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# *Deafening Silence or Noisy Whisper: Omission Bias and Foregone Revenue under the WTO Agreement on Subsidies and Countervailing Measures*

David Collins\* and Tae Jung Park\*\*

## **ABSTRACT**

This article applies the behavioral economics theory of Omission Bias to the Agreement on Subsidies and Countervailing Measures (ASCM) of the World Trade Organization (WTO), assessing whether WTO and Appellate Body's assessment of "foregone revenue" as illegal subsidies indicate a bias against finding culpability in omissions as distinct from commissions. Using available caselaw, the article shows that there is no evidence of Omission Bias among WTO adjudicator's in terms of their rulings, but rather the caselaw discloses evidentiary and practical problems which may prevent the instigating and enforcing of claims of this nature. Specifically the test for this kind of subsidization is complex and its application is frustrated by the lack of tax expertise among WTO panelists and Appellate Body members as well as the opacity in many countries' revenue and tax incentive regimes. The article concludes by acknowledging the need for greater transparency in domestic revenue laws and the more ready use of expertise in tax relief cases in the WTO dispute settlement system.

## **I. Introduction**

Modern discourse on the negative effects of globalization often contemplates the role of the state in softening the impact of foreign competition on the declining prosperity of those employed in equivalent domestic industries, most typically manufacturing. The capacity of states to provide support in the way of subsidies remains highly contentious because governmental assistance targeted at certain firms is widely-regarded as economically

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inefficient in most circumstances with limited social benefits as well as negative externalities in the form of lost wages and decreases in productivity across the global economy as a whole.<sup>1</sup> This is why certain forms of subsidy (such as that aimed at assisting goods destined for export) are proscribed under international law, specifically through the discipline of the Agreement on Subsidies and Countervailing Measures (ASCM)<sup>2</sup> of the World Trade Organization (WTO). Yet subsidies remain attractive policy tools for governments grappling to prevent unemployment and some of these may be permissible under the WTO regime.

Tribunals constituted under the WTO Dispute Settlement Understanding which apply subsidies disciplines like the ASCM are analogous to domestic courts in that they render binding decisions affecting the outcome of litigants based on the interpretation of established rules to a distinct set of factual circumstances. These bodies produce outcomes which may reflect more than mechanically applied and purely rational legal reasoning. Decisions can also be assessed for their embodiment of behavioral tendencies which heuristics or shortcuts which explain why outcomes are often difficult to anticipate, despite the system's goal of predictability.

With the above trends in mind, this article will examine whether the panels and the Appellate Body of the WTO exhibit the irrational decision-making tendency identified by behavioral economists as "Omission Bias" in the specific context of their application of article 1.1 (a)(1)(ii) of the Agreement on Subsidies and Countervailing Measures (ASCM) when assessing whether an actionable or prohibited subsidy has been granted by a Member State. It considers the way in which the WTO caselaw approaches the concept of subsidization which is based on a member government's decision not to collect government revenue that is otherwise due, in other words through the failure to act, rather than the conventional form of subsidy in which there is the provision of direct assistance by the state, for example in the case of grants. This indirect or seemingly passive subsidization typically consists of the granting of relief for taxation or "tax breaks" to domestic firms.

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<sup>1</sup> See e.g. Stephen J. Spurr, *Economic Foundations of Law* 24-25 (Second Edition, Routledge, 2010).

<sup>2</sup> Marrakesh Agreement Establishing the World Trade Organization, Annex IA, Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, 1867 U.N.T.S. 14, 33 I.L.M. 1154 [hereinafter ASCM]

Forbearance from the collection of taxes is a highly controversial<sup>3</sup> as well as economically questionable<sup>4</sup> practice aimed at stimulating economic activity and foreign investment. Some politicians view it as a suitable response to the pressures of globalization in which suppliers from states with lower regulatory burdens enjoy in a competitive advantage relative to those with stricter standards, such as those concerning labor and the environment.<sup>5</sup>

The structure of this article is as follows. Following the Introduction, Part II will outline the ASCM as the WTO's chief instrument for controlling governmental assistance to domestic firms in a manner that interferes with international trade in goods. This part will also introduce the concept of Omission Bias as a potential explanatory theory underlying the observed tendency in many legal contexts for the law punish wrongful failures to act differently or less strenuously than wrongful actions even where outcomes are identical. Part III will link these two concepts, considering the extent to which the ASCM's control of subsidies (as applied by WTO panels and the Appellate Body in two cases) captures the behavioral irrationality of omission bias. This analysis will be extended in Part IV which will attempt to explain the observed tendency within the ASCM case law on forbearance, not as an iteration of omission bias, but rather as a consequence of more rational and purposeful decision-making. This is related chiefly to evidentiary issues associated with foregone payments and the need to establish a counterfactual as well as the complexity and opacity of many domestic revenue laws which render financial obligations of firms to governments difficult to identify.

## **II. The Agreement on Subsidies and Countervailing Measures and Omission Bias**

### *A. The Agreement on Subsidies and Countervailing Measures (ASCM)*

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<sup>3</sup> Politicizing Investment Makes the World Poorer, *The Financial Times* (London) Dec. 2, 2016

<sup>4</sup> Particularly when tax incentives are poorly coordinated, *see* R Greenbaum, BD Russell & T Petras, Measuring the Distribution of Economic Development Tax Incentive Intensity, 24 *Econ. Dev. Qtl.* 154, 154-168 (2010). The value of tax incentives is highly dependent on the particular context in terms of the country's developmental status, for more reference, *see* A Klemm, Causes, Benefits and Risks of Business Tax Incentives, 17 *Int'l Tax & Pub. Finance* 315, 315 (2010)

<sup>5</sup> T Mann, Carrier Will Receive \$7 Million in Tax Breaks to Keep Jobs, *Indiana's Wall Street Journal*, Dec. 2, 2016.

The ASCM is the WTO's chief instrument for the regulation of subsidies. Building from Art XVI of the GATT 1947, the ASCM regulates certain kinds of government actions that positively affect the wealth of domestic producers,<sup>6</sup> giving them an unfair advantage over their foreign counterparts in the production and trade of goods (although not services). The ASCM sets up two categories of subsidy: prohibited (meaning that they are automatically illegal)<sup>7</sup> and actionable<sup>8</sup> (meaning that they are illegal if injury to the domestic industry can be demonstrated). The former covers subsidies which are linked to export and therefore have a presumptively deleterious effect on world trade. The ASCM provides a definition of "subsidy" to set out the types of governmental actions it was designed to address. The ASCM progressively filters certain types of actions that member states agreed would be considered actionable government subsidies,<sup>9</sup> meaning those which should not necessarily be sanctioned. This process includes four cumulative tests:

Test (A): *Is there a financial contribution*: For the ASCM to apply, article 1.1(a) of the ASCM requires that the government action in question should be a "financial contribution." Financial contribution occurs when: 1) government practice involves a direct transfer of funds;<sup>10</sup> and importantly also 2) government revenue that is otherwise due is foregone;<sup>11</sup> as well as 3) a government provides goods or services other than general infrastructure.<sup>12</sup> This article will focus on the second category of contribution: foregone revenue.

Test (B): *Is a Benefit thereby conferred*: The ASCM requires that a benefit is thereby conferred as a result of financial contribution.<sup>13</sup> This occurs where domestic producers receive an advantage relative to applicable commercial benchmarks.<sup>14</sup> In the context of foregone revenue, the relevant producer is granted the entitlement not to pay money which

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<sup>6</sup> See Richard Diamond, *Privatization and the Definition of Subsidy: A Critical Study of Appellate Body Textualism*, 11 J. INT'L ECON. L. 649, 664 (2008).

<sup>7</sup> ASCM, *supra* note 5, Art 2

<sup>8</sup> *Id.* Art 5

<sup>9</sup> Diamond, *supra* note 6, at 664.

<sup>10</sup> ASCM, *supra* note 5, at art. 1.1(a)(1)(i).

<sup>11</sup> *Id.* at art.1.1(a)(1)(ii).

<sup>12</sup> *Id.* at art 1.1.(a)(1)(iii).

<sup>13</sup> ASCM, *supra* note 5, at art. 1.1(b).

<sup>14</sup> Panel Report, Canada-Measures Affecting the Export of Civilian Aircraft, 19.119, WT/DS70/R (Apr. 14, 1999) at ¶ 9.113. [hereinafter Canada Aircraft].

is owed and other enterprises operating within the same sphere of economic activity are not, and as such one consumer is placed at a disadvantage relative to the other one.

Test (C): *Is the subsidy specific*: If the test (A) and (B) are met, the ASCM regards the government action in question a subsidy.<sup>15</sup> However, there is another requirement for a subsidy to be subject to sanction under the ASCM in the form of countervailing measures by injured Members. This is the qualification of specificity. In order to be “specific” the subsidy must be limited to specific, meaning certain and identifiable enterprises or industries, rather than broadly extended to the economy as a whole as in the case of generalized assistance programs. The purpose of this requirement is to exclude from the control of the ASCM subsidies regimes which have as their aim the broad stimulation of the economy generally, rather than as targeted support for a particular enterprise or industry.

Test (D): *Does the subsidy cause injury*: To be actionable, the specific subsidy must cause injury to the equivalent industry.<sup>16</sup> The requirement of injury varies depending on the retaliatory action that the affected member state is considering taking. If the member is seeking remedy through the WTO’s Dispute Settlement Body, then it must prove that the subsidy caused adverse effects to the interests of another member;<sup>17</sup> if the member is seeking remedy through the imposition of a countervailing duty of equivalent magnitude to negate the benefit of the subsidy as granted, it must prove that the subsidized imports caused injury to another member’s domestic industry.<sup>18</sup>

## B. Omission Bias

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<sup>15</sup> ASCM, *supra* note 5, at art 1.1. The ASCM presents test (A) and (B) as part of a single examination located in article 1.1 of the ASCM. This article states that “for the purpose of this Agreement, a subsidy shall be deemed to exist if..” and list the requirements of financial contribution and benefit.

<sup>16</sup> In addition to actionable subsidies, the ASCM defines two other types of subsidies: prohibited subsidies and non-actionable subsidies. Neither of these categories are relevant here. First, it is highly unlikely that the allocation of free emissions units will fall into the category of prohibited subsidies. See Jason Bordoff, *International Trade Law and the Economics of Climate Policy: Evaluating the Legality and Effectiveness of Proposals to Address Competitiveness and Leakage Concerns*, in *Trade and Competitiveness: Is a Collision Inevitable?* 23 (Isaac Sorkin & Lael Brainard, eds., 2009).

<sup>17</sup> ASCM, *supra* note 5 at art 5.

<sup>18</sup> *Id.* at art 11.

The well-established and growing field of behavioral economics suggests that, far from being purely rational agents motivated by self-interest and a strict assessment of the costs and benefits of decisions which characterized classical economics, empirical evidence shows that humans actually make choices based on heuristic biases or shortcuts, which often reflect an emotional or intuitive understanding of reality which may be distorted and in some cases even counter-productive.<sup>19</sup> The ability to understand these motivations, in part through their categorization and in some cases anticipate their role in various forms of decision-making has led to the application of behavioral economics to law. In some respects this sphere of analysis represents an offshoot of the school of law and economics (the analysis of strategic behavior of actors based on incentives<sup>20</sup>) and in other ways it explores the role of psychology and cognitive processes in evaluating the effectiveness of laws as well as, for some scholars, as an explanation for trends in judicial decision-making.<sup>21</sup>

In light of the above, Omission Bias is the tendency to judge harmful actions as worse than equally harmful omissions (inaction). Omission Bias, which has been confirmed through empirical tests, has been described as a variety of moral bias in which individuals exhibit the tendency to view acts that are harmful (relative to the alternative option) as worse than omissions that are equally harmful (relative to the alternative) or in some cases, even more harmful.<sup>22</sup> It would seem as though individuals are considered to bear greater moral responsibility for harmful outcomes they actively facilitated than those they facilitated passively.<sup>23</sup> Another plausible explanation for this bias may be because actions are more obvious than inactions. As applied to a legal context, Omission Bias may be observed perhaps most obviously in the legal status of euthanasia or assisted dying.

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<sup>19</sup> D Kahneman, *Thinking Fast and Slow* (Farrar, Straus and Giroux, 2011); R Thaler and C Sunstein, *Nudge* (Yale University Press, 2008)

<sup>20</sup> See e.g. F Parisi and D Pi, "The Economic Analysis of International Treaty Law" in E Kontorovich and F Parisi, *Economic Analysis of International Law* (Edward Elgar, 2016)

<sup>21</sup> See e.g. D Teichman and E Zamir, "Judicial Decision-Making: A Behavioural Perspective" in E Zamir and D Teichman eds. *The Oxford Handbook of Behavioral Economics and the Law* (Oxford University Press, 2014)

<sup>22</sup> J Baron & L Ritov, *Reference Points and Omission Bias* 59 *Org. Behavior. & Human Dec. Proc.* 475-98 (1994)

<sup>23</sup> D Teichman and E Zamir, "Judicial Decision-Making: A Behavioral Perspective" in E Zamir and D Teichman eds. *The Oxford Handbook of Behavioral Economics and the Law* (Oxford University Press, 2014) at 673

Most countries allow passive euthanasia (the withholding of normal medical treatment for those who are considered to be those for whom death is not a worse alternative than life in their current state) whereas active euthanasia or assisted suicide still remains prohibited in most countries, even for those who wish to die. The distinction between acts and commissions is thought to be at the heart of this variance in the law's approach to the issue.<sup>24</sup>

In addition to the moral element which may apply in the assisted dying context, there may be a role in the perception of causality behind Omission Bias. Individuals who claim that actions are worse than equivalent harms of omission tend to believe that the causal relationship between the agent and the harm is greater in the case of actions than it is in inactions. Omitting to do something which leads to harm seems more remote to that harm in the chain of events than a direct action which causes harm.<sup>25</sup> As heuristic biases are understood as shortcuts by which humans render decision-making more simplistic, omission bias may play a greater role in situations where causality is more complex, i.e. in situations where facts are complicated or where alternative outcomes (counterfactuals) are less readily evident. This particular explanation has relevance for the context of subsidies under WTO law, as will be illustrated below.

### **III. The Application of “Revenue Forgone” under the ASCM by WTO panels and the Appellate Body**

To re-iterate from the above, this article suggests that the distinction between commission (doing something) and omission (not doing something) is analogous to the “revenue foregone or not collected”<sup>26</sup> component of the ASCM's definition of subsidy found in Art.

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<sup>24</sup> J Baron, “History of Moral Judgement Research” in E Zamir and D Teichman eds. *The Oxford Handbook of Behavioural Economics and the Law* (Oxford University Press, 2014)

<sup>25</sup> *Id.* at 72-73. (Baron uses the following example to illustrate the differences in perception: “Most people regard it as worse to push a man off a footbridge and in front of a train in order to cause the man to fall and be hit by the train thereby slowing it and saving five people on the track ahead than it is to pull a lever that redirects a trolley onto a side track in order to save five people ahead on the main track if, as a side-effect, pulling the lever drops a man off a footbridge and in front of the train on the side tracks, where he will be hit.”)

<sup>26</sup> Alan O. Sykes, *The Questionable Case for Subsidies Regulation*, 2 *J. Legal. Anal.* 474, 481 (2010) (introduce brief summary of different classification of subsidies under ASCM and examines how ‘revenue foregone or not collected’ is has been decided by the court”)



1.1 (a)(1)(ii). This premise facilitates the assessment of applications of this feature of the ASCM through the lens of Omission Bias.

From the text of the ASCM, “revenue foregone” is to be treated the same as other forms of subsidy, such as the “direct transfer of funds” (equity, grants or loans).<sup>27</sup> In case of governmental assistance of firms leading to harmful market distortions, omissions (e.g. Member states not collecting tax) are as bad as actions (e.g. providing equipment or grants). Thus, the text of the ASCM does not on its face evince Omission Bias. Accordingly, it should be expected that economically harmful inaction (i.e. not collecting revenue which is owed) and harmful action (i.e. direct financial contributions in the form of grants) should not be treated differently by panels or the Appellate Body when this provision of the ASCM is applied in practice. This article will now consider whether this equivalence is demonstrated by the case law under the ASCM.

In so doing it must first be noted that there have been only a handful of cases in which Art. 1.1(a)(1)(ii) (“revenue foregone”) was considered by a WTO panel or the Appellate Body. Of the 116 cases that cited the ASCM, only 11 referred to Article 1.1 and only 2 explicitly referred to Article 1.1 (a)(1)(ii). The very small sample of “foregone revenue” cases immediately suggests that either: 1) tax break or omission-type subsidies are a much less common form of assistance than direct benefits such as grants, meaning that complaints of this nature are necessarily rare or 2) while such types of assistance may be common practice, states are much less likely to bring claims through the WTO dispute settlement procedure for omission-style assistance programs. The former conclusion may be supported by Global Subsidies Initiative, which reports that the most basic form of subsidy is that of grants or other direct payments.<sup>28</sup> With respect to the second explanation for the observed lack of cases, if states are less willing to bring claims based on revenue

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<sup>27</sup> Marc Benitah, *The Law of Subsidies under the WTO/GATT System* 241 (Kluwer, 2001) (introduce case studies and explains how direct transfer of funds are regarded as the type of subsidies under the WTO/GATT system)

<sup>28</sup> The Global Subsidies Initiative (GSI) is established in 2005 by the International Institute for Sustainable Development (IISD), the GSI analyses subsidies – transfers of public money to private interests – and how they support or undermine efforts to achieve sustainable development. See available at, <http://www.iisd.org/gsi/about-gsi> (accessed April 2017); D Collins, *Performance Requirements and Investment Incentives Under International Economic Law* 36-44 (Edward Elgar, 2015) (noting that tax concessions (the omission of collection of revenue) are more common in countries with well-developed tax systems, meaning developed countries as opposed to developing countries).

foregone, it may be the consequence of states believing that omission-oriented assistance is insufficiently harmful to their trading interests to warrant engaging the WTO dispute settlement procedure and incurring the costs of so doing. This explanation seems unlikely given that tax break can represent a significant advantage to a trading firm which has the potential to distort international trade, as illustrated in the two cases below. Alternatively and perhaps most plausibly, it may be that omission-style claims will be too difficult to prove, particularly in the case of actionable subsidies where harm and causation must be shown. This latter point is relevant to our discussion below on the complexity and opacity of many domestic revenue laws. Before embarking on the analysis of this point, the two cases dealing with the revenue otherwise due concept will be introduced. These two cases, both of which involve complaints against the US, are *United States- Foreign Sales Corporation*<sup>29</sup> and *United States – Conditional Tax Incentives for Large Civil Aircraft*.<sup>30</sup> A third case referencing foregone revenue, *EU – Polyethylene*, was composed in May 2015 but there is as yet no panel report available.

#### A. *US-Foreign Sales Corporation*

In 1985 United States and European Union, Japan, Australia and Canada conducted a consultation over the alleged illegality of the US Foreign Sales Corporation (FSC) tax regime in which certain corporations were given favorable tax treatment (essentially a tax break) based on the volume of their exports. The European Union insisted that the FSC regime was a subsidy under Article 1.1 of the SCM which, as emphasized above, declares that a “subsidy” exists if “government revenue that is otherwise due is foregone or not collected” and a “benefit is thereby conferred.”<sup>31</sup> The European Union argued that the exemption of foreign source income from represented income to the U.S. Treasury that would have been otherwise due resulted in the conferral of a benefit to the relevant exporting company, its corporate parent, and affiliates.<sup>32</sup> In making its claim against the

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<sup>29</sup> Appellate Body Report on U.S. Tax Treatment for Foreign Sales Corporations, WT/DS108/R (WTO) at 4.177 (Oct. 8, 1999) available at 1999 WL 973750 [hereinafter US-FSC Appellate Body].

<sup>30</sup> Panel Report, United States – Conditional Tax Incentives for Large Civil Aircraft, WT/DS487/R, 28 November, 2016 (hereinafter US – Tax Incentives).

<sup>31</sup> US-FSC Appellate body, *supra* note 30, para 44.

<sup>32</sup> *Id.*

US through the WTO dispute settlement system, the European Union referred to three specific tax benefits of the FSC regime that were each an illustration of the forgoing of income that was otherwise due.

The first exemption was under Internal Revenue Code, Section 921(a), which deemed Exempt FSC Foreign Trade Income as “income which is not effectively connected with the conduct of a trade or business within the United States.”<sup>33</sup> The amount of an FSC’s Exempt Foreign Trade Income was based on the percentage of the FSC’s overall foreign trade income for the taxable year. The second tax benefit was the exemption of FSC foreign trade income from anti-deferral rules, allowing these corporations to defer taxable income over a longer time period.<sup>34</sup> The third tax benefit was the ability of FSC shareholders to deduct all dividend income received from an FSC.<sup>35</sup> The panel unsurprisingly agreed with the EU’s arguments, finding that, through the FSC scheme, the United States had acted inconsistently with its obligations under Article 3.1(a) of the SCM Agreement.<sup>36</sup> Upholding the panel’s finding that the FSC measure constituted a prohibited subsidy under Article 3.1(a) of the SCM Agreement, the Appellate Body held that all three FSC’s exemptions represented an interconnected scheme to forego revenue that was otherwise due.<sup>37</sup>

In rendering its decision, the Appellate Body explained that the concept of “foregone revenue” under the SCM requires a comparison between the revenue actually raised and the revenue that would have been raised “otherwise.” The Appellate Body agreed with the panel’s decision to apply a “but for” test in determining whether revenue had been foregone that was “otherwise due.”<sup>38</sup> This test examines the situation that would have existed but for the measure at issue and determines whether there would have been a higher tax liability in the absence of the measure. In other words, it requires the composition of a

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<sup>33</sup> Id. para 16, Section 864 IRC sets out the rules for determining whether the income of a foreign corporation is "effectively connected with the conduct of a trade or business within the United States".

<sup>34</sup> US-FSC Appellate Body, supra note 30, para 17.

<sup>35</sup> Id. para 18.

<sup>36</sup> Panel Report, United States- Tax Treatment for Foreign Sales Corporation, WT/DS108/RW ¶¶ 8.37, 8.39 (Aug. 20, 2001) [hereinafter, US-FSC Panel]

<sup>37</sup> US-FSC Appellate Body, supra note 30, para 73.

<sup>38</sup> Id. para 77.

counterfactual (what would have happened) as well as a normative benchmark (what is the normal situation from which there has been a departure). The narrower and more formalist construction of “revenue otherwise due” which had been proposed by the United States was rejected.<sup>39</sup> Reviewing the domestic revenue laws, the Appellate Body established instead that the foreign source income of the FSC would have been taxed “but for” the contested measure. To be sure, neither the panel nor the Appellate Body used the language of omission to describe the measure which, of course, consisted of an action – the government passed a law precluding the payment of tax in certain circumstances.

The Appellate Body had some reservations about whether the “but for” test is an appropriate general test that should apply in all situations of foregone revenue. The AB reasoned:

We would have particular misgiving about using a “but for” test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measures.<sup>40</sup>

This suggests that in order for the “revenue foregone” element of subsidization to be present, there must actually be a tax law in existence which requires payment from which there is a departure, not merely the theoretical possibility that payment would be required at some point in the future.<sup>41</sup> In other words, it requires the suspension of an operational law, rather than the lack of one. This semantic distinction is telling because it hints at the Appellate Body re-casing the omission to collect tax passively as the proactive decision to amend the tax laws in a particularly situation. In other words, it re-conceptualized the omission as a commission.

Crucially also, the Appellate Body went on to caution that although the panel’s “but for” test led to a finding of violation of the ASCM in this case, it may not do so in other

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<sup>39</sup> *See Id.* ¶¶ 105-6. (stating that the actual examination of foregone revenue must be based on actual substantive realities and not be restricted to pure formalism)

<sup>40</sup> US-FSC Appellate Body, *supra* note 30, para 91.

<sup>41</sup> *Id.*

cases where revenue laws are less clearly articulated, or not articulated at all.<sup>42</sup> The problem with this understanding, as the Appellate Body itself recognized, is that the application of a formalistic “but for” test may not be reliable in cases where there are weak or poorly defined revenue laws from which forbearance is difficult to determine.<sup>43</sup> It might not always be possible to identify a general tax rule that would apply to the revenues in question in the absence of the contested measure.<sup>44</sup> A strict “but for” test could even create an incentive on Member states to design their tax systems in a way to render it difficult to identify an alternative measure and thus easily circumvent the test. In this respect, the Appellate Body believed that the “otherwise due” phrase requires the identification of “some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised’ otherwise.” In a close reading of the ASCM, the Appellate Body agreed with the Panel that the term “otherwise due” implies some kind of comparison between the revenues due under the contested measure and revenue that would be due in some other situation. Furthermore, the word “forgone” implies that the government has given up an entitlement to raise revenue that it could “otherwise” have raised. However, the entitlement cannot be an abstract because, in theory, governments could tax all revenues. Therefore, some normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised “otherwise”.<sup>45</sup> This benchmark must be found in the domestic tax rules of the Member state in question. The Appellate Body noted here that the WTO member countries have sovereign power to tax or not to tax any particular categories of revenues it wishes and therefore, what is “otherwise due” depends on the rules of taxation of each Member.<sup>46</sup> This reasoning appears to emphasize the active role in the crafting of tax breaks – there must be a clearly defined obligation to pay tax from which there is an express derogation. In that sense, the reasoning evidenced in this case does not

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<sup>42</sup> *Id.*

<sup>43</sup> Felicity Deane, *Emissions Trading and WTO Law: Global Analysis*, 143 (Edward Elgar, 2015) (introduce brief analysis of “but for” and examines the difficulties to exercise such analysis).

<sup>44</sup> WTO, *WTO analytical Index (Guide to WTO Law and Practice)* 2<sup>nd</sup> ed. 756 (Cambridge, 2007) (explains how Appellate body in US-FSC has reservation list about ‘but for’ test including unavailability of domestic law).

<sup>45</sup> US-FSC Appellate Body, *supra* note 30 at Para 90

<sup>46</sup> *Id.*

contemplate a genuine omission in the sense understood by the phenomenon of Omission Bias articulated above.

### *B. US-Tax Incentives for Civil Aircraft*

This dispute, one of the largest ever brought through the WTO dispute settlement system in terms of its financial impact, concerned seven tax-related incentives for civil aircraft (“aerospace tax measures”) provided by the state of Washington in the United States to the aircraft manufacturer Boeing. The European Union argued that the availability of the tax incentives was conditional on the initial siting of a “significant commercial airplane manufacturing program” in the state of Washington.<sup>47</sup>

The European Union, bringing the claim at the behest of the aircraft manufacturer Airbus, argued that the Washington State tax incentives constituted a prohibited subsidy on the grounds that the incentives were contingent on the use of domestic over imported goods. The Panel found in favor of the European Union as it held that the favorable tax rate for the manufacturing or sale of commercial airplanes is a prohibited subsidy within the meaning of the SCM Agreement’s reference to “revenue foregone.” In presenting its argument, the EU proposed various benchmarks for comparison for the aerospace tax measures and contends that, in relation to these benchmarks, government revenue that would otherwise be due was foregone.<sup>48</sup> The panel followed the normative benchmark approach in the *US-FSC*, holding that the tax incentives by the state of Washington were foregone revenue that was otherwise due.<sup>49</sup> In other words, Boeing benefited from the advantage of not having to pay tax that it was liable for under US laws, namely aerospace tax measures pursuant to codified provisions of Washington State law. This foregoing of revenue would apply to eligible taxpayers at any time during the entire period in which the measures were in force. The EU contended that government revenue does not need to have been actually foregone for there to be a financial contribution, but rather that it is the

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<sup>47</sup> US-Tax Incentives, *supra* note 31, para. 7.3.

<sup>48</sup> *Id.* para 7.41.

<sup>49</sup> *Id.* para. 7.157.

foregoing of the government's entitlement to collect revenue that is determinative of a financial contribution.<sup>50</sup>

In their reasoning on the forbearance component of the subsidy, the panel held that the foregoing of revenue was constituted by the government's promise to do so in the future, not only by particular instances of it being done. In that sense it was not only an omission of collection which could constitute a subsidy, but also a contingent omission which had not yet crystallized. Perhaps most importantly, like the panels and Appellate Body in *US-FSC*, the panel emphasized the potential difficulty of exercising normative benchmark test given that such test may "be unique to the particular domestic regime" and further "that disparate tax measures, implemented over time, do not easily offer up coherent principles serving as a benchmark."<sup>51</sup> In short, given the artificial nature of the counterfactual test needed to assess revenue forgone, the panel worried that the difficulties to pinpoint the tax laws based on the unstable nature of implementing tax law in the member states could frustrate the designation of this type of policy as a prohibited subsidy. Understanding the tax structure and principles of member's tax regime is essential for exercising normative benchmark test. The panel further noted that the task of the panel is to develop an understanding of the tax structure and principles that best explains that Member's tax regime, and to provide a reasoned basis for identifying what constitutes comparable income of comparably situated taxpayers. Moreover, the panel should compare the reasons for the challenged tax treatment with the benchmark tax treatment it has identified after scrutinizing a member's tax regime<sup>52</sup> Put more simply, there cannot be a prohibited omission unless the alternative, the commission, is sufficiently clearly defined for the departure to reach the status of a behavior which transgresses ASCM rules.

#### **IV. Alternative Explanations for Observed Difficulties Associated with the application of "Revenue Foregone" to the ASCM**

The two cases above disclose that WTO adjudicators are prepared to hold that acts of omission can be illegal and attract sanction as subsidies, but only where there is a clear

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<sup>50</sup> *US-Tax Incentives*, supra note 31, para 7.41.

<sup>51</sup> *Id.* para 7.50

<sup>52</sup> *Id.*

indication of departure from a defined course of action in the relevant domestic revenue laws. These cases also reveal that doing so is a problematic jurisprudential exercise tied to the feasibility of crafting normal conditions and the departure therefrom based on the available evidence relating to the member's tax regime. This may explain where there have been so few "revenue foregone" disputes which have been argued through the WTO dispute settlement system.

Rather than illustrating an Omission Bias, which does not appear evident from this limited caselaw, and certainly not from the text of the ASCM itself, there are three practical difficulties precluding findings of liability under the ASCM on the basis of the state's omission, which may superficially give the impression (at least based on the lack of caselaw) that an Omission Bias is in operation in relation to this particular variety of subsidization as defined under the ASM.

First, there are evidentiary difficulties in proving "foregone revenue" because this process requires the identification of an appropriate counter-factual based on the domestic revenue laws from which there has been an express derogation in the form of tax relief. Second, it is difficult to escape the conclusion that the lack of expertise in taxation among the panels and the Appellate Body could exacerbate the difficulties associated with the above exercise, knowledge of which could act as a disincentive for states to bring these types of claims. Finally, administrative inefficiency and possibly secretiveness at the national and sub-national level render the identification of the relevant revenue laws from which the initial obligation or its suspension are derived is itself problematic. Taken together these issues suggest that findings of illegality in the context of subsidies based on omissions rather than commissions is a highly problematic adjudicatory exercise and as a consequence, the observed dearth of such findings should not be construed as indicative of Omission Bias but rather a reflection of the rationality and pragmatism of WTO adjudicator as well as WTO member states contemplating such claims. These three explanations will now be examined in greater detail in turn.

#### ***A. Evidentiary Difficulties with the "Revenue Foregone" Concept***



The factual difficulties associated with subsidies cases and the ensuing potential for miscalculation of appropriate countermeasures has been observed by commentators.<sup>53</sup> Proving “foregone revenue” for the purposes of finding an illegal subsidy is clearly a difficult exercise. As noted in the two cases above, to demonstrate an omission (i.e. government revenue which is otherwise due is foregone or not collected government), the claimant in a dispute must prove that the respondent government was entitled to payment from a domestic firm by law which it elected to forgo (also encapsulated in a domestic measure) and that this exercise caused a benefit. However, finding the normative benchmark (what the obligation to pay was before the exemption was granted) is a difficult task. The panels and the Appellate Body are required to imagine what the normal situation should have been – what payment was the firm legally obliged to make to its government and, perhaps harder, how much worse would their position have been vis a vi their competitors in that other situation. Commentators have identified the difficulty in establishing an appropriate counterfactual for the purposes of constructing remedies in WTO subsidies because of the underspecified nature of trade effects.<sup>54</sup> These difficulties are particularly acute in this context because the concept of “otherwise due” calls for a benchmark of normality which may not always be readily identifiable for a range of different taxes and exemptions, as seen in both of the cases discussed above.

For example, when one firm pays less tax than another, is the firm that pays a lower tax “subsidized,” or is the firm that pays the higher tax just “taxed” at a higher rate? In other words, which tax rate applies as the normative benchmark? The *FSC* case recommends that WTO adjudicators should look to the higher rate as the benchmark, and find a subsidy on that basis. This approach maybe applicable in certain case. For instance, consider an economy of 1000 firms engaged in various activities. Assume that 999 of the firms are subject to a 25 percent income tax rate, while one of them is exempt from tax? It is understandable that the one firm with tax exemption is being subsidized. But now reverse the facts, and suppose that 999 firms are taxed at a lower rate, and only one at the

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<sup>53</sup> H Spamann, *The Myth of ‘Rebalancing Retaliation in WTO Dispute Settlement Practice* 9 J. INT’L ECON. L. 31 (2006).

<sup>54</sup> A Sykes, “The Dispute Settlement Mechanism: Ensuring Compliance” in A Narlikar, M Daunton and R Stern, *The Oxford Companion on the World Trade Organization* 578 (Oxford University Press, 2012) (stating that “[A]rbitrators have struggled with issues concerning the proper counterfactual...”).

higher rate. Is there a “subsidy” to the 999 firms? Or suppose that a state government that routinely taxes corporate income is searching to attract new business investment in competition with other states that have no corporate income tax. The state offers certain potential new investors a 20-year exemption from its ordinary corporate tax. Is it sensible to say that the state that offers a time-limited exemption is conferring a “subsidy,” while the states that offer an apparently perpetual tax exemption are not? The situation becomes more complicated when such acts are cast as omissions rather than commissions, which as suggested earlier, depends on one’s point of view. As a more concrete example, If President Trump passes a law which raises tax on domestic firms which use imports (an import tax) this is an act of volition – a tax which did not exist is now put in place by the government. But of course the raising of tax on certain firms but not on others (the ones which do not use imports in their production) has the effect of assisting some firms just as it punishes others. Should this be construed as a tax incentive for firms to use domestic goods over imported ones? Certainly. However, it is more likely to be viewed as a performance requirement (or negative incentive) rather than as a subsidy.<sup>55</sup> If, however, there had been a tax on all inputs from all sources (whether domestic or foreign) and President Trump lifted the tax with respect to domestic goods, then, while still an act of volition in as much as it required the passing of a law, this policy seems more like an omission because it is a pull-back from an existing regulation rather than the application of a new one, regardless of the fact that the effect on the competitiveness of firms is identical.<sup>56</sup>

The “inherent instability” of the “otherwise due” concept set forth in the WTO Subsidies Agreement, has been observed by commentators who stress that there may be cases where it is difficult to identify an appropriate “universal set of reference” against which to compare a particular domestic tax measure to determine the existence or extent of an alleged subsidy.<sup>57</sup> That is, it is always possible that there is no comparable income and a comparable taxpayer situation against which to judge whether a measure at issue

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<sup>55</sup> Performance requirements designed to favour the use of locally produced goods over foreign produced ones are known as “trade-related investment measures” and are governed through the WTO Agreement on Trade-Related Investment Measures. They will not be explored further in this article.

<sup>56</sup> This paradox is somewhat reflected in the use of the terms “tax incentive” (which suggests a deliberative action to lower tax burdens through the passing of new tax laws) and the often interchangeable “tax break” (which suggests the simple reduction in an existing tax owed).

<sup>57</sup> Benitah, *supra* note 27 at 188.

leads in revenue “otherwise due”. This exercise is even more problematic in the context of non-market or transition economies, where the “normal” situation, meaning the situation which would have existed without the subsidy is itself an artificial construct.<sup>58</sup>

### ***B. Lack of Expertise on the Panel and Appellate Body***

Given the factual difficulties discussed above, the panels’ and Appellate Body’s lack of tax expertise can further problematize the proof of foregone revenue.<sup>59</sup> Assessing a government’s entitlement to payment and the ensuing benefit from not collecting along with the conducting of comparability test arguably requires reasonably high level of understanding of tax law. As the panel and the Appellate Body agreed in *US-FSC*, the basis of comparison in determining what would otherwise have been due “must be the tax rules applied by the Member in question.”<sup>60</sup> But in order to apply the ASCM to these rules, the panel and the Appellate Body have to understand what these laws mean and how derogations from them in the form of tax breaks impact on an enterprise’s financial position and its standing relative to its competitors. Again, as the appropriate normative benchmark and counterfactual are legally complex concepts, they are also technically complex ones and it is far from certain that it is possible to appreciate these concepts without sufficient grounding in tax law, as would be found in most domestic tax courts.<sup>61</sup>

It could be asserted that the panel and the Appellate Body should not only be accustomed to tax issues at a general level in terms of their economic significance as agents of trade protectionism and international market distortions but, as a corollary, they should also have reasonably strong familiarity with the domestic tax laws of the relevant Member

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<sup>58</sup> This issue has been identified most closely with the levying of anti-dumping and countervailing duties against China. *See e.g.* D Ahn, J Lee, *Countervailing Duty against China: Opening a Pandora's Box in the WTO System?* 14 J. INT’L ECON. L. 329(2011).

<sup>59</sup> *See generally*, Jennifer E. Farrell. *The Interface of International Trade Law and Taxation* (IBFD, 2013); Yariv Bauner, *International Trade and Tax Agreement may be coordinated but not reconciled*, 25 VA. TAX. REV. 251 (2005); Li. Jinyan, *Relationship between International Trade Law and National Tax Policy: A Case Study of China*. *Bulletin for Int’l Tax.* 77, 87(2005).

<sup>60</sup> *See* Appellate Body Report, *Canada-Certain Measures affecting the Automotive Industry*, ¶ 90, WT/DS139/AB/R, WT/DS142/AB/R [hereinafter *Canada Auto*].

<sup>61</sup> For example in the US tax matters are handled by tax-specific federal courts: available at <https://www.ustaxcourt.gov/about.htm> (accessed Jan 24 2017).

state. Given the vast complexity of many countries' tax codes<sup>62</sup>, the only way this could be achieved effectively would be through the use of experts.

The need for expertise in various areas as an aid to dispute settlement is recognized in the WTO Dispute Settlement Understanding. This can be found in Article 13 ('Right to Seek Information') and additionally, in the context of subsidies, SCM Permanent Group of Experts (PGE) under the WTO SCM committee. The underlying rationale for panels' authority to seek expertise is that this authority is indispensably necessary to enable a panel to discharge its duty imposed by Article 11 of the DSU to "make an objective assessment of the matter before it, including an objective assessment of the facts of the case and the applicability of, and conformity with, the relevant [WTO] agreements".<sup>63</sup> Thus, panels' right to seek and advice under Article 13 of the DSU is foundational to ensuring that panels properly influence their function under Article 11 of the DSU. Yet, surprisingly, WTO panels and the Appellate Body made use of expertise in only 13 disputes.<sup>64</sup> Worse, as one in ten WTO cases involves tax issues, the WTO does not assign tax experts to adjudicate on tax-related disputes.<sup>65</sup> The WTO Secretariat did not appoint any tax experts in *US-FSC*, instead choosing three trade experts. It is difficult to escape the conclusion that, as difficult as the assessment of normative benchmark and the establishment of a suitable counterfactual are, this is virtually impossible without some prior experience of tax law or else significant assistance in the form of experts.

It is not clear why the panels are reluctant to request the assistance of tax experts. It is intuitively true that reaching harmonized and coordinated appreciation of international tax and trade rules is extremely difficult when experts in two different areas work together. It may have been difficult to find a geographically neutral panelist who is sufficiently

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<sup>62</sup> L Zelenak, *Complex Tax Legislation in the Turbo Tax Era*, 1 COLUM. J. OF TAX L. 91 (2010)

<sup>63</sup> Appellate Body Report, *US-Import Prohibition of Certain Shrimp and Shrimp Products*, ¶ 106 WT/DSWT/DS58/AB/R. *See also* Appellate Body Report, *Argentina-Measures Affecting Imports of Footwear Textiles and Other Items* ¶ 82,84,86 WT/DS56/AB/R and Corr.1.

<sup>64</sup> Garbrielle Z. Marceau & Jennifer K. Hawkins, *Experts in WTO Dispute Settlement*, 3 J. INT'L DISPUTE SETTLEMENT, 493, 494 (2012).

<sup>65</sup> In the response to the criticism of the permanent panel body, the flexibility of ad hoc selection offers an opportunity for parties to choose a higher quality panel than would be achieved through the use of a permanent panel body, *see* A.W. Shoyer, *Panel Selection in WTO Dispute Settlement Proceedings*, 6 J. INT'L ECON. L. 1, 208 (2003); For more reference on permanent panel body, *see* W.J Davey, *The Case for a Permanent Panel Body*, 6 J. INT'L ECON. L. 1 177 (2003).

knowledgeable of international tax, domestic tax and international trade issues.<sup>66</sup> In any event, just as panelists are not required to be trained lawyers and few have any knowledge of understanding of complex tax policy issues.<sup>67</sup> A Permanent Group of Experts (PGE) under the SCM Committee could help resolve this matter. Indeed, the use of a PGE is stipulated in the article 24 of the SCM agreement itself. To this end, the WTO SCM Committee—open to the participation of all Members—was charged with establishing, and did establish, a Permanent Group of Experts (PGE) comprising “five independent persons, highly qualified in the fields of subsidies and trade relations”.<sup>68</sup> It appears as though none of the panels has ever made use of the PGE so far.<sup>69</sup> Without adequate technical assistance, it seems quite likely that a panel or the AB would encounter major difficulties in investigate the nature of the tax obligations contained in complex domestic legislation for the purposes of assessing the revenue foregone element of subsidization.

### ***C. Difficulties in Identifying the Relevant Domestic Tax Law***

Finally, and linked to the above points, the assessment of revenue foregone has the added practical difficulty of the need for the relevant tax measure itself to be clearly identifiable for the purposes of a claim to be brought through the WTO Dispute Settlement System and subsequently adjudicated by the panels. It is far from clear that this is the case, particularly in relation to situations where existing tax laws are not enforced with respect to certain firms. While states have an incentive to disseminate the availability of favorable tax policies as an aid to the stimulation of foreign investment<sup>70</sup>, the forbearance of collecting revenues due from domestic firms as an aid to their trade competitiveness is the type of policy which can lead to international disapproval through fora like the WTO. Consequently there is an incentive to keep these laws opaque or to ensure that specific instances of uncollected revenue are not widely publicized.<sup>71</sup> One cannot escape the

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<sup>66</sup> Farrell, *supra* note 44, at 138.

<sup>67</sup> J. Waincymer, International tax and international trade policy objectives in L. Hinnekens & P. Hinnekens (eds), *A Vision of Taxes within and outside European Borders* 892 (Kluwer Law int'l, 2008).

<sup>68</sup> ASCM, *supra* note 5 at art 24.3.

<sup>69</sup> Marceau & Hawkins, *supra* note 49, at 499.

<sup>70</sup> Whether this actually works is debatable: see S James, “Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications” World Bank, September 2013 available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2401905](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2401905) (accessed January 2017)

<sup>71</sup> Of course there is a contrasting pressure on politicians to announce these laws boldly, as in recent statements from US President Donald Trump

conclusion that omission-style subsidies are perhaps even more difficult to identify than direct forms of subsidy such as grants or loans. Direct forms of subsidy would seem to require proactive communications between the state and the private enterprise expressing entitlement to a bonus or extra assistance. On the other hand, failures to collect revenue that is due could take the form of administrative oversights or neglect, which by their nature should be easier to “hide” particularly in countries lacking a tradition of transparency. Further studies into this aspect of unfair trade practices would be most welcome.

Transparency in trade laws is one of the pillars of the WTO. In the case of the ASCM, it is impossible for member states to take action against another members’ potential subsidization without being fully appraised of that members domestic policies which provide assistance to certain industries. The Trade Policy Review Mechanism (TPRM) plays a key role in this regard. As the main transparency instrument of the WTO, the TPRM allows members to monitor and evaluate the nature and extent of each-others’ trade-oriented regulations, including notifications regarding subsidization programs, with a view to achieving effective enforcement of obligations through the Dispute Settlement System.<sup>72</sup> TPRM periodic reviews of each members trade laws are conducted on the basis of a report prepared by the WTO Secretariat which itself is based largely on published sources.<sup>73</sup> This means that if the facts relating to a state’s subsidy of a specific enterprise is not disclosed to the public, it will be very difficult to ascertain its existence, let alone demonstrate causation in terms of its adverse trade effects on other members. While generally speaking the member governments as well as private sector representatives tend to cooperate well with the Secretariat during the preparation of these reports<sup>74</sup>, it is an inescapable conclusion that much of the data upon which a subsidies claim could be based may be inaccessible, either due to administrative failings such as poor coordination between various levels of government or because of intentional secrecy. Interestingly, the panel in *Australia – Automotive Leather* based some of their conclusions on reports of export subsidization found in local newspapers,<sup>75</sup> information which would have been otherwise unavailable.

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<sup>72</sup> S Laird and R Valdes, “The Trade Policy Review Mechanism” in A Narlikar, M Daunton and R Stern, *The Oxford Handbook on The World Trade Organization* 469 (Oxford University Press, 2012).

<sup>73</sup> *Id.* at 471.

<sup>74</sup> S Laird and R Valdes, *supra* note 57 at 473.

<sup>75</sup> Specifically *The Sydney Morning Herald: Australia – Automotive Leather* WT/DS126/R

This may be one reason why the subsidies cases which come before the WTO panels tend to be large, high profile disputes for which there is considerable media and public scrutiny, as well as a substantial record of documentation, such as in the Civil Aircraft dispute discussed above. Most instances of “revenue foregone” may well go un-noticed, or certainly do not reach the level of publicity required to substantiate a claim in an international tribunal.

#### **IV. Conclusions**

This article attempted to apply the theory of Omission Bias to the decisions of the WTO panels and Appellate Body concerning a narrow provision of the ASCM which listed “revenue foregone” was equated to the non-collection of taxes which would have normally been owed. The question was asked whether the manner in which WTO adjudicators approached this concept indicated a reluctance to infer subsidization in instances of omission (not collecting) as distinct from more direct forms of subsidization such as grants or loans. The results of this investigation are limited in that there is a very small sample of such instances in the WTO case law, leading to the interesting but untested suggestion that the lack of such claims may itself suggest Omission Bias (claimant states do not view this kind of subsidization as illegal) or perhaps more obviously, that these types of claims are perceived as harder to prove and therefore not worth the time and expense. In both cases, “revenue foregone” was held to constitute an illegal subsidy, seemingly dispelling the assertion that there is an Omission Bias at play in the WTO dispute settlement system.

Yet there is evidence that findings of omission-oriented subsidization may be less common than one would expect given the prevalence of these forms of incentives as instruments of economic policy. Rather than indicate the heuristic bias against finding liability when there has *only* been an omission, there are rational and highly practical reasons for the dearth of caselaw on this matter which are alluded to in the two existing decisions. The reasoning of the WTO panels and adjudicators in the two relevant cases where the test for “revenue foregone” is applied is manifestly complex, both legally and factually. In situations of trade distorting subsidies it is much harder to demonstrate liability

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(adopted 25 May 1999) at 7.178

for omissions (not collecting) than commissions (giving) because the former requires the extrapolation of a normative benchmark and a counterfactual. This difficult task is exacerbated by the fact that WTO panelists and Appellate Body members tend to lack tax expertise and do not appear to compensate for this by securing the assistance of experts. This is even further problematized by the evident dilemma in pinpointing the domestic revenue law from which there has been a derogation because such laws are either opaque or because specific instances of tax relief are not based on enacted regulations for which there are transparent disclosures but rather as instances of neglect which could be masked as a simple administrative oversight.

The lack of a greater number of omission-oriented subsidies WTO cases in which such policies are held as illegal under the ASCM may therefore be described as less of the deafening silence of Omission Bias in operation (disclosing the moral constraints of emotional adjudicators) than it is somewhat of a noisy murmur hinting more prosaically at the need for greater transparency and effective use of expertise.