

18 September 1990

UNITED STATES - COUNTERVAILING DUTIES ON  
FRESH, CHILLED AND FROZEN PORK FROM CANADA

*Report by the Panel adopted on 11 July 1991  
(DS7/R - 38S/30)*

I. INTRODUCTION

1.1 In a communication dated 19 September 1989, which was circulated in document DS7/1 of 28 September 1989, the delegation of Canada requested consultations with the United States under Article XXIII:1 regarding the United States' decision to place a countervailing duty on imports of fresh, chilled, and frozen pork from Canada. These consultations, held on 11 October 1989, had not resulted in a resolution of the issue and Canada requested, in document DS7/2, the formation of a panel under Article XXIII:2 to examine the complaint set out in document DS7/1. The CONTRACTING PARTIES established, on 4 December 1989, the Panel with the standard terms of reference as provided for in document L/6489 and authorized the Council Chairman to decide, in consultations with the parties concerned, on the composition of the Panel (SR.45/2, page 9)

1.2 The terms of reference are as follows:

"To examine, in the light of the relevant GATT provisions, the matter referred to the CONTRACTING PARTIES by Canada in document DS7/1 and to make such findings as will assist the CONTRACTING PARTIES in making recommendations or in giving the rulings provided for in Article XXIII:2."

1.3 Pursuant to the authorization by the CONTRACTING PARTIES, and after securing the agreement of the parties concerned, the Chairman of the Council decided on the following composition of the Panel:

Chairman:	Mr. Peter Hussin
Members:	Mr. Anthony W. Dell Mr. Rudolf Ramsauer

1.4 The Panel met with the two parties on 2 April and 18 May 1990. The report was submitted to the two parties on 3 August 1990.

II. FACTUAL ASPECTS

2.1 In 1984, the US Department of Commerce (DOC) initiated a countervailing duty investigation on imports of live swine and fresh, chilled and frozen pork from Canada, based on a petition filed by the US National Pork Producers' Council. The scope of the investigation covered subsidies to both pork and live swine, and most of the alleged subsidy programmes were to live swine producers. The DOC published a preliminary determination of subsidization on 3 April 1985 and a final determination of subsidization on 17 June 1985. The DOC concluded that certain benefits falling within the definition of subsidies under US countervailing duty law were provided to Canadian producers of live swine and to Canadian processors or exporters of pork products.

2.2 During the investigation, the Canadian Meat Council (CMC), representing Canadian pork processors, had argued that the DOC should apply the "upstream subsidies" provision of Section 771A of the Tariff Act of 1930 to measure the amount of any benefit allegedly provided indirectly to pork processors as a result of the subsidization of swine producers. Section 771A identifies the conditions which must be met before a subsidy given to an input into a product under investigation can be found to benefit

this product. One of the conditions is that "a competitive benefit has been bestowed when the price for the input product ... is lower than the price that the manufacturer or producer which is the subject of countervailing duty proceeding would otherwise pay for the product in obtaining it from another seller in an arms-length transaction." The CMC argued that had the DOC used Section 771A, it would have found that a "competitive benefit" had not been bestowed on the pork processing sector by the provision of assistance to swine producers.

2.3 The DOC declined to conduct an upstream subsidy enquiry under Section 771A, concluding that "live swine was not an 'input' into unprocessed pork".<sup>1</sup> The basis of the DOC determination was two criteria: (i) the level of value added by pork processors and (ii) the rôle of the processor in converting swine into pork. The DOC stated: "Given the congressional mandate to acknowledge the special nature of agriculture, our practice, the ITC's past practice, which is now sanctioned by the CIT and the reasonableness of treating the new and next stage product together for purposes of subsidy analysis, we do not consider live swine to be an input into unprocessed pork."<sup>2</sup>

2.4 The CMC appealed the final subsidy determination by the DOC to the US Court of International Trade (CIT). The particular point of the appeal was the decision by the DOC not to apply Section 771A. The CIT remanded the DOC decision stating that: "By limiting the applicability of the upstream subsidies provision, Commerce apparently would, as in this case, automatically impute early stage subsidies to later stage products on the grounds that the products are essentially the same at all stages."<sup>3</sup> The CIT required the DOC to conduct an upstream subsidy investigation, in accordance with Section 771A, if it believed swine subsidies bestowed an upstream subsidy on packers of pork. The CIT considered that "[i]f the statutory approach to upstream subsidies is inadequate, it is not the rôle of Commerce or the Court, but of Congress to remedy any deficiency"<sup>4</sup>. In a separate appeal, the CIT upheld the DOC affirmative subsidy determination as it applied to swine.<sup>5</sup>

2.5 The DOC did not, however, carry out an upstream subsidy enquiry because shortly thereafter the CIT upheld the US International Commission's determination that the domestic industry for fresh, chilled, and frozen pork in the United States was not materially injured or threatened with material injury by reason of the subsidized imports. This decision had the effect of rendering the earlier case moot.<sup>6</sup> With respect to live swine, the ITC issued an affirmative injury determination; therefore the final countervailing duty order was limited to live swine.

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<sup>1</sup>Federal Register, Vol. 50, No. 116, 17 June 1985, p.25097.

<sup>2</sup>Federal Register, Vol. 50, No. 116, 17 June 1985, p.25099.

<sup>3</sup>Canadian Meat Council v. United States, 661 F. Supp. 622 (Court of International Trade 1987).

<sup>4</sup>Canadian Meat Council v. United States, 661F.Supp.622 (Court of International Trade 1987) p.629.

<sup>5</sup>Alberta Pork Producers' Marketing Board v. United States, 669 F. Supp. 445 (Court of International Trade 1987).

<sup>6</sup>Live Swine and Pork from Canada, Investigation No. 701-TA-224 (Final), USITC Pub No. 1733, July 1985.

2.6 Subsequent to the CIT decision in the pork and swine case, Congress amended, in 1988, the Tariff Act of 1930 by adding Section 771B. This provision reads:

"In the case of an agricultural product processed from a raw agricultural product in which

- (1) the demand for the prior stage product is substantially dependent on the demand for the latter stage product, and
- (2) the processing operation adds only limited value to the raw commodity,

subsidies found to be provided to either producers or processors of the product shall be deemed to be provided with respect to the manufacture, production, or exportation of the processed product."

2.7 On 5 January 1989, the US National Pork Producers' Council again filed a petition with the DOC to initiate a countervailing duty investigation on fresh, chilled and frozen pork imported from Canada. The DOC published an affirmative preliminary determination of subsidization on 8 May 1989<sup>1</sup>, and an affirmative final determination of subsidization on 24 July 1989.<sup>2</sup> The ITC affirmative final threat of injury finding was made on 28 August 1989.<sup>3</sup> Of the eighteen programmes found to be countervailable, five were found to have been provided to pork processors; the others were provided to producers of live swine. The DOC final subsidy determination found the subsidy to pork to be \$00.08 per kilogramme (\$ Can). Of this, \$00.079144 per kilogramme was attributed to subsidies provided to Canadian producers of live swine and \$00.000856 per kilogramme (or 1.1 per cent of the total) was attributed to subsidies provided to pork processors.

2.8 In making its determination, the DOC decided that the criteria of Section 771B of the Tariff Act of 1930 were fulfilled and deemed that subsidies found to have been provided to live swine were provided with respect to the manufacture, production, or exportation of fresh, chilled, and frozen pork. Briefly summarized, the United States used the following methodology to determine the amount of the subsidies bestowed upon the production of the fresh, chilled, and frozen pork:

- (a) Applying the test set forth in Section 771B, the DOC first examined the demand for live swine and found that it depended substantially on the demand for fresh, chilled, and frozen pork. "Swine producers raise most swine for slaughter. Pork constitutes the primary product of the slaughtered pig. Thus, the demand for pork and for live swine are inextricably linked."<sup>4</sup>
- (b) Second, the DOC examined the processing operation used to manufacture fresh, chilled, and frozen pork and determined that it added limited value to the live swine. The DOC held that pork producers in Canada add approximately 20 per cent in value to the live swine, but recognized that even this figure encompassed various levels of processing that often went beyond the initial steps needed to first make a pig into pork. The DOC concluded that the processing operation added only limited value because the processing represented by the 20 per cent figure failed to change "the essential character of the live swine".<sup>5</sup>

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<sup>1</sup>Federal Register, Vol. 54, No. 87, 8 May 1989, pp. 19582-19590.

<sup>2</sup>Federal Register, Vol. 54, No. 140, 17 July 1989, pp. 30774-30778.

<sup>3</sup>Fresh, Chilled, or Frozen Pork from Canada, Investigation No. 701-TA-298 (Final), USITC Publication 2218.

<sup>4</sup>Federal Register, Vol. 54, p.30775.

<sup>5</sup>Federal Register, Vol. 54, No. 140, 24 July 1989, p.30776.

- (c) Having determined that the statutory criteria had been met, the DOC then used the percentage carcass weight equivalent for live swine (0.795) to convert the subsidies pertaining to live swine into subsidies to fresh, chilled, and frozen pork. The two largest programmes in the investigation used similar conversion factors and the DOC concluded that 79.5 per cent most closely approximated the conversion factor used by the Canadian stabilization programmes and the provincial marketing boards and packers in determining the final price to be paid for live swine.
- (d) The result of the determination was that the DOC found countervailable subsidies on fresh, chilled and frozen pork based on subsidies granted to producers of live swine where the criteria contained in Section 771B were met.

### III. MAIN ARGUMENTS

#### Findings and recommendations requested by the parties

3.1 Canada requested the Panel to find that the United States, by levying a countervailing duty on pork in excess of an amount equal to a subsidy determined to have been granted on the production of pork, had failed to comply with the conditions set out in Article VI:3 for the levying of countervailing duties and thus had acted inconsistently with Article II of the General Agreement. It requested the Panel to recommend that the United States refund the excess duties collected, that no further duties be collected unless the conditions of Article VI:3 were met and that the United States terminate Section 771B.

3.2 The United States requested the Panel to find that the countervailing duty was levied consistently with Article VI:3 and to recommend the rejection of the complaint.

#### Article VI of the General Agreement

3.3 Canada pointed out that the United States had bound its tariff on fresh, chilled, and frozen pork under the GATT. Article II.2.b provided that a contracting party might impose a countervailing duty on the importation of any products regardless of a binding of the tariff, provided it was applied "consistently with the provisions of Article VI." Canada argued that Article VI should be interpreted in a narrow way. This Article, in allowing anti-dumping and countervailing duties, provided contracting parties with a unilateral exception to the GATT's obligations under Articles I and II. Where an exception to the GATT rules existed, it was an accepted interpretation of the CONTRACTING PARTIES that the rights under that Article must be narrowly defined so as to avoid abuse of its provisions. In support of its position Canada quoted paragraph 4 of the first and paragraph 39 of the second report of the Group of Experts on anti-dumping and countervailing duties<sup>1</sup> and paragraph 4.4 of the report of the Panel on New Zealand - Imports of Electrical Transformers from Finland<sup>2</sup> and concluded that the interpretation applied to Article VI generally as an exception applied *mutatis mutandis* to the imposition of countervailing duties under Article VI:3.

3.4 Canada further argued that Article VI:3 had been carefully circumscribed in order to avoid abuse of its provisions. The obligation that "no countervailing duty shall be levied" constituted a prohibition on the imposition of any countervailing duty unless conditions stipulated in the first sentence were met, i.e. it must not be "in excess of an amount equal to the estimated bounty or subsidy determined to have been granted directly or indirectly." The word "equal" in this context established a maximum which must not be exceeded. While the Article recognized that a subsidy might be granted directly

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<sup>1</sup>BISD 8S/145 and BISD 9S/201 respectively.

<sup>2</sup>L/5814

or indirectly on the manufacture, production or export of a product, the provision made it clear through the use of the words "any product" and "such product" that, if a countervailing duty was levied, it had to be based on an examination of subsidies to the specific product under investigation.

3.5 Recalling that Article VI:3 stipulated that the estimate of the subsidy granted directly or indirectly had to be "determined", Canada submitted that the word "determined" was to be understood as an establishment of the facts. In support of its position, it quoted conclusions of the Panel on Swedish Anti-Dumping Duties where it was stated that "... it was clear from the wording of Article VI that no anti-dumping duties should be levied unless certain facts had been established. As this represented an obligation of the contracting party imposing such duties, it would be reasonable to expect that that contracting party should establish the existence of these facts when its action is challenged."<sup>1</sup> This conclusion was reconfirmed by the Panel on New Zealand - Imports of Electrical Transformers from Finland.<sup>2</sup> Although the two cases involved anti-dumping duty actions, they defined Article VI obligations and therefore were also relevant for countervailing duty cases. Similarly, the note Ad Article VI paragraphs 2 and 3 spoke of "the payment of anti-dumping or countervailing duty pending final determination of the facts in any case of suspected dumping or subsidization." Facts were meant to be established before countervailing duties were imposed. Referring to the interpretation of Article VI:3 in the Subsidies Code, Canada pointed out that Article 2:1 of the Code stated that countervailing duties may only be imposed pursuant to an investigation "to determine the existence, degree and effect of any alleged subsidy". In its use it was clear that the intention of the signatories had been that, in making a determination, there was to be an assessment of all the relevant facts in a substantive investigation. Such assessment would preclude such conduct as assuming or deeming "the existence, degree and effect of any alleged subsidy" despite evidence to the contrary. In conclusion, Canada submitted that the US finding under Section 771B that the demand for swine was substantially dependent on the demand for pork and that pork processing added only limited value to swine did not constitute a proper determination of the facts, as required by Article VI. The United States had failed to explain how pork processors were indirectly subsidized and by what amount. The United States had not identified the mechanism by which pork was indirectly subsidized.

3.6 The United States submitted a different reading of Article VI. It argued that Article VI permitted contracting parties to levy a countervailing duty in order to restore trade to the position in which it would have been in the absence of a subsidy. The United States noted that the GATT purposefully left the term "subsidy" undefined. Notwithstanding the absence of a definition in Article VI of the type of practices that constituted "subsidies", Article XVI provided the best interpretative assistance as to the use of the term in the GATT. Thus, for example, the notification provision of Article XVI:1 required a contracting party to notify the GATT if it "grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory." Moreover, an Article XVI:5 panel report on subsidies, adopted by the CONTRACTING PARTIES on 24 May 1960, had stated that it was not sufficient "to consider increased exports or reduced imports only in an historical sense".<sup>3</sup> Rather, the panel report shifted the focus of the provision to the particular incentives created by a subsidy, writing: "Mutatis mutandis this interpretation must apply to the effects on imports. The criterion is therefore what would happen in the absence of a subsidy."<sup>3</sup> Similarly, the Drafting Committee Report further substantiated the broad reach of the practices included in the term "subsidy".

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<sup>1</sup>BISD 3S/81, paragraph 15

<sup>2</sup>L/5814, paragraph 4.4

<sup>3</sup>BISD 9S/191, paragraph 10

The Committee's Report indicated that the Committee had purposefully inserted the words "directly or indirectly" to make clear that Article XVI:1 "can thus not be interpreted as being confined to subsidies operating directly to affect trade in the product under consideration."<sup>1</sup> Thus, the General Agreement indicated that a contracting party might, in order to implement the remedies established at Article VI, offset the full effects on trade caused by a subsidy provided to a product and thus restore trade to the position it would have been in without the subsidy.

3.7 Canada challenged this argument by contending that, if accepted, it would expand the scope of Article VI to permit the imposition of countervailing duties of an arbitrary amount to offset the effects on trade caused by a subsidy. Canada further said that this argument suggested that the notification of a subsidy pursuant to Article XVI, *ipso facto*, meant that it was a countervailable subsidy. Canada submitted that while Article XVI was intended to identify those subsidies affecting trade, it did not in any way suggest that these would necessarily be countervailable subsidies. The countervailability of a particular subsidy was to be established in accordance with the provisions of Article VI and the Subsidies Code. Canada considered that the US argumentation was the result of confusing two separate and distinct concepts involved in a countervail investigation. The identification and measurement of a countervailable subsidy were separate and distinct from the consideration of whether subsidized imports were causing injury. It was only in the context of assessing injury that the issue of trade effects was relevant. The US argument that countervailing duties were permitted at a level necessary to offset the trade effects of a subsidy was therefore based on a faulty interpretation of Articles VI and XVI. Article VI provided the right to levy countervailing duties but only up to the amount of the subsidy determined to exist, and only if the subsidized imports could be shown to be causing material injury. Unquestionably, the drafters of this Article had been concerned about the effects of subsidies. They had been, however, also concerned about the abusive use of countervail and therefore had carefully circumscribed its use.

3.8 The United States also argued that Article VI did not prescribe a specific standard for determining the existence of or measuring subsidies. It considered that the language, interpretative history and purpose of Article VI provided no support for the limitations Canada would read into Article VI remedies. To the contrary, the text and drafting history of Article VI suggested no such restrictions. For example, the United States had codified different standards to meet different requirements in respect of countervailing remedies. Section 771A contained standards for upstream subsidies on most products. A separate standard, uniquely tailored to agricultural products, was codified in Section 771B. Yet a third example was the so-called "trading house rule", under which the DOC totalled the subsidies received by the producers of the good and subsidies received by the trading house to determine the net subsidy provided to the good. In the absence of such an approach, producers could avoid the imposition of countervailing duties by selling through unsubsidized trading houses that requested and received exclusions from the final countervailing duty findings. None of these standards was expressly required - or expressly prohibited - by the General Agreement.

3.9 Canada considered that the US interpretation of the rights under Article VI was dangerous because it opened the spectre of products being subjected to countervailing duties on the basis of subsidies to other products in situations where no adequate investigation of the amount of subsidization had taken place. It was based on the presumption that Article VI should allow a contracting party the unqualified right to ensure that countervailing duties on inputs were not avoided. It overruled the rights of an exporter to a proper investigation to determine whether countervailing duties should be imposed. Such an interpretation perverted the meaning of the Article and would render it incapable of preventing countries from imposing countervailing duties when there was no evidence that the products benefited from a subsidy or that the finding of the amount of the subsidy was rooted in economic reality.

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<sup>1</sup>New York Report, UN Doc. EPCT/34, at 26 (1947), quote reprinted in GATT, Analytical Index, Article XVI-12, paragraph 4.

3.10 In the United States' view, Canada erred in confusing the application of a standard with the determination of a subsidy. The standard was contained in the applicable statutory provision. The determination of a subsidy was made in the course of an investigation. The DOC had compiled the information it needed, after a thorough investigation, to make the specific determination of the subsidy bestowed on fresh, chilled, or frozen pork from Canada. Thus, the DOC had in fact made the requisite "determination" of a subsidy.

#### Section 771B of the Tariff Act of 1930

3.11 Canada submitted that, even if the conditions set out in Section 771B were met, this did not satisfy the requirement of Article VI:3 that the amount of the subsidy be determined. The decision to use Section 771B of the Tariff Act of 1930 obliged the DOC simply to deem that subsidies to producers of raw agricultural products were passed on to processors of the raw agricultural products if two conditions are met: (a) the demand for the prior stage product is substantially dependent on the demand for the latter stage product, and (b) the processing operation adds only limited value to the raw agricultural product. These two "tests" were wholly inadequate to determine if 100 per cent of the subsidies to an agricultural input were passed through. There was nothing unique about the agricultural sector that would warrant such specialized "tests". Indeed, they could be applied to any number of different products at various stages of production and would not unambiguously indicate the degree, if any, to which subsidies to an input were passed through to a further processed product. Furthermore, the first test of Section 771B might have some relevance for products in an isolated market. When applied to agricultural products which were traded internationally, however, it did not reveal anything about the degree of indirect subsidization. In the case of pork and swine, the demand for swine was, of course, substantially dependent upon the demand for pork. In the case of Canadian swine, however, the demand was dependent not only on the demand for Canadian pork but also the demand for US pork. Because Canadian swine producers were not solely dependent upon Canadian pork processors to purchase their product, Canadian pork processors did not have the necessary market power to extract from Canadian swine producers any subsidies the latter might have received. This test of Section 771B appeared to have been designed from the perspective of an isolated market without due consideration being given to the impact of international trade on the demand for unprocessed agricultural products. The second test of Section 771B was irrelevant for determining if subsidies to inputs producers benefit processors of the input. It was the nature of the supply and demand for swine that determined the degree of indirect subsidization and not the amount of value added.

3.12 The United States responded that at issue here was a particular methodological problem on which the GATT was silent. In the US view a subsidy that affected the trade of a raw agricultural commodity would necessarily affect the trade of a product processed exclusively from the raw commodity because the production of the two products was inextricably linked. Section 771B had been enacted to address the special commercial and economic circumstances presented by some agricultural industries in connection with the provision of subsidies and the effectiveness of countervailing remedies sanctioned by the General Agreement. Indeed, a raw agricultural commodity was often devoted completely to the production of a processed product. Similarly, a product processed from a raw agricultural commodity often was produced substantially from the raw product. Whenever these circumstances coexisted, a subsidy that affected the production of the raw product necessarily affected trade in the product processed exclusively from the raw product because the production of the two products was inextricably linked. In this regard, a countervailing duty imposed on the raw commodity alone would fail to offset the full effects on trade caused by the subsidy to the raw commodity because production - and the effects of the subsidy - would simply shift to the product processed exclusively from the raw commodity. Statistics compiled by the US Department of Agriculture prior to the enactment of Section 771B had provided ample support for this contention. According to a September 1986 Foreign Agriculture Circular published by the US Department of Agriculture "Approximately 215,000 to 225,000 tons of fresh, chilled, and frozen pork may be imported from Canada in 1986. This is an increase of about 20 per

cent from 1985 and largely represents the pork equivalent that would have been produced from the decline in live hog imports in 1986. Pork imports are not subject to a countervailing duty." Section 771B was intended to address such circumstances by operating narrowly in those instances where, based on the facts of the investigation, production of the raw agricultural product and the processed agricultural product was inextricably tied. The two conditions established by Section 771B were fully consistent with the letter of Article VI:3 and the purpose of Article VI. That was to say that a duty assessed on only the raw product would fail to offset the full effects on trade caused by the subsidy to that product because production would simply shift to production of the processed product, thus defeating the purpose of the Article VI remedies.

3.13 Canada responded that, had the law been concerned about product shifting, Section 771B would have had to contain provisions directly relating to this matter. For example, one would have expected a requirement for countervailing duties to have been imposed on the raw agricultural product prior to triggering the use of Section 771B. Furthermore, there could be a requirement that the DOC examine the degree to which, if any, product shifting was occurring. In fact, neither the DOC nor the ITC had examined the impact of the swine countervailing duty on trade in pork products to determine whether product shifting was occurring. Section 771B, whether or not needed to deal with product shifting, had to be consistent with GATT obligations. The possibility that product shifting might occur, and Canada considered that there was no evidence that this was the case with regard to pork, was no justification for a measure which was GATT-inconsistent. There was no justification for legislation which required the imposition of countervailing duties without a proper analysis of the degree of actual subsidization taking place. The United States responded that evidence submitted during the DOC's investigation confirmed that even authorities in Canada reported that Canadian live swine producers began slaughtering in Canada the hogs they had been shipping to the US and exporting pork instead as a result of the "countervail effect". In addition, the United States pointed out that actual evidence of product shifting after the countervailing duty on swine went into effect was available to the US Congress when it considered Section 771B for processed agricultural products.

3.14 Canada further said that while there might be a need to be able to countervail indirect subsidization in the agricultural sector, any countervailing duty action had to be consistent with GATT obligations. A contracting party's view of adequate policy reasons did not justify the imposition of GATT-inconsistent measures. Furthermore, the two tests in Section 771B were not precise and offered great opportunity for arbitrary and vague determination by US authorities. There was no standard for what comprised "limited" for the value added test. There was no indication of how US authorities determined whether the demand for the prior stage product was substantially dependent upon the demand for the latter stage product. This uncertainty violated the requirement of Article VI that a determination of facts be made before applying a countervailing duty. Canada was of the view that a variety of other factors needed to be considered on a case-by-case basis in determining the degree of pass-through. Of fundamental importance in this case was the integration of the Canadian and US swine and pork markets which limited the degree to which any subsidies to Canadian swine producers were passed through to Canadian pork producers. In North America, the Canadian and US swine and pork markets were integrated. As such there was no difference between the prices Canadian and US pork and swine producers received (adjusted for transportation and other costs). While exports of swine and pork were important to Canada (approximately 25 per cent of Canadian production), they normally represented no more than 4 per cent of the US market. Consequently, North American prices were primarily determined by supply and demand conditions in the United States. The US Government and US industry agreed that "the pork market was best characterized as a North American market rather than as separate US and Canadian markets".<sup>1</sup> The live swine market was similarly integrated with US pork processors continuing to import

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<sup>1</sup>Fresh, Chilled, or Frozen Pork from Canada, Investigation No. 701-TA-298 (Final), USITC Publication 2218, September 1989, p. A-45.

Canadian live swine in spite of the US countervailing duty on Canadian live swine. Given the integration of the swine and pork markets, Canadian swine producers, in considering where to market their swine, had two options: selling to US pork processors or selling to Canadian pork processors. Canadian swine producers would, naturally, sell to the processor offering them the highest price (net of the various costs associated with selling, such as shipping). If Canada were an isolated market and subsidies provided to Canadian swine producers were shown to affect swine supply, this would be expected to cause Canadian swine prices to decline. However, given the integrated nature of the North American market, any such supply response in Canada would have a negligible impact on North American and Canadian swine prices. To support its position Canada provided statistical information on the basis of which it considered that swine prices did not decline to any significant degree and subsidies allegedly provided to Canadian swine producers were not passed through to pork producers in any substantial way. An indirect subsidy investigation, taking into account the relevant economic factors, was required in order to determine whether, and to what degree, alleged subsidization of swine producers was passed through to Canadian processors.

3.15 The United States responded that the tests set forth in Section 771B were narrowly tailored to address a very specific problem. While Section 771B did not precisely define the type of processing operation that added "only limited value" to a particular product such as live swine, the pre-enactment history of this provision indicated that this provision required a determination whether the operation used to process the raw commodity into the processed product must add significant value to the raw commodity, or otherwise alter its essential character. In determining whether the demand for the prior stage product was substantially dependent on the demand for the latter stage product, DOC must analyse whether the production of the raw agricultural commodity was devoted almost exclusively to the product under investigation. The United States further responded that whether or not North America should be considered a single integrated market was not relevant to determining the amount of the subsidy. Furthermore, the price of products sold on a commodity basis, which was determined by overall supply and demand, was essentially the same for all commodities sold at a given time in a given market. The upstream subsidy test of Section 771A, if applied to agricultural commodities, would understate the magnitude and permit wholesale circumvention of the countervailing duty. Thus, in a market characterized by price-taking behaviour, as with the agricultural commodities described in Section 771B, trying to demonstrate the price effects suggested by Canada would be an exercise in futility. Under Section 771B, subsidies on processed agricultural products were determined by the existence of the two factors, i.e. (a) the demand for the prior stage product was substantially dependent on the demand for the latter stage product and (b) the processing operation added only limited value to the new commodity. The United States observed that Canada's formulation for determining the amount of subsidies to the processed product measured the aggregate shift in prices resulting from supply changes in the primary product caused by the subsidization. This methodology conceded the fact that there was subsidization to the processed product based on the subsidies to the primary product. The methodology also acknowledged that such subsidies affect the supply of swine. It then simply said that, when considered in the context of the "North American market", the price impact of the subsidization was minimal. The United States did not think that Canada's methodology offered any particular improvement in determining the appropriate measure of subsidies to processed products. Under this approach, it would appear that the larger the relevant market, the less the effects of the subsidy, and therefore, the less of the amount of the subsidy Canada would deem passes through. To put it another way, the smaller the overall market share of the subsidizing country, the less the amount of the subsidy would be assumed to be "passed through", because the less the impact of the subsidization would be manifest in the aggregate price shift. In the United States' view there was no merit in a result that allowed a valid countervailing duty order on a primary product to be nullified by an easily accomplished minor processing operation. Canada's methodology would permit this result, even though it was known that subsidies to its swine had averaged CAN \$17 per head and even though it was known that product shifting had occurred.

3.16 Canada replied that it had not requested the United States to undertake a price differential analysis in order to determine the degree to which input subsidies benefited the product subject to a countervailing duty investigation. Canada had suggested to the United States different methods which, in its view, met the requirement of Article VI. The United States, however, had refused to use a different method. In the case of commodities such as pork and swine in North America, markets were competitive. There was a large number of independent buyers and sellers, none of whom could individually affect market prices which were set in arms-length transactions. As such, if pork processors were to benefit from subsidies provided to Canadian swine producers, the benefits could only be passed through if subsidies increased swine production and resulted in lower market prices. Were the market vertically integrated or dominated by a few very large buyers or sellers, then it might be possible for other mechanisms to be used to transfer subsidy benefits, such as kickbacks. This, however, was not the situation in the North American market. Canada considered that an appropriate input subsidy analysis should look at the impact of subsidies on prices to determine if there was any benefit to the product under investigation. Reliance on Section 771B prevented US authorities from undertaking an appropriate analysis of input subsidies to determine the degree, if any, by which subsidies to inputs benefited the product under investigation. This lack of analysis resulted in the US violating its Article VI obligations and inappropriately imposing countervailing duties. As to the product shifting, Canada considered that, to the extent it occurred, it would be an entirely natural response to the imposition of a countervailing duty. Operators in the market, faced with a countervailing duty, would naturally seek ways to avoid the duty. A distinction had been made, however, between actions designed to avoid a legal obligation to pay a duty and actions designed to evade it. The possibility of product shifting did not allow a country to take action inconsistent with the GATT, particularly as the GATT already mandated a mechanism to deal with such a situation by undertaking an investigation consistent with the obligations of Article VI. Moreover, according to statistical information provided by Canada, pork exports to the United States did not accelerate after the countervailing duty was applied to live swine.

3.17 The United States said that the pork case was not the only instance where section 771B had been applied. The United States had a longstanding administrative practice in countervailing duty investigations involving processed agricultural products where it had found that subsidies provided to producers of a raw product were in fact provided to producers of the processed product for the same reasons as those in this case. In all those cases the DOC had reasoned that, when the level of value added was small and the rôle of the producer was simply to make the product ready for the next customer, it was inappropriate to characterize the raw product as an "input" when it was, in fact, an earlier stage of the same product. This approach was not unique to the experience of the United States. In fact, the Government of Canada itself had found that subsidies provided to producers of a raw agricultural product benefited the processed product in one of their own countervailing duty cases, under circumstances remarkably similar to those in the instant case. In the final affirmative countervailing duty determination involving boneless manufacturing beef from the European Economic Community, the Government of Canada (1) had considered subsidies provided to producers of a raw agricultural commodity (culled cows) as being provided to producers of a processed product (boneless manufacturing beef), and (2) had allocated the full amount of the subsidies provided to the raw agricultural commodity to the processed product under investigation. Therefore, although the Government of Canada now argued before the Panel that the United States had abused the provisions of Article VI:3 in applying Section 771B, its own practice in fact demonstrated the opposite.

3.18 Canada did not consider the decisions taken in the Canadian countervail case involving EC manufacturing beef relevant because Canadian authorities had considered cattle producers and beef processors to be part of the same industry. Thus, a subsidy to cattle producers had been considered a subsidy to the whole industry and there had been no need to determine the degree of pass through. In the case of swine and pork, the ITC had twice found the industries to be separate. Canada further argued that the beef case had been about export subsidies. Indirect subsidies had been a very small proportion of the total countervailable subsidy accounting for only 0.1 per cent and 14 per cent of the

duty on beef originating in Denmark and Ireland respectively. In the pork case there had been no export subsidies and 98.9 per cent of the US countervailing duty resulted from the assumption that all of the subsidies to swine producers benefited pork processors. Canada also pointed out that the EC had never raised the issue of measurement of indirect subsidies with Canada. Had the EC done so, Canada would have been prepared to consider their arguments. In the pork case, however, Canada had twice made formal requests of the United States to conduct a proper investigation. The United States refused to consider alternatives to using Section 771B because its mandatory legislation prohibited the DOC from doing so.

#### Determination and amount of subsidy

3.19 In Canada's view the United States had not, through an examination of all the relevant facts, determined the degree, if any, to which subsidies to swine producers were indirectly passed through to pork producers. As such, the decision by the United States to impose a duty exceeding \$00.000856 per kilogramme was inconsistent with Article VI:3 of the General Agreement. Practically all, i.e. 98.9 per cent of the countervailing duties imposed by the United States on imports of Canadian pork in this case were attributable to subsidies allegedly provided to swine producers. Only 1.1 per cent of the countervailing duty was attributable to subsidies provided directly to pork producers. Article VI:3 of the General Agreement imposed an obligation upon contracting parties not to impose countervailing duties in excess of the subsidy determined to have been granted, either directly or indirectly, on the product in question. This obligation was reinforced in the Subsidies Code which interpreted Article VI of the GATT. Article 4:2 of the Subsidies Code stated "No countervailing duty shall be levied on any imported product in excess of the amount of the subsidy found to exist, calculated in terms of subsidization per unit of the subsidized and exported product." On the basis of the DOC investigation, the only justified countervailing duty was that equal to the amount of subsidy determined to have been provided directly to pork producers. In this case, these subsidies amounted to \$00.000856 per kilogramme (\$ Can) (as opposed to the \$00.0791 per kilogramme attributed to subsidies to swine producers). Any duty imposed in excess of this amount was a violation of the tariff binding the United States had negotiated on pork products.

3.20 The United States disagreed that Article VI of the General Agreement required the United States to apply one standard and method of analysis - a so-called "pass-through" analysis designed especially for input product situations - for all products, notwithstanding that the basis for a particular standard or methodology might not be appropriate to all products. Canada's argument was simply unsupported by the text and interpretative history of the General Agreement. The narrow interpretation proposed by Canada would undermine the effectiveness of Article VI remedies. Thus, the narrow functioning of Section 771B, as illustrated by the facts of this case, was fully consistent with, and supported by, the text and drafting history of Article VI. For example, in this investigation, Section 771B(1) required the DOC to determine whether the demand for the live swine depended substantially on the demand for pork. The weight of information in DOC's record demonstrated that the demand for live swine was completely dependent on the demand for pork. In other words, there was little or no demand for live swine other than by reason of its later value as pork. Section 771B(2) required the DOC to determine whether the operations used to process the live swine into pork added only limited value. Based on its analysis of the 20 per cent value added in the context of the type of operations actually performed by processors, the DOC concluded that the operation used to process live swine into pork had added only limited value because it had not changed the essential character of the live swine. Once the DOC had determined that the relationship between live swine and pork matched the requirements established under Sections 771B(1) and (2), the DOC regarded the subsidies provided to live swine as provided with respect to the manufacture, production, or exportation of fresh, chilled and frozen pork. The evidence obtained by the DOC in its investigation also supported its decision to select the percentage pork yield from a live swine as the appropriate methodology by which to convert the live swine that received subsidies into fresh, chilled, and frozen pork. The average warm carcass yield

for a market hog in Canada was 79.5 per cent. This yield factor measured the ratio of the weight of the warm dressed carcass to the weight of the live hog. This factor also determined in part the settlement price paid by the pork packer to the hog farmer. Finally, and most important, the percentage pork yield from live swine was used by the Tripartite Programme and the Quebec Farm Income Stabilization Insurance Programme - the two largest subsidy programmes investigated - to calculate the benefits paid to live swine producers. Therefore, because the conversion factor of 79.5 per cent most closely approximated the pork yield from live swine, it was reasonable and fully consistent with US obligations under Article VI for the DOC to use this factor to convert the live swine that received subsidies into fresh, chilled, and frozen pork. Thus, the DOC had properly determined the existence of a subsidy and its amount based on facts and circumstances in the administrative record of the investigation of fresh, chilled and frozen pork.

#### IV. FINDINGS

4.1 The Panel noted that the legal issues before it arise essentially from the following facts and arguments: The United States, following a petition by the United States National Pork Producers Council, has imposed a countervailing duty on fresh, chilled and frozen pork from Canada. The subsidies which this duty was designed to offset were mainly subsidies provided by the Canadian Government to producers of live swine. In making its countervailing duty determination, the United States authorities applied the recently added Section 771B of the Tariff Act of 1930. According to this provision, subsidies found to be provided to the producer of a raw agricultural product shall be deemed to be provided with respect to the production of products processed from the raw product if two conditions have been met, namely if

- "(1) the demand for the prior stage product is substantially dependent on the demand for the latter stage product, and
- (2) the processing operation adds only limited value to the raw commodity".

The United States authorities found that the demand for live swine is substantially dependent on the demand for pork and that the processing of swine into pork adds only limited value, and therefore they decided in accordance with Section 771B that the subsidies granted to the Canadian producers of swine shall be deemed to have been provided with respect to the production of pork.

4.2 Canada argued that the United States, by levying a countervailing duty on this basis, acted inconsistently with Article VI:3 of the General Agreement, the relevant part of which reads:

"No countervailing duty shall be levied on any product ... in excess of an amount equal to the estimated ... subsidy determined to have been granted, directly or indirectly, on the ... production ... of such product."

4.3 The Panel noted that the parties did not dispute that Canada had granted subsidies to swine producers, that swine producers and pork producers are separate industries operating at arm's length and that the subsidies granted to swine producers could have indirectly bestowed a subsidy on the production of pork. The sole issue in dispute between the parties was whether the United States acted consistently with Article VI:3 when it determined that a subsidy had been bestowed on the production of pork equal to the full amount of the subsidy granted to producers of swine based solely on the findings that the demand for swine is substantially dependent on the demand for pork and that processing of swine into pork adds only limited value.

4.4 The Panel examined this issue in the light of the wording of Article VI:3, the relationship between this provision and Article XVI, and the purpose of Article VI:3. In conducting this examination, the Panel took into account that Article VI:3 is an exception to basic principles of the General Agreement, namely that the importation of products listed in a Schedule of Concessions must not be subject to charges other than ordinary customs duties not in excess of those set forth in that Schedule (Article II:1(b)), and that charges of any kind imposed in connection with importation must meet the most-favoured-nation standard (Article I:1). The Panel also noted in this context that discriminatory trade measures may under the General Agreement only be taken in expressly defined circumstances (e.g. Article XXIII:2). In conformity with the practice followed by the CONTRACTING PARTIES in previous cases (cf. BISD 30S/164; BISD 35S/65, L/6513, page 33; L/6568, page 25), the Panel found that Article VI:3, as an exception to basic principles of the General Agreement, had to be interpreted narrowly and that it was up to the United States, as the party invoking the exception, to demonstrate that it had met the requirements of Article VI:3.

4.5 The Panel noted that, in the view of the United States, the term subsidy in Article VI:3 should be interpreted in the light of Article XVI:1 and a CONTRACTING PARTIES' decision on the scope of the notification obligations under that provision (BISD 9S/188). The United States concluded from the references to trade effects in Article XVI:1 and in this decision (BISD 9S/191) that Article VI:3 should be interpreted to permit contracting parties to offset the full trade effects caused by a subsidy.

4.6 The Panel considered that the definition of the term subsidy was not at issue because both parties agreed that the Canadian programmes in question constituted subsidies; the issue was rather whether the determination that a subsidy granted to the producers of one industry has been bestowed on the production of another industry may be based solely on a finding that the conditions of Section 771B are met (para. 4.3 above). In this respect, the Panel noted that Article VI:3 stipulates that a countervailing duty levied on any product shall not exceed an amount equal to the subsidy granted directly or indirectly on the production of "such product". According to this clear wording, the United States may impose a countervailing duty on pork only if a subsidy has been determined to have been bestowed on the production of pork; the mere fact that trade in pork is affected by the subsidies granted to producers of swine is not sufficient. The Panel moreover noted that the purposes of Article VI and Article XVI were fundamentally different: the former provision provides for a right to react unilaterally to subsidies while the latter sets out rules of conduct and procedures relating to subsidies. It is for these reasons not justified in the view of the Panel to conclude from the references to trade effects in Article XVI:1 that Article VI:3 permits contracting parties to offset the full trade effects caused by a subsidy granted to the producers of a product by levying countervailing duties on other products without it having been determined that subsidies have been bestowed on these other products.

4.7 The Panel considered the policy arguments the United States had advanced to support its position, in particular the argument that farmers would, with the interpretation advanced by Canada, be defenceless in all cases in which subsidies on agricultural raw materials affected trade in products processed from these materials. However, the Panel noted that the General Agreement and the Subsidies Code provide for mechanisms other than countervailing measures to deal with such cases (see Articles XVI:1 and XXIII of the General Agreement as well as Articles 8 and 13 of the Subsidies Code). The Panel moreover found that such an argument did not justify an interpretation of Article VI:3 contrary to its clear wording. As previous panels have emphasized (BISD 35S/227; L/6568, page 20 and L/6513, page 33), the purpose of the dispute settlement procedures is to ensure the implementation of existing commitments; if it is considered that the existing mechanisms are not sufficient, any changes must be sought through negotiation.

4.8 Having found that Article VI:3 permits contracting parties to levy a countervailing duty on a product only if a subsidy has been determined to have been bestowed on the production of that particular product, the Panel proceeded to examine whether the determination that the subsidies granted to producers

of live swine have been bestowed on the production of pork may be based solely on a finding that the criteria set out in Section 771B have been met. The Panel noted the views of the United States that Article VI:3 does not prescribe any particular methodology for determining whether a subsidy has been bestowed on a product and that the methodology underlying Section 771B was fully consistent with the purpose of Article VI:3. The Panel noted in this respect that the words in Article VI:3 "to determine" and "estimated" as well as the practices of the contracting parties under that provision, as reflected in Part I of the Subsidies Code, indicate that the decision as to the existence of a subsidy must result from an examination of all relevant facts. The Panel considered that the issue was not whether the United States had applied a methodology for establishing facts consistent with Article VI:3 but rather whether the facts which the United States did take into account were all the facts relevant for the determination it has made. The Panel therefore proceeded to examine whether the United States, by basing its determination that pork production is subsidized in Canada on a finding that the conditions set out in Section 771B had been met, had demonstrated that it had taken into account all facts necessary to meet the requirements of Article VI:3.

4.9 The Panel found that, given the existence of separate industries for swine and pork production in Canada operating at arm's length, the subsidies granted to swine producers could be considered to be bestowed on the production of pork only if they had led to a decrease in the level of prices for Canadian swine paid by Canadian pork producers below the level they have to pay for swine from other commercially available sources of supply. The Panel fully recognized that subsidies need not in all cases, particularly in cases involving only one industry, have a price effect to be countervailable; its finding was merely that Canadian pork producers, as an industry separate from the swine producers and operating at arm's length, could not have been considered to be subsidized unless the subsidy bestowed on swine production has had a price effect. For this reason, the determination that pork production had been subsidized as a result of the subsidies provided to swine producers required an examination of the impact of the subsidies on the price of swine.

4.10 The Panel noted that the impact of a subsidy granted to raw material producers on the price which processors of that material have to pay does not normally depend only on the proportion of the material consumed in processed form and the value added through processing. The Panel therefore found that the two factors which the United States established in accordance with Section 771B, namely the substantial dependence of the demand for swine on the demand for pork and the limited value added in the production of swine into pork, could not justify the conclusion that the subsidies granted to swine producers had led to a decrease in the level of prices for Canadian swine paid by Canadian pork producers below the level they have to pay for swine from other commercially available sources of supply and that this decrease was equivalent to the full amount of the subsidy. Other factors would need to be examined in order to arrive at such a conclusion. The Panel noted that it was not its task to identify these other factors; however it considered that, for example, they could include the extent to which Canadian swine is internationally traded (because it is less likely that competition among the Canadian swine producers cause the domestic price of swine to decline by the full amount of the subsidies if the Canadian swine producers can export at international prices) and the per unit cost of producing the additional output of swine that the subsidies may have caused (because the extent to which such additional output affects the price for swine depends in part on the cost of producing that output). The Panel therefore concluded that the determination of the United States that the Canadian government had bestowed a subsidy on the production of pork equal to the amount granted to the producers of swine on the basis of the finding that the conditions set out in Section 771B were met could not be considered a determination based on all facts necessary to meet the requirements of Article VI:3.

4.11 Having made this finding, the Panel examined Canada's request that the Panel recommend the reimbursement of the countervailing duties levied. The Panel noted that the CONTRACTING PARTIES had requested in a previous case the reimbursement of an anti-dumping duty (BISD 32S/70) and that a panel established under the Subsidies Code, whose report has not yet been adopted, recommended

that a countervailing duty be reimbursed (SCM/85, page 22). However, the Panel also noted that the case before it differs from the past cases in one important respect. In these cases the panels found that the duties should not have been levied at all, in one case because no causal link between the allegedly dumped imports and the injury to the domestic industry had been established, and in the other because the petition had not been made by the affected industry. The present Panel has not made the finding that the countervailing duty should not have been levied at all. It merely found that the determination that a subsidy was bestowed on pork production was not made in conformity with Article VI:3. It is not excluded that a subsidy determination meeting the requirements of Article VI:3 leads to the conclusion that the subsidies bestowed on swine producers benefit - at least in part - the production of pork. Under these circumstances it did not seem appropriate for the Panel to recommend that the CONTRACTING PARTIES request the immediate reimbursement of the duties concerned. It therefore decided to recommend that the CONTRACTING PARTIES give the United States the option of either reimbursing the amount of the countervailing duties designed to offset the subsidies granted to producers of swine or making a subsidy determination which meets the requirements of Article VI:3 and reimbursing the duties to the extent that they exceed an amount equal to the subsidy so determined to have been granted to the production of pork.

4.12 Canada further requested the Panel to recommend the withdrawal of Section 771B. The Panel noted that its mandate was to examine the complaint by Canada set out in document DS7/1, which relates to the levying of countervailing duties on pork, and not to Section 771B as such. Accordingly, the Panel limited itself to making recommendations confined to the pork case.

## V. CONCLUSIONS

5.1 In light of the findings set out above, the Panel concluded that the United States countervailing duties on fresh, chilled and frozen pork from Canada are being levied inconsistently with Article VI:3 of the General Agreement because the United States' determination that the production of pork had benefited from subsidies was not made in accordance with the requirements of that provision.

5.2 The Panel recommends that the CONTRACTING PARTIES request the United States to either reimburse the countervailing duties corresponding to the amount of the subsidies granted to producers of swine or to make a subsidy determination which meets the requirements of Article VI:3 and reimburse the duties to the extent that they exceed an amount equal to the subsidy so determined to have been granted to the production of pork.