 – EC)* that a consideration by the complaining party of the sector or agreement in which suspension would be 'least harmful' to itself would necessarily be pertinent." It reasoned that the DSU principles "do not entitle a complaining party to freely choose *the most* effective sector or agreement under which to seek suspension." Instead, according to the Arbitrator, they entitle the complaining party "to move out of the same sector or same agreement, where it considers that suspension *in that sector or agreement* is not 'practicable or effective [original emphasis].'"

Second, and more seriously, in assessing whether it was "practicable or effective" for Brazil to cross-retaliate, the Arbitrator considered that a "20 per cent benchmark" constituted a "reasonable threshold" to estimate the extent to which Brazil could find alternative sources of supply for certain categories of consumer goods imported from the United States. Applying the 20 per cent benchmark to the share of U.S. imports for these categories of goods, the Arbitrator concluded that "Brazil would still have at its disposal imports of other consumer goods from the United States amounting to a total value of at least US$409.7 million from which to suspend concessions or other obligations."

There is no discussion in either report as to why Brazil's ability to cross-retaliate should be linked to this 20 per cent benchmark. This figure does not appear in the DSU. The Arbitrator simply stated, without explanation, that this was a "reasonable threshold." Moreover, the ability of a complaining importing country to find alternative sources of supply can vary greatly on a product-by-product basis. The Arbitrator stressed that "[i]n applying a benchmark of 20 per cent, this Arbitrator is not intending to signal that this is the appropriate percentage to use in this kind of analysis in all cases." Yet given the lack of explanation for this figure, it is unclear why this is the appropriate percentage to use even in <u>this</u> case.

Although Brazil will be permitted to impose cumulative countermeasures up to the value of U.S. $294.7 million, this is a variable amount. The level of the countermeasures can change annually, depending in part on the total amount of WTO-inconsistent U.S. export credit guarantee transactions in the prior year. If the level of authorized countermeasures rises above U.S. $409.7 million, then Brazil can cross-retaliate under the GATS or the TRIPS. However, if the level falls below this threshold, then Brazil's retaliation will be confined to goods alone.

No one considers the use of retaliation to be a panacea to guarantee compliance. Yet decisions such as this one impair the ability of complaining parties to use the rules of the WTO to seek compliance in a manner that minimizes harm to their own economies.

Finally, the ability of Brazil to cross-retaliate in the future is now to some extent in the hands of the United States. The Arbitrator set out a complex formula on how the level of countermeasures can vary. As noted above, this is linked in part to the transaction value secured by certain U.S. export credit guarantees. The amount of the U.S. subsidies, while substantial, could be calibrated to ensure that the cross-retaliation "threshold" set out by the Arbitrator is never reached.

ANALYSIS:

1. Prohibited Subsidies

Request for "one time" countermeasures rejected

Brazil sought authorization for "one time" countermeasures of U.S. $350 million in relation to the U.S. "Step 2" prohibited subsidies, to cover the period from July 1, 2005 (the deadline for compliance) and July 30, 2006 (when the Step 2 program was repealed by Congress). The Step 2 program was in existence when Brazil made its request for countermeasures, although it had been repealed by the time the "compliance" panel had been established under DSU Article 21.5. The compliance panel declined to make any findings on it.

The Arbitrator rejected Brazil's request. It did "not consider that there would be a legitimate basis to such countermeasures as requested by Brazil in relation to past payments made until the repeal of Step 2, in the absence of a multilateral determination of non-compliance in relation to such payments and independently of any continuing situation of non-compliance."

U.S. export credit guarantees: Arbitrator "not convinced" that countermeasures should be based on the amount of the subsidy

Brazil sought authorization to take countermeasures in relation to a U.S. export credit guarantee program, "GSM 102."

The Agreement on Subsidies and Countervailing Measures (SCM Agreement) provides that in the event of non-compliance related to prohibited subsidies, the DSB "shall grant authorization to the complaining Member to take appropriate countermeasures…." A footnote adds that "[t]his expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited."

The Arbitrator found that "in considering whether proposed countermeasures are 'appropriate' and 'not ... disproportionate'…it is legitimate to give consideration also to the prohibited nature of the subsidy, in itself." It added that "it is permissible that the assessment of the overall trade impact on the complaining Member not be precise, nor that the countermeasure should be directly equivalent to that impact." However, the amount of the countermeasures "must at least be within a range of permissibly 'appropriate' amounts, and its assessment can take into account a variety of factors which flow from the failure to withdraw the subsidy and are relevant to the trade impact on the complaining Member."

The Arbitrator then examined how Brazil had calculated the amount of the proposed countermeasures. Brazil argued that its methodology reflected the "amount of the subsidy." The United States did not disagree with the "amount of the subsidy" as "a starting point for the calculations", but argued that Brazil's approach to calculating the amount of the subsidy was "flawed."

The Arbitrator stated that it was "not convinced" that "an 'amount of subsidy' approach, of itself and without adjustment, will always be consistent with the legal standard" set out in the

SCM Agreement. It stressed that "in most cases such an approach will not be 'appropriate', notwithstanding its convenience…." The Arbitrator stressed that "there should be a degree of relationship between the level of countermeasures and the trade-distorting impact of the measure on the complaining Member."

The Arbitrator did not exclude the possibility that "in particular circumstances, the complaining Member could perhaps rightly claim that a countermeasure in the amount of the subsidy would be 'appropriate.'" However, it reasoned that "in most cases, the trade-distorting impact of the subsidy on one or several other Members would not necessarily bear any particular relationship to the amount of the subsidy." In the view of the Arbitrator, "it cannot be assumed that the total amount of the subsidy is an appropriate measure of its trade effects, or even that it is necessarily a relevant 'proxy' for those effects."

Turning to the specifics of Brazil's request, the Arbitrator found that the "principle advanced by Brazil for the calculation of its proposed countermeasures is flawed" because it included elements that did not constitute "benefits" under the SCM Agreement, and which reflected "certain trade effects of the measure as well." The Arbitrator found that "even if we were convinced that the 'amount of the subsidy' approach was an appropriate benchmark for adjudging the appropriateness of the countermeasure sought by Brazil, we could not agree that Brazil's approach actually does measure that amount, as a matter of legal principle." It also rejected the "net cost to government" approach proposed by the United States.

The Arbitrator then went through the elements of the calculation proposed by Brazil, including "additionality", which Brazil defined as "additional economic activity for US exporters that would not otherwise have occurred." At the conclusion of its analysis, the Arbitrator determined that "the amount of US$1.122 billion proposed by Brazil will not result in appropriate countermeasures." The Arbitrator consequently made "modifications to the calculation of the interest rate subsidy and additionality in order to more accurately calculate the trade-distorting impact of the GSM 102 programme on Brazil." Based on these modifications and its other determinations, the Arbitrator found that the appropriate countermeasures for the prohibited subsidies, based on the amount of GSM 102 transactions in 2006, was U.S. $147.4 million. The Arbitrator accepted Brazil's request that the amount of countermeasures could be "variable on an annual basis and that would depend on, among other things, the total amount of GSM 102 transactions in the most recent concluded fiscal year."

Cross-retaliation:

In its request to the DSB, Brazil sought authorization to suspend obligations not just under the GATT, but also under the GATS and the TRIPS Agreement. The Arbitrator agreed with a prior ruling that the principles and procedures set out in DSU Article 22.3 with respect to cross-retaliation "imply 'a margin of appreciation' for the complaining party", although it stressed that the consideration by the complainant of the principles and procedures in this provision "must be a substantive and reasoned one."

The Arbitrator then considered whether "a plausible determination" could have been made by Brazil that it was not "practicable or effective" to suspend obligations in trade in goods alone. The Arbitrator said that it could take into account the cumulated level of countermeasures arising from both decisions (*i.e.*, on both prohibited and actionable subsidies).

The Arbitrator noted that "[i]n these proceedings, Brazil has assumed…that it would be entitled to a total amount of countermeasures in the amount of US$2.681 billion (US$1.644 billion in relation to the prohibited subsidies plus US$1.037 billion in relation to the actionable subsidies)." However, the Arbitrator had determined that "the cumulated amount of countermeasures to which Brazil is entitled to is US$294.7 million." It ruled that "the amount of countermeasures that we have determined to be permissible is significantly lower than the amount assumed by Brazil in its request, and this fact alone compels a finding that the complaining party has not followed the principles and procedures of Article 22.3." It added that Brazil could not have applied "a proper consideration" of the principles and procedures set out in DSU Article 22.3, "because the amount of the countermeasure it assumed was much greater than the countermeasure determined by the Arbitrator."

The Arbitrator then examined whether Brazil could plausibly have considered that it was not practicable or effective to suspend concessions on trade in goods alone to the level of U.S. $294.7 million. After examining the pattern of U.S. imports into Brazil, the Arbitrator said that it was "not convinced that Brazil could plausibly determine, on the basis of the elements presented to us in these proceedings, that it is not practicable or effective to seek to suspend concessions or other obligations in relation to the entirety of the broad range of consumer products that it proposes to exclude from consideration, in particular in the areas where the US share of imports is relatively small."

The Arbitrator found that it was useful to consider "the extent to which it may be expected that Brazil would in fact have alternative sources of supply at its disposal" for certain product categories. It found that "[w]hile there is no exact mathematical precision to this determination, we consider that, for the purposes of our assessment in these proceedings, a US share of imports of 20 per cent constitutes a reasonable threshold by which to estimate the extent to which Brazil may be able to find alternative sources of supply" for certain categories of imported consumer goods.

Applying the 20 per cent benchmark to the share of U.S. imports for certain categories of consumer goods, the Arbitrator concluded that "Brazil would still have at its disposal imports of other consumer goods from the United States amounting to a total value of at least US$409.7 million, from which to suspend concessions or other obligations. This would therefore still leave a value of US imports of consumer goods significantly in excess of US$294.7 million, to which suspension could be applied." Accordingly, the Arbitrator found that "Brazil could not plausibly have reached the conclusion that it is not practicable or effective to suspend concessions or other obligations in trade in goods alone, even if it had considered the 'necessary facts', i.e. taking into account a level of permissible countermeasures not exceeding US$294.7 million."

The Arbitrator found that there was at least U.S. $409.7 million worth of Brazil's imports of specified consumer goods from the United States that could be the subject of countermeasures, which it referred to as "the threshold." It recalled that the level of permissible countermeasures was variable. It stated that if the level of the variable countermeasures that Brazil would be entitled to in a given year exceeded this threshold, then "the suspension of concessions or obligations applied to trade in goods alone would not be 'practicable or effective' within the meaning of Article 22.3(c) of the DSU." The Arbitrator concluded that "in the event that the level of countermeasures that Brazil would be entitled to in a given year should increase to a level that would exceed the threshold…then Brazil would be entitled to suspend certain obligations under the TRIPS Agreement and/or the

GATS….with respect to any amount of permissible countermeasures applied in excess of that figure."

However, if the level of permissible countermeasures fell below this threshold, then "Brazil would be entitled to suspend concessions or other obligations only in trade in goods." In order to determine whether suspension of certain obligations under the TRIPS Agreement or the GATS was permissible in a given year, the Arbitrator stated that the threshold should be updated to account for the change in Brazil's total imports from the United States.

2. Actionable subsidies

Countermeasures must be commensurate with impact on Brazil alone

Brazil also sought authorization to take countermeasures in the annual amount of U.S. $1.037 billion in relation to U.S. marketing loans and countercyclical payments. For this claim regarding actionable subsidies, the Arbitrator in its second report was called upon to determine whether the countermeasures sought were "commensurate with the degree and nature of the adverse effects determined to exist."

The SCM Agreement defines "adverse effects" arising from subsidies to include "serious prejudice to the interests of another Member." The Agreement adds that "serious prejudice" may arise in a number of circumstances, including where "the effect of the subsidy is…significant price suppression, price depression or lost sales in the same market." Brazil argued that since this related to the existence of a significant price suppression on "the *world market*, the entirety of the effects of this price suppression on that market, in other words the worldwide impact of the price suppression, must be the basis for the award of countermeasures in relation to these 'adverse effects' [original emphasis]." The Panel disagreed, reasoning that "in determining whether Brazil's proposed countermeasures are 'commensurate with the degree and nature of the adverse effects determined to exist', we must consider whether they are commensurate with the impact *on Brazil* of the price suppression" resulting from the granting of the subsidies on the world cotton market [original emphasis].

After reviewing Brazil's calculations, the Arbitrator concluded that the world price for cotton would have been higher by 9.38 per cent "but for US marketing loans and countercyclical payments." It determined that the adverse effects on the rest of the world from these U.S. subsidies amounted to U.S. $2.905 billion. However, Brazil's share of cotton production in the rest of the world was 5.1 per cent in 2005. After "making this apportionment", the Arbitrator found that the amount of countermeasures "commensurate with the degree and nature of the adverse effects determined to exist" was U.S. $147.3 million.

On the issue of cross-retaliation, the Arbitrator followed the same reasoning as that set out above for prohibited subsidies.

The Arbitrator therefore concluded that Brazil would be entitled to suspend concessions for actionable subsidies up to the value of US$147.3 million annually for trade in goods. If the cumulative level of permissible countermeasures increased above the threshold of U.S. $409.7 million, then Brazil would also be entitled to suspend obligations under the TRIPS Agreement and/or the GATS.

The decisions of the Arbitrator in *United States – Subsidies on Upland Cotton: Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 4.11 of the SCM Agreement* (DS267/ARB/1) and *United States – Subsidies on Upland Cotton: Recourse to Arbitration by the United States under Article 22.6 of the DSU and Article 7.10 of the SCM Agreement* (DS267/ARB/2) were released on August 31, 2009.

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