

THE DISC CASE¹

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A. Introduction	1
1. The Origins of the DISC Legislation	2
2. The GATT Legal Problem	5
B. From Complaint to Legal Ruling: 1971-1976	9
1. The GATT is Told to Mind Its Own Business	9
2. The Complaint and the Counter-complaints	12
3. Establishing the Procedure	14
4. Waiting for the Panel	17
5. The Panel Ruling on DISC	18
a. The "Deferral" Defense	20
b. The Bi-level Pricing Defense	24
c. The Outcome	32
6. The Panel Ruling on the Counter-complaints	33
C. From Legal Ruling to Final Outcome: 1976-1984	39
1. The Initial Impasse: 1976-1978	39
2. Three Efforts to Resolve the Issues: 1978-1980	42
3. DISC's Last Stand: 1980-1984	45
4. Evaluating the Outcome	50
D. The Lessons of the DISC Case	55

A. INTRODUCTION

DISC stands for Domestic International Sales Corporation, the name of a 1971 law granting special tax benefits to United States exporters. In 1972, the European Community brought a lawsuit charging that the DISC legislation violated the GATT Article XVI:4 which prohibits export subsidies. The United States responded by filing three counter-complaints charging that, if DISC was in violation of GATT, so was the "territoriality" principle in the income tax laws of France, Belgium and the Netherlands. The four lawsuits, generally referred to as the DISC case, turned out to be a landmark event in the development of GATT law. The DISC case is considered by many to

¹ This description and analysis of the DISC case was published originally as *Reforming GATT Adjudication Procedures: The Lessons of the DISC Case*, 72 MINNESOTA LAW REVIEW 1443-1509 (1988). The present, slightly revised text is taken from Chapter V of the author's *ENFORCING INTERNATIONAL TRADE LAW: THE EVOLUTION OF THE MODERN GATT LEGAL SYSTEM* (Butterworths, USA 1993). Inconveniently, citations to GATT cases in the footnotes to this version refer the reader to the 240 page Appendix of Cases in that book, which is not included in this version. The footnotes to the original version contain full citations.

be the largest and most conspicuous failure in the history of GATT litigation. As often happens with dramatic failures, however, the DISC case has also exerted a strong influence on almost every aspect of modern GATT dispute settlement practice.

1. The Origins of the DISC Legislation

The origins of the DISC case lie in the deteriorating trade and payments position of the United States in the late 1960s and early 1970s. In August 1971, the United States responded to the crisis by abandoning its promise to redeem U.S. dollars for a fixed quantity of gold.² At the same time, it announced a package of other trade and payments measures designed to improve its balance-of-payments position. The proposed DISC law was part of the package.

The DISC legislation was an effort to encourage exports by lowering income taxes on profits from exporting. It achieved this objective in the following rather roundabout manner: Exporters were invited to create a separate domestic corporation, a DISC, which was just a paper shell with no assets, no employees and no business function other than lowering taxes. Exporters were then permitted to "sell" their export goods to the DISC, and then to have the DISC "resell" the export goods to the ultimate foreign buyer. The profits from the two-step sale transaction would then be divided between the DISC and its parent company, according to one of several formulas in the statute. The profits attributed to the DISC would then be divided in half. One half of the DISC's profits would be deemed distributed back the exporter, and the exporter would pay income tax on them. Taxation of the other half of the DISC's profits would be "deferred."

² N.Y. Times, 16 August 1971, p. 14, col. 1 (text of President Nixon's statement). See generally Kenneth W. Dam, *The Rules of the Game: Reform and Evolution in the International Monetary System* (Chicago: University of Chicago Press, 1982).

Deferral was a tricky concept. It meant that the exporter's income tax liability for the other half of the DISC's profits was not being totally forgiven. Liability was just being suspended -- for as long as the profits were retained inside the DISC and were used only for export-related business. No interest was charged on this suspended liability. After some hesitation, business executives and their accountants began to ignore the contingent tax liability, and to treat the yearly tax savings as permanent gain that could be reported as corporate earnings. This accounting judgment was based on a political judgment that the Congress would in fact honor the law's promise of perpetual deferral.

Under the 1971 version of the law, the most commonly used formula resulted in deferring taxes on 25% of the exporter's total export profits. Under less generous allocation formulas adopted after 1976, the average deferral was about 17-18% of the exporter's total export profits.³

DISC was more than an emergency balance-of-payments measure. More than a year before the August 1971 crisis, the U.S. Treasury Department had proposed DISC as a tax reform measure.⁴

The Treasury Department had then taken the position that DISC was necessary to correct for several kinds of competitive disadvantage that United States exporters were experiencing due to differences between United States and foreign tax laws. The one disadvantage referred to repeatedly in the GATT lawsuit was the so-called "tax haven" problem.

³ The original DISC law is Sections 501-507, Revenue Act of 1971, Public Law No. 92-178, 85 Stat. 535 (1971), codified as amended in 26 U.S.C. §§ 991-997 (1982). In 1976, the DISC law was amended to limit the tax exemption to profits earned on increased imports -- that volume of exports which exceeded 67 percent of the average volume of exports during a four-year base period beginning seven years prior to the tax year in question. Section 1061, Tax Reform Act of 1976, Public Law No. 94-455, 90 Stat. 1649 (1976), 26 U.S.C. § 995 (1982). In 1982, the law was amended again to reduce the share of DISC income eligible for tax deferral from 50 percent to 42.5 percent. Section 204(a), Tax Equity and Fiscal Responsibility Act of 1982, Public Law No. 97-248, 96 Stat. 324 (1982), 26 U.S.C. § 291(a)(4) (Supp. 1985). The estimate that the amended DISC resulted in deferral of taxes on approximately 17-18% of total export income was made by the United States in a statement to the GATT Council. C/M/159 (meeting of 29-30 June 1982). See also Staff of the Senate Finance Committee, Deficit Reduction Act of 1984: Explanation of Provisions Approved by the Committee on March 21, 1984, Committee Print 89-169, 89th Cong., 2d Sess. (1984) at 633 [hereinafter cited 1984 Senate Report].

⁴ A 1970 bill containing DISC passed the House but failed to pass the Senate. Sections 401-408, H.R. 18970, 91st Cong., 2d Sess. (1970).

A tax haven is a country which offers low or zero income tax rates to certain firms the government is seeking to attract. Exporters use tax havens in the much same way that DISCs were designed to be used. They set up a branch or a wholly owned subsidiary corporation inside the tax haven country. They then sell export goods, at the lowest possible price, to the tax-haven branch or subsidiary, which then resells the goods to the ultimate foreign buyer. The sale to the subsidiary is normally just a paper transaction, with the goods moving straight from the exporter to the ultimate foreign buyer. The fictitious sale allows some of the profits to be transferred to the branch or subsidiary in the tax-haven country. If the tax laws of the home country do not intrude, some of the exporter's profit escapes with little or no tax. According to U.S. testimony before GATT in the DISC case, the tax saving is commonly as much or more than the saving resulting from DISC's 25% (or 17%) deferral.⁵

Prior to 1962, United States exporters had generally been able to enjoy tax benefits from tax-haven transactions.⁶ In that year, however, the tax benefits were taken away by a new part of the Internal Revenue Code known as Subpart F.⁷ Under Subpart F, income of foreign subsidiaries derived from certain tax-avoiding types of tax-haven transactions, including the fictitious sale-resale transaction described above, was taxed as part of the parent company's income.

In many other countries, however, the tax benefits of tax-haven operations have been available for decades under what is called the "territoriality" principle. In simplest terms,

⁵ C/M/159 (meeting of 29-30 June 1982).

⁶ Unlike some "territorial" European tax laws which do not tax the income of a company's branches in other countries, U.S. law allowed separation of the income of the tax-haven entity, only if it was a separate corporation incorporated abroad. And unlike some European laws which allow the parent to repatriate the foreign profits without being taxed, U.S. law treated repatriated profits as taxable income to the parent; to escape U.S. income taxation, the income of the separate tax-haven subsidiary had to remain abroad.

⁷ Internal Revenue Code, §§ 951-964 (1982).

"territoriality" means that the government does not tax income earned outside the country's territory, nor does it impose more than a token tax on the proceeds of such foreign earnings when they are remitted to the home country. After 1962, exporters in countries following the territoriality principle were still able to use tax havens to reduce their income tax, while most United States exporters were no longer able to do so. The DISC was meant to eliminate this tax disadvantage.⁸

The fact that DISC was rooted in a concern for tax equity was of critical importance in the GATT lawsuit. Because the Treasury Department believed strongly in the legitimacy of the law's tax equity objective, it defended DISC with an intensity considerably greater than that expended on the typical beggar-thy-neighbor trade measure. Indeed, the United States never yielded on that point.

Unfortunately, the United States could not resist trying to capture a small balance-of-payments advantage as well. Instead of simply exempting tax-haven export sales from Subpart F, the new law created a domestic tax haven -- the DISC -- and required that the fictitious sale-resale transaction be made with the DISC. This was done to reduce the outflow of dollars by keeping all the export profits within the United States. The "domestic" character of the DISC distinguished it from the tax-haven benefits under the territoriality principle. That distinction would be DISC's undoing in GATT.

2. The GATT Legal Problem

⁸ A Treasury Department publication described DISC as "an effort to increase exports and improve balance of payments by placing U.S. exports on a more equal tax footing with their foreign counterparts." U.S. Department of the Treasury, The Operation and Effect of the Domestic International Sales Corporation Legislation, 1974 Annual Report (Washington: 1976) p. 1.

GATT Article XVI:4 prohibits governments from granting subsidies on the export of all products except primary products:

... contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market.⁹

In trade policy terms, a "subsidy" is any advantage which distorts the market behavior of the recipient in favor of the subsidized transaction. A 1960 report adopted by the GATT Contracting Parties concluded that selective remission or exemption of income taxes with respect to exported goods was an export subsidy within the meaning of Article XVI:4.¹⁰ Although Article XVI:4 was then in force for only about seventeen developed countries, the United States was one of those seventeen.¹¹

There were three possible defenses to the charge that DISC violated Article XVI:4. The most obvious defense was the claim of substantial equivalence -- that the DISC merely gave U.S. exporters the same tax benefits that exporters in other countries had been deriving from tax-haven transactions under the "territoriality" principle. Under the territoriality principle, however, the exporter could shield income from taxation only to the extent it could demonstrate that the income was created by some economic activity located abroad. The DISC law required no such separately

⁹ The GATT obligation with regard to export subsidies on primary products is stated in Article XVI:3; governments undertake to "seek to avoid" using such subsidies, and cannot use subsidies that result in the subsidizing party having "more than an equitable share of world export trade in that product." Although DISC applied to exports of primary as well as nonprimary products, no claim that DISC violated Article XVI:3 was ever made.

¹⁰ GATT, BISD 9th Supp. 185 (1961).

¹¹ The history which led to the adoption of Article XVI:4 by only a part of the GATT membership is discussed in John H. Jackson, *World Trade and the Law of GATT* (Indianapolis: Bobbs-Merrill, 1969) pp. 372-74. The drafting history of Article XVI:4 is described at length at notes 43-58 *infra*.

identified foreign activity. The success of this first defense would depend on whether the United States could establish that this domestic-foreign distinction made no difference.

The other two possible defenses were of a more technical character. One was weak, the other strong. The weak technical defense was based on the fact that DISC merely deferred tax liability, rather than granting an outright "exemption" or "remission" -- the terms used to describe income tax subsidies in the 1960 GATT report referred to above. The defense was weak because the distinction was almost totally lacking in substance. The deferral of taxes on DISC income was intended to create exactly the same sort of market-distorting economic incentive as conventional tax subsidies. Moreover, it was actually having that effect, for businesses were in fact treating the deferral as a permanent exemption. The only real question raised by this defense, it seemed, was whether the GATT's legal process would have enough decision-making capacity to cut through the smokescreen.

The stronger technical defense arose from the condition stated in Article XVI:4: an export subsidy is prohibited only when it "results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market." Proving this price effect requires two additional showings: (1) that the export price of the subsidized product is lower than its domestic price, and (2) that the difference is the "result" of the subsidy. This requirement is usually referred to as the "bi-level pricing requirement."

Bi-level pricing is very difficult to prove. For any product, there are usually many transactions at different prices in both domestic and export markets, each transaction having some distinctive characteristics that could justify some or all of the price difference from other transactions. Moreover, even where that the export price is clearly lower, it is extremely difficult to determine whether the lower price is the "result" of the subsidy. Most export prices are set by

market forces in the country into which that exporter is selling. If exports occur, they will occur at that market price, whether or not there is a subsidy. Even in cases where export subsidies can have a causal effect -- that is, where market-determined export price is not high enough to cover costs -- it is extremely unlikely that an income tax subsidy like DISC could induce such export sales, because relief from income tax liability can never change a losing transaction into a profitable one. The only case where an export subsidy could have a causal effect is where the market-determined export price does not yield an adequate rate of return over the long run.

Notwithstanding the apparently insurmountable proof requirements imposed by the bi-level pricing defense, it had one glaring weakness. It made no sense as a matter of policy. The reason for barring export subsidies was that they harmed producers in the importing country by encouraging export transactions that would not normally take place. An export subsidy could create such harmful effects whether or not it caused lower export prices, simply by increasing the volume of exports. At the time the DISC case began, most of the countries obligated under Article XVI:4 shared this view. Just a few years later, in 1979, they would in fact eliminate the bi-level pricing requirement by adopting a new "Subsidies Code" containing a rewritten version of Article XVI:4 without it.¹²

The bi-level pricing defense would thus pose a classic test for the GATT legal system -- a legal norm which is clearly stated in the legal text, but which is just as clearly regarded to be wrong.

¹² The restatement of the Article XVI:4 obligation on export subsidies is found in Article 9:1 of the Subsidies Code. Article 9:1 says, flatly and without qualification, "Signatories shall not grant export subsidies on products other than certain primary products."

B. FROM COMPLAINT TO LEGAL RULING: 1971-1976

1. The GATT is Told to Mind Its Own Business

The DISC case began in an atmosphere of major crisis. The United States repudiation of its promise to redeem dollars in gold was an event that shook the world trading system, and the shock was magnified even further by the package of other trade-distorting measures announced at the same time. President Nixon announced the measures on 15 August 1971, and the United States gave formal notice in GATT the following day.¹³ The GATT Council met in emergency session on 24-25 August,¹⁴ a working party met from 6 to 11 September to examine the problem further, and the working party's report was then discussed at another special Council meeting on 16 September.¹⁵

The initial United States notice to GATT on 16 August had mentioned DISC as one of the emergency measures proposed, but at the Council meeting the following week, the United States delegation changed course, did not mention DISC at all, and tried to block further consideration of the DISC proposal. It had been agreed that the working party would examine the ten percent surcharge and "other measures in the United States Programme of a nonmonetary nature which have a direct impact on international trade."¹⁶ The United States stated it could accept the terms of reference, but only with the understanding that the "programme" referred to would be confined to the

¹³ L/3567 (16 August 1971).

¹⁴ C/M/71.

¹⁵ The report of the working party was divided into three documents. The report on the 10% surcharge imposed by the U.S. is L/3573 (13 September 1971), reprinted in GATT, BISD 18th Supp. 212-23 (1972). The working party also produced a "note" concerning the exchange of views about the proposed DISC legislation, L/3574 (13 September 1971), and a "record" of the exchange of views about another proposed measure called the Job Development Tax Credit, L/3575 (13 September 1971). In the Council meeting that followed, the Council "adopted" the surcharge report and "took note" of the latter two documents. C/M/72 (meeting of 16 September 1971).

¹⁶ C/M/71 (meeting of 24-25 August 1971).

measures discussed in its opening statement that day -- the list of measures that, this time, did not include DISC.

When the working party met, other governments refused to exclude DISC from the discussion. The European Community and Canada expressed the view that DISC would be GATT-illegal, and Switzerland and Sweden added more general expressions of opposition (including a prophetic warning that, once enacted, an economy-wide tax benefit like DISC would be next to impossible to repeal). The statements concerning the DISC proposal were recorded in a separate GATT document.¹⁷ The United States objected to the working party discussion of DISC, objected to the issuance of the GATT document recording the discussion, and objected to the Council's subsequent decision to "take note" of the document.¹⁸

The conspicuously uncooperative attitude of the United States was apparently due to a jurisdictional problem in Washington. In the United States government, as in most others, a jurisdictional line exists between the matters which belong to the finance minister (the Treasury Department) and those which belong to the trade minister (formerly the State Department, and since 1962 the United States Trade Representative, or USTR). Trade ministers are supposed to deal with trade measures, and they meet together in GATT. Finance ministers deal in the more elite area of fiscal and monetary matters, and they meet in the IMF and the OECD. Finance ministers tend to outrank trade ministers, and so tend to be in charge of where the line is drawn. In this case, the Treasury Department viewed DISC as an exercise of a Treasury Department responsibility -- the elimination of economic frictions due to the interface of national tax systems. Treasury officials had

¹⁷ L/3574 (13 September 1971).

¹⁸ C/M/72 (meeting of 16 September 1971).

their own system of international relations for dealing with such issues. There was no reason to discuss the DISC legislation in GATT.

The Treasury Department eventually had to bow to the international obligations of the United States requiring that export subsidies, including tax subsidies, be dealt with in GATT. But it would do so only grudgingly, and only on its own terms. Within the U.S. government, the Treasury Department would insist on managing the GATT lawsuit itself. It would devise the strategy of bringing three counter-complaints against the "territoriality" tax systems of France, Belgium and the Netherlands. Moreover, it would insist that the Treasury Department's General Counsel argue all four cases before the GATT panel -- the only time, to the author's knowledge, that the United States has ever been represented by an outside department in such proceedings.

Within GATT, the Treasury Department would insist on bringing the GATT adjudication procedures up to finance ministry standards. It would first insist that the four cases be heard by the same panel, so that Treasury's point about the identity between DISC and the three European tax systems would be sure to be understood. Once that was done, Treasury would then insist that the panel include at least one tax expert -- someone with the capacity to understand the finer points of international tax policy.

2. The Complaint and the Counter-complaints

The DISC law was enacted in late 1971 and came into force at the beginning of 1972. On 4 February 1972, the European Community presented the United States with a request for bilateral consultations under GATT Article XXIII:1, the first step in a GATT lawsuit.¹⁹ The Community request was made bilaterally, without formal notice to GATT.

The Community's legal complaint was not in keeping with its generally negative attitude toward formal legal claims. A common speculation, which would arise repeatedly throughout the case, was that the Community was less interested in DISC than in the possibility of embarrassing the United States, as a way of reducing the uncomfortable number of U.S. legal claims against the European Community during this period.

If the Community's bilateral complaint had been meant to dampen United States legal ardor, it did not have that effect. In May, the United States responded with a similar bilateral request for Article XXIII:1 consultations with France, Belgium and the Netherlands, claiming that the "territoriality" features of their income tax laws resulted in at least the same tax subsidy to their exporters that DISC was granting to U.S. exporters.²⁰ Like the EC request for consultations, this action was not notified to GATT.

The strategy behind the three United States counterclaims appeared to be somewhat ambivalent, an ambivalence that could be said to be characteristic of DISC itself. On the one hand, there was an obligation to defend DISC, for DISC was a law passed by the United States Congress. The best defensive strategy was to link DISC firmly to the three European laws, and hope the

¹⁹ The consultation request is described in the Community's subsequent Article XXIII:2 complaint, L/3851 (1 May 1973).

²⁰ The consultation request is described in the United States' subsequent Article XXIII:2 complaint, L/3860 (17 May 1973).

Europeans would not budge. On the other hand, DISC had never been viewed as optimal tax policy; it was an evil made necessary by the evils of other tax laws. If the tax policy experts could have had their way, they would have followed the Subpart F policy of international tax neutrality to the end, and would have eliminated both DISC and the European "territoriality" systems. The way to satisfy this optimal policy was to adopt an offensive posture and to press the counter-complaints to the fullest, even if doing so brought down DISC in the process.

As a practical matter, the three United States counter-complaints seemed primarily intended to be defensive. European governments were unlikely to accept a legal ruling holding the territoriality principle GATT-illegal, for territoriality was a basic principle of their entire income tax structure. The main body of the United States legal position tended to confirm this defensive posture, for the United States frequently presented legal arguments, such as its bi-level pricing defense, which also undercut its counter-complaints that "territoriality" systems were GATT-illegal.

On occasion, however, there appeared to be another voice speaking for the United States. The United States repeatedly presented its case in negative terms which focused on the possibility of mutual illegality -- "If DISC is illegal, then so are the European systems." The United States also seemed willing on occasion to place DISC at risk by actively pressing arguments against the legality of the European tax systems which weakened the legal defense of DISC as well.

One of the irritants which drew United States officials into this more dangerous attacking posture was their conviction that the European tax systems really were granting greater subsidies than DISC. According to U.S. tax experts, the European laws permitted exporters to shift an unjustifiably large share of their export income to tax-haven entities because they permitted underpricing the goods "sold" to those entities. United States tax practice, by comparison, was to

apply fairly rigorous "arm's length pricing" standards. The U.S. tax officials found it particularly irritating, therefore, to be accused of subsidizing by European tax officials who, they believed, were actively promoting even greater subsidies at home.²¹

The ambivalence in the United States legal position would last to the very end of the case. The offensive posture would eventually have a significant effect on the outcome. In an effort to preserve its case against the European laws, the United States would make some concessions that would help to undermine its best defense for DISC.

All this was still in the future, however. First, the complaints had to move forward to adjudication. This alone would take almost four more years.

3. Establishing the Procedure

The two sets of bilateral consultations were not held until July 1972. The delay was caused by U.S. insistence on having its counter-complaints discussed at the same time. By itself, the request for parallel treatment was not unreasonable, for DISC has been enacted expressly for the purpose of offsetting a perceived inequity in these other laws. What was ominous, however, was the suggestion that the United States would have refused to participate in the proceeding if its demands had not been met. An obligation to consult is not worth much if the object government is allowed to impose conditions unilaterally.

The July 1972 consultations did not produce a solution. The European Community then allowed the issue to remain dormant for almost a year. The Community may have had second

²¹ Treasury officials had for some years been building a large dossier on European shortcomings in this area, including, *inter alia*, published administrative guidelines in France expressly calling for relaxation of arm's length pricing standards where export transactions were involved.

thoughts about compromising its antilegalist position; it may simply have needed more time to coordinate positions with the tax authorities of France, Belgium and the Netherlands; or it may simply have wanted to wait and see whether the domestic opposition to DISC inside the U.S. government, which was considerable, might lead to repeal for internal tax policy reasons.

On 1 May 1973, the Community stopped waiting and submitted a written request asking the Contracting Parties to rule, under Article XXIII:2, on its claim that DISC violated GATT Article XVI:4.²² The United States replied on 17 May with its own Article XXIII:2 request, asking the Contracting Parties to rule on its three similar complaints against France, Belgium and the Netherlands.²³

It took three months for the parties to reach agreement on the procedure for handling these complaints. The normal procedure would have been to appoint a panel to rule on the legal issues in each complaint. The Community so requested. Although the United States was normally the GATT's most ardent supporter of the panel procedure during this period, in this case it proposed deferring the litigation phase for six months or so in order that the four complaints might first be sent to a negotiating body, such as a working party consisting of all interested governments. The practice of not taxing export income, the United States explained, was common to many other tax systems, and adjustment of all these tax laws would never be easy. It would be wiser, therefore, to begin by examining the general phenomenon in a negotiating body which might be able to identify a general solution suitable for everyone.²⁴

²² L/3851 (1 May 1973).

²³ L/3860 (17 May 1973).

²⁴ C/M/87 (meeting of 29 May 1973).

When this idea failed to obtain support, the United States accepted the creation of a panel, but only on condition that a single panel hear all four complaints, and that the panel have at least one tax expert. The EC objected, stating that the usual practice of separate panels for separate complaints should be followed. The procedural deadlock was settled by an agreement to create a five-member panel to hear the four legal complaints. The panel would have at least one but not more than two tax experts. To keep the cases formally separate, the panel would be treated as four separate panels. But all four panels would have identical members, all four cases would be heard at the same times, and all four panel reports would be issued simultaneously.²⁵

The result was a victory for the position that a complaining party should always have a right to adjudication of its legal claims by a panel if it insists. But the United States had also won its basic point by creating the procedural linkage between adjudication of the four cases. It had also won small edge for its substantive theory by obtaining agreement to the tax experts; their appointment to the panel, a distinctive departure from normal practice, would tend to affirm the U.S. view that the case turned on being able to understand and compare the actual operation and effects of the tax laws in issue.

On balance, the bullying conduct of the United States tended to overshadow the victory for the panel procedure. Once again, the United States had simply refused to go forward unless its various conditions were met. The right to a panel becomes quite hollow if defendants can impose conditions at will.

The GATT's response to the United States' conduct proved to be one of the better legacies of the DISC case. Over the years, governments have gradually restrained the veto powers that come

²⁵ C/M/89 (meeting of 30 July 1973).

with the practice of consensus decision-making. These restraints have been slowly worked into GATT practice, driven by a more effective consensus among the GATT membership about the need to respect the complainant's right to a prompt hearing. The DISC example has been one of the focal points of that consensus; things which smell of DISC-like tactics now bring a sharp and quick negative reaction.²⁶

4. Waiting for the Panel

GATT records contain no mention of the DISC case by either party between the July 1973 Council decision to establish the panel and November 1975 when the European Community first complained of the delay in appointing panel members.²⁷ It was not until February of 1976 that the five members of the panel were actually appointed.²⁸ The panel consisted of three diplomats from GATT delegations in Geneva and two professors of public finance, one from the London School of Economics and one from the University of Turin.

The official explanation for the delay was the difficulty of locating tax experts who understood the case, were acceptable to the parties and were willing to serve.²⁹ Staffing the panel was undoubtedly difficult, as is shown by the United States decision to accept the two European tax experts. According to participants interviewed by the author, the U.S. Treasury Department remained insistent to the end on finding experts who knew the European tax systems well enough to

²⁶ Procedural improvements stimulated by the DISC case have been reflected in legal texts adopted in 1979, 1982 and 1988. These texts are described in: Chapter IV, Part G; Chapter VIII, Part F(1); and Chapter X, Part B(4).

²⁷ C/M/110 (meeting of 21 November 1975); SR.31/2 (meeting of 26 November 1975).

²⁸ C/M/112 (meeting of 17 February 1976).

²⁹ SR.31/2 (meeting of 26 November 1975) (statements by the GATT Director General and the U.S. representative).

understand how they operated in fact, and who could thus understand the Treasury Department's legal theories equating those laws to DISC.

It is extremely doubtful, however, that the search for panelists caused the full two and a half year delay. For long periods during this delay, the Community did not appear very concerned about going forward. Part of the reason may have been that pressure in Washington to repeal the DISC started rising again. The Congress did take the knife to DISC in 1975 and again in 1976, but the result in both cases was only to reduce the level of the tax benefits.³⁰ A second reason may have been reluctance to press the attack on DISC while the U.S. trade legislation authorizing participation in the Tokyo Round was pending. The Congress did not enact the legislation until the very end of 1974.³¹

Even though these two political factors probably had more to do with the delay than did the problem of finding panelists, the DISC case is still remembered as a case where esoteric demands about the composition of a panel caused extraordinary delay. As another highly visible lesson about the potential evils of abusing the veto power, the remembered version has had a useful impact. It has led to increased attention when unreasonable demands are made, and a series of GATT Council decisions seeking to improve the panel selection process.³²

5. The Panel Ruling on DISC

³⁰ Exports of certain scarce resources were excluded from DISC benefits by Section 603, Tax Reduction Act of 1975, 89 Stat. 26 (1975). The Tax Reform Act of 1976, see note 3 supra, limited DISC benefits to income from increased exports.

³¹ Trade Act of 1974, 88 Stat. 1978 (1975).

³² See Chapter VIII, Part F(2) and Chapter X, Parts B(4) and C(1).

By February 1976, the five-member panel was in place. The first hearing took place on 16-18 March, at which time the panel heard from the parties and also from Canada in support of the complaint against DISC. The panel met again from 28 June to 1 July to hear rebuttals, and again in camera from 26 to 30 July. The panel then completed work without coming together again, by means of a "postal procedure" of its own creation. The panel's four separate reports on the four complaints were issued on 2 November 1976.³³

The panel's report on the DISC complaint came to a carefully worded conclusion that "the DISC legislation in some cases had effects which were not in accordance with the United States obligations under Article XVI:4."³⁴ From the moment it was issued, however, the panel report was treated as a finding that DISC as a whole would have to be changed. No one ever requested a more precise definition of the "some cases" or asked that the remedy be limited to them.³⁵

Logically, the analysis leading to the panel's conclusion divided into two major issues. The first issue was whether, standing alone, DISC was inconsistent with the provisions of Article XVI:4. This first issue involved the validity of the two technical defenses, deferral and bi-level pricing; the DISC report concluded that neither defense was valid. The second issue was whether the existence of similar tax subsidies in the three European tax laws could somehow exonerate or otherwise justify DISC. This second issue collapsed when the panel ruled, in the three other cases, that the European

³³ L/4422 (DISC), L/4423 (France), L/4424 (Belgium), and L/4425 (Netherlands). The four reports are reprinted in GATT, BISD, 23d Supp. (1977), at 99 (DISC), 114 (France), 127 (Belgium) and 137 (Netherlands). Hereinafter, the reports will be cited only to paragraph number and page citations in BISD.

³⁴ GATT, BISD 23rd Supp. 113, paragraph 74 (1977).

³⁵ There was one moment, in the first Council meeting, when the delegate of Argentina mentioned that the report "often referred only to some aspects" of the challenged laws, and suggested that the panel's conclusions were "not final." C/M/117 (meeting of 12 November 1976) (quotation from summary record). The delegate from Argentina never spoke in any of the subsequent Council meetings. No other delegate ever mentioned the matter.

tax laws were also inconsistent with Article XVI:4. The DISC report itself never had to address the second issue, except to say that one violation did not justify the other. The crux of the DISC report, therefore, was the panel's rejection of the two technical defenses.

The panel's rulings on the two technical defenses have been criticized quite severely, on the ground that the reasoning behind each finding was vague, incomplete, and in several respects logically flawed.³⁶ Although the logical shortcomings of the panel's analysis are quite evident, closer examination shows that they were not really the sort of analytic failure they appeared to be.

a. The "Deferral" Defense

The most important issue with regard to DISC's gimmick of deferring tax liability was not whether deferral of tax liability was a subsidy, but how large a subsidy it was. There was no doubt that deferral of taxes without interest represented a subsidy to the extent of the foregone interest. But a ruling limited to the interest subsidy would substantially understate the actual money value of the DISC subsidy to exporters. Firms were treating deferral as though it were a complete exemption from tax liability. If the true value of the subsidy could somehow be established, it would change the dimensions of the problem, making it possible to characterize DISC as a serious violation with meaningful commercial impact.

Every interested GATT delegation probably recognized that deferral was just a smokescreen, and was prepared to treat the DISC subsidy as tantamount to a full exemption. The problem was whether the panel had a sufficient basis for reaching a formal finding to that effect. The United States was insisting that the contingent tax liability was a material risk that reduced the subsidy's real

³⁶ See John H. Jackson, *The Jurisprudence of International Trade: The DISC Case in GATT*, 72 *American Journal of International Law* 747, 764-71 (1978).

value, and a government's representations about the meaning of its own laws could not be casually dismissed. Evidence to support a contrary conclusion was not easy to come by, because the subsidy's actual value turned on a political judgment about the likelihood that the U.S. Congress would not change its mind.

According to GATT lore, GATT panels are supposed to be good at this sort of practical judgment. Panelists are chosen, it is said, not for their legal expertise--they are often not lawyers -- but for their practical wisdom about real-world phenomena. The reality is somewhat different. When confronted with having to rule on the legality of another government's action, even pragmatic people begin to worry about the juridical soundness of what they are doing. Indeed, they probably worry more than well-trained lawyers would, for diplomats and other laymen tend to have an exaggerated notion of the objective foundation required for legal conclusions.

GATT panels had confronted this problem often in the past, and they had typically tended to take a rather limited view of the kind of decisions they could make stick on their own authority. The caution was greatest in the early days of GATT, in the late 1940s and early 1950s, when the legitimacy of the GATT itself was a touch-and-go thing in many capitals. In response to these concerns, GATT panels and their Secretariat advisors had developed a style of vague, almost impressionistic, decision-making that merely suggested the adverse ruling, leaving it to subsequent review and enforcement proceedings to make something more of it.³⁷ This artful style of decision making had to some extent become institutionalized, being embodied in a vocabulary and syntax that was passed from one generation of panel members and Secretariat staff to the next.

³⁷ Five detailed case studies of early GATT legal decisions are presented in Robert E. Hudec, *The GATT Legal System and World Trade Diplomacy*, 2d ed. (Salem, N.H.: Butterworths, 1990) Chapters 11-15.

The DISC panel responded to this problem the way that most GATT panels had done in the past. The panel report left it rather vague as to exactly what the subsidy was, and how large it was. The report said clearly enough that the foregone interest was a subsidy,³⁸ but did not say whether deferral involved any other element of economic gain. The panel then went on to drop some elliptical remarks suggesting that the effects of the undefined subsidy were quite substantial:

The Panel noted that the United States Treasury had acknowledged that exports increased as a result of the DISC legislation and the Panel considered that the fact that so many DISC's had been created was evidence that DISC status conferred a substantial benefit.

The panel noted that the DISC legislation was intended, in its own terms, to increase United States exports³⁹

That is all the panel said. The panel never stated clearly what conclusion it had drawn about the nature or the size of the subsidy, much less why.

Evasive decisions such as this can certainly be criticized as poor legal craftsmanship. Oddly enough, however, the GATT experience up to that point had been that they tended to work rather well. What made them work was the fact that the GATT member governments, to whom such decisions were addressed, usually knew the answer anyway. Governments would supply the missing parts of the conclusion in the reviewing process that followed, by treating the decision as though it had said clearly what in fact it had only implied.

By 1976, the GATT was beginning to outgrow this ultracautious decision-making style. The need for caution was less, because by then governments had come to accept GATT and its law as a

³⁸ GATT, BISD 23d Supp. 113, paragraph 71 (1977).

³⁹ Id., at 112, paragraphs 68-69. According to a subsequent European Community statement, as of September 1976 some 9090 DISCs had been created, approximately 75 percent of U.S. exports in fiscal 1976 had been channelled through DISCs, and U.S. estimates indicated that DISC had increased exports by \$8 billion. GATT Doc. C/M/119 (meeting of 2 March 1977).

necessary part of the international order. Moreover, there was less reason to rely on the underlying consensus to do the work, because the GATT of the 1970s was a much looser and more contentious sort of association. Surprisingly, however, the old technique still worked as far as the DISC defenses were concerned. From the moment the DISC panel report was published, there was never any debate over the subsidy finding. The GATT membership simply knew that deferral was a sham, and the United States had enough sense not to argue against that consensus once the panel had rejected the U.S. position. The panel's few remarks indicating the necessary conclusion, inadequate though they were, had been enough to remove the deferral defense from further consideration.

The diplomatic style of decision making was on its way out, however. Subsequent efforts to use their techniques have come to grief in several cases where a contentious defendant succeeded in overcoming the suggested decision by insisting on the letter of what was not said.⁴⁰ More important, as governments began to increase the visibility of GATT adjudication procedures, the old style of decisions have come to be viewed as a sign of legal weakness, a surrender by the panel to anticipated resistance by the defendant. Among the new procedural norms adopted by the Contracting Parties is one that specifically asks panels to reach clearer decisions.⁴¹ In view of expectations for today's dispute settlement procedure, the old impressionistic technique will today normally have the effect of diluting rather than strengthening the consensus supporting any legal ruling.⁴²

⁴⁰ The clearest example was a pair of 1978 complaints against the European Community's export subsidy on sugar, brought by Australia and Brazil. Appendix, Complaints 86 and 87. The Appendix entries cite several published accounts of these two cases.

⁴¹ "The terms of reference of a panel should be formulated so as to permit a clear finding with respect to any contravention of GATT provisions and/or on the question of nullification and impairment." GATT, BISD 29th Supp. 14 (1983).

⁴² In a 1980 article, the author took the position that the old impressionistic technique could play a useful role by avoiding the head-on collisions invited by "wrong cases" -- lawsuits making legal demands that cannot be met politically. Robert E. Hudec, GATT Dispute Settlement After the Tokyo Round: An Unfinished Business, 13 Cornell International Law Journal 145, 189-92 (1980). Viewing the issue again in the light of the developments in GATT adjudication over the past ten years, the author would not make the same judgment about a "wrong case" brought in the present-day GATT. A clear decision may still produce an undesirable collision

b. The Bi-level Pricing Defense

The issue of bi-level pricing presented the panel with an even more difficult decision-making problem -- an express condition that appeared impossible to satisfy, but which most GATT members considered to be wrong in the first place. The panel resolved this issue in the same way it resolved the deferral issue. The panel report contained a few vague paragraphs suggesting a finding that the bi-level pricing requirement had probably been satisfied in some cases, and on this basis concluded that DISC had been shown to be in violation of Article XVI:4 "in some cases." Once again, the answer worked. The panel had again said enough for the underlying consensus to attach, and from the moment it was issued the panel report was treated as a clear ruling that the bi-level pricing requirement was satisfied. In six years of further debate about the decision, nothing further was said about the bi-level pricing defense.

The panel's ruling on the bi-level pricing issue offers a rather striking example of the power of consensus in GATT adjudication -- the power that ultimately supplies the force behind all legal decision making in GATT. The consensus was not hard to understand. As pointed out earlier, the bi-level pricing requirement made no sense as a matter of policy. Export subsidies are equally harmful whether they induce lower prices or greater volumes at existing prices; the latter effect is actually the more prevalent.

What is interesting about this particular consensus is that it appears to have already been in existence in 1955, when Article XVI:4 was adopted. Strange as it seems, the bi-level pricing

between GATT law and an immovable policy, but under the high expectations and high visibility of today's procedure the harm done by an evasive decision would be greater.

requirement seems to have been put into the text of XVI:4 by mistake. How this happened, and how the panel worked around this mistaken text, makes an interesting story.

Article XVI:4 had not been included in the original GATT agreement of October 1947. The text, including its bi-level pricing requirement, was added to the General Agreement in the 1954-55 Review Session.⁴³ The text was not drafted in 1955, however. It had been drafted in 1946-48, as Article 26(1) of the Charter of the International Trade Organization (ITO).⁴⁴ Although the text of the GATT had been drawn almost verbatim from the commercial policy provisions of the draft ITO Charter, ITO Article 26(1) had been left out of the original GATT agreement due to its more controversial character. The United States regarded Article 26(1) as a major limitation on its trade policy freedom, and had refused to accept it until the entire ITO had been accepted.⁴⁵

When the ITO Charter failed to be ratified, the GATT contracting parties had convened the 1954-55 Review Session to consider what changes were needed to enable GATT itself to serve as the world's permanent trade organization. The Review Session agreed that GATT would need to

⁴³ Protocol Amending the Preamble and Parts II and II of the General Agreement on Tariffs and Trade, done 10 March 1955, 278 U.N.T.S. 168, 8 U.S.T. 1967, T.I.A.S. No. 3930.

⁴⁴ The text of ITO Charter Article 26(1) had read:

No member shall grant, directly or indirectly, any subsidy on the export of any product, or establish or maintain any other system, which subsidy or system results in the sale of such product for export at a price lower than the comparable price charged to buyers in the domestic market, due allowance being made for [different condition or terms of sale, etc.]

⁴⁵ GATT/CP.2/SR.6 (19 August 1948). A more candid explanation might have added that, since GATT was an effort to sneak a bit of the ITO Charter into force prior to its ratification by the U.S. Congress, the political acceptability of this new agreement would be improved if this potentially irritating subsidy prohibition were left out.

regulate export subsidies in the long run. Almost automatically, governments had turned to old ITO Article 26(1) as an already established legal text suitable for this purpose.⁴⁶

The history of the 1946-48 ITO negotiations contains no explanation of the bi-level pricing requirement in Article 26(1). It appeared in the very first U.S. proposals which opened the ITO negotiations, and it remained essentially unchanged from beginning to end.⁴⁷ The most likely reason for the bi-level pricing requirement was a desire to purely political desire to narrow the scope of this new and potentially controversial obligation. The prohibition of export subsidies, even though it applied only to subsidies on industrial exports and not agricultural exports, was expected to arouse considerable opposition in legislatures. The bi-level pricing requirement would have served to soften such opposition by limiting the prohibition to the few cases where the distorting effects of export subsidies would be the most visible. Conceivably, its purpose could even have been polite sabotage, for the bi-level pricing condition was introduced by the United States, the country chiefly responsible for blocking incorporation of Article 26(1) into the original GATT.⁴⁸

The 1954-55 Review Session draftsmen who reintroduced the old ITO Charter text gave no indication that they appreciated the very restrictive nature of the bi-level pricing requirement. To the

⁴⁶ Virtually every government proposal for the new export subsidies provision used the language of Article 26(1). See, e.g., L/264 (28 October 1954) (South Africa); L/273 (9 November 1954) (Denmark).

⁴⁷ The various draft texts, in chronological order, were: Chapter III, Section D:2, Proposals for Consideration by an International Conference on Trade and Employment, U.S. Department of State Publication No., 2411, Commercial Policy Series No. 79 (1945); Article 25:2 Suggested Charter for an International Trade Organization of the United Nations, U.S. Department of State Publication No. 2598, Commercial Policy Series No. 93 (1946); Article 30(2), Preliminary Draft Charter for the International Trade Organization of the United Nations, U.S. Department of State Publication No. 2728, Commercial Policy Series No. 98 (1946) (the "London Draft"); Article 26(1), Draft Charter of the International Trade Organization of the United Nations, U.S. Department of State Publication No. 2927, Commercial Policy Series No. 106 (1947) (the "Geneva Draft").

⁴⁸ The evidence indicates that the ITO Charter draftsmen appreciated full well that export subsidies could be economically harmful whether or not they caused lower export prices. ITO Charter Article 25:1 made it clear, for example, that the important characteristic of subsidies, including export subsidies, was their effect on the volume of trade. The effect on volume is the only effect of a subsidy that Article 25 requires to be reported.

contrary, virtually every reference to the Review Session's new Article XVI:4 indicated an assumption that the text committed governments to abolish all export subsidies on industrial goods, completely and without qualification. In the closing plenary meeting that approved the text of XVI:4, one delegate after another referred to the text as "a ban on subsidies of manufactured goods",⁴⁹ or a "total abolition of industrial [export] subsidies,"⁵⁰ or concluded that "subsidization of the export of industrial goods was prohibited."⁵¹

The same absolutist understanding of Article XVI:4 was manifest five years later when, in 1960, seventeen developed country governments finally agreed to put Article XVI:4 into full legal effect as a binding obligation.⁵² This view was most clearly expressed in a proposal by the French delegation that, together with the formal acceptance of Article XVI:4 itself, the adhering governments should also adopt an illustrative list of practices deemed to be "export subsidies" under Article XVI:4. The French delegation described the list as "a certain number of practices which would be prohibited under paragraph 4 of Article XVI."⁵³ The working party report approving the illustrative list likewise spoke as though the enumerated practices were prohibited without qualification.⁵⁴

⁴⁹ SR.9/41 (meeting of 3 March 1955) (delegate of Australia).

⁵⁰ Id., (delegate of France).

⁵¹ Id., (delegate of Denmark).

⁵² The long and convoluted history of bringing Article XVI:4 into force is described in John H. Jackson, *supra* note 11 at 372-74.

⁵³ L/1260 (1 August 1960). See also SR.17/3, (meeting of 4 November 1960) (delegate of France).

⁵⁴ GATT, BISD 9th Supp. 185-88 (1961) (text of 1960 working party report and illustrative list, as adopted by Contracting Parties).

This curious tendency to ignore the bi-level pricing requirement can be traced to a change in government policy toward export subsidies. Most of the seventeen governments who would sign GATT Article XVI:4 had overcome their initial caution and were now prepared to prohibit industrial export subsidies absolutely. In fact, they had already done so in another forum. Developed countries of Europe and North America were also members or participants in the Organization for European Economic Cooperation (OEEC) -- the institution set up to coordinate postwar economic reconstruction of Western Europe and to administer the Marshall Plan. In 1955, at the same time the Article XVI:4 text was being adopted in GATT, these same governments were adopting a Decision of the OEEC Council obliging OEEC members to cease export subsidies on industrial products by the end of the following year.⁵⁵ The OEEC obligation was absolute, containing no bi-level pricing requirement. OEEC's export subsidy obligation was finally put into force in 1959 and 1960, the same time as GATT's, and with the same illustrative list defining certain export subsidies.⁵⁶ The illustrative list adopted by GATT in 1960 was a verbatim copy of a list attached to the 1960 OEEC decision,⁵⁷ and was adopted explicitly for the purpose of ensuring that GATT obligations on export subsidies would be the same as OEEC obligations.⁵⁸

Strange as it may seem, therefore, the evidence is compelling that the bi-level pricing requirement was carried into the text of Article XVI:4 inadvertently, and never did represent the

⁵⁵ Decision of the Council of 14th January 1955 Concerning Measures Designed to Aid Exporters, OEEC Doc. C(55)6, cited in OEEC Doc. C(60)130, published in OEEC, Code of Liberalization (July 1960 edition)

⁵⁶ Decision of the Council Concerning Measures Designed to Aid Exports, OEEC Doc. C(60)130, 24 June 1960, amending decision C(59)202, published in OEEC, Code of Liberalisation (July 1960 edition).

⁵⁷ The French proposal, L/1260 (1 August 1960), identifies the text of the proposed illustrative list as having been taken from the annex to OEEC Document C(59)202.

⁵⁸ SR.17/3 (meeting of 4 November 1960).

intention of the signatory governments. The available documents do not make clear to what extent this negotiating history was known, or put before the panel. It is quite likely that in 1976 there were still a few delegates and Secretariat officials who had participated in the Article XVI:4/OEEC exercise, but it is possible that the relevance of this experience was not realized.

Even with the full story before them, of course, the panel members would have found it very difficult to strike the bi-level pricing requirement from Article XVI:4 on the ground that the draftsmen had not really meant to say it. What was needed was a legally plausible theory for saying that Contracting Parties had actually acted somehow, in a legally effective manner, to create the broader kind of legal prohibition that was their true purpose -- an obligation absolutely prohibiting all industrial export subsidies.

The European Community offered a legal theory arguing that such an obligation had been created by the 1960 GATT decision adopting the OEEC's interpretative list. Even though the interpretative list was, by its terms, merely an enumeration of certain practices that were to be considered "export subsidies," the GATT decision approving the list had seemed to treat the practices listed as though they were absolutely prohibited. It was possible, argued the Community, to read the prohibitory tenor of the 1960 decision as a second, separate GATT decision -- a decision that the enumerated practices could be "presumed" to satisfy the two-price rule. There was not the slightest evidence, of course, that anyone was actually thinking about the price effects of these practices in 1960. But, since the delegates clearly did believe they were creating an unqualified legal prohibition of these practices, it was not really inaccurate to ascribe to them the predicate thought needed to reach that conclusion.

Applying this theory, the European Community offered the panel a legal analysis showing that DISC violated Article XVI:4. DISC's tax deferral was equivalent to either an "exemption" or a "remission" of income taxes listed in items (c) and (d) of the 1960 illustrative list. Items on the list were presumed to result in the kind of bi-level pricing required by the two-price rule of Article XVI:4.⁵⁹

The panel might well have accepted the Community's "presumption" theory in any event, but the panel's task was made somewhat easier by an interesting tactical gamble taken by the United States at this point. The strongest defense of DISC would have been to reject the Community's proposed "presumption" and to insist that bi-level pricing had to be proved with specific evidence. This position, of course, would have utterly doomed the United States counter-complaints against the three European tax laws. When forced to the choice, the U.S. Treasury Department was not prepared to sacrifice the three counter-complaints quite so easily. Instead, it chose to gamble by accepting the Community's "presumption" theory with a clever twist. In the words of the panel report,

The representative of the United States accepted that those tax practices which clearly fell within the 1960 illustrative list [i.e., the clear "exemptions" from tax in the three European tax laws] did carry the presumption of bi-level pricing but that practices not in the list, including tax deferral [DISC], did not carry that presumption.⁶⁰

The gamble did not pay off. The panel accepted the theory endorsed by both parties -- the 1960 illustrative list meant to create a presumption of bi-level pricing for the practices enumerated --

⁵⁹ GATT, BISD 23rd Supp. 109, paragraph 51 (1977) (DISC report). The Community went on to submit a variety of other proofs and arguments to show that the two-price requirement was satisfied, claiming (1) that the burden was on the United States to prove the contrary, (2) that U.S. businesses had affirmed in testimony before Congress that DISC had lowered their prices, and (3) the price effects could be shown by theoretical price calculations. *Id.*, at 109-110, paragraphs 52-55.

⁶⁰ *Id.*, at 110, paragraph 56.

but it declined to accept the United States argument that DISC's deferral of taxes was not one of the practices on the list. It found that interest-free deferral of tax liability involved an "exemption" from taxation, at least to the extent of the interest forgone. Thus, DISC was subject to the presumption of bi-level pricing.⁶¹

At this point, the panel's nerve faltered and it retreated to a more complex conclusion. In an apparent effort to avoid resting the decision on the "presumption" theory alone, the panel announced that the presumption was not meant to be absolute,⁶² and that the panel had to examine evidence of whether bi-level pricing had actually occurred. The report then suggested in extremely general terms, a conclusion that bi-level pricing had occurred.

The Panel considered that, from an economic point of view, there was a presumption that an export subsidy would lead to any or a combination of the following consequences in the export sector: (a) lowering of prices, (b) increase of sales effort and (c) increase of profits per unit. Because the subsidy was both significant and broadly based it was to be expected that all of the effects would occur and that, if one occurred, the other two would not necessarily be excluded. A concentration of the subsidy on prices could lead to a substantial reduction in prices. The Panel did not accept that a reduction in prices in export markets needed automatically to be accompanied by similar reductions in domestic markets. These conclusions were supported by the statements by American personalities and companies and the Panel felt that it should pay some regard to this evidence.⁶³

It was the tenuous quality of this analysis that forced the panel to limit its ultimate conclusion to the rather feeble finding that "the DISC legislation in some cases had effects which were not in accordance with the United States' obligations under Article XVI:4."

⁶¹ Id., at 113, paragraphs 71 and 72.

⁶² Id., paragraph 72.

⁶³ Id. The reference to American personalities and companies was a reference to testimony before Congressional committees avowing that DISC had permitted reduction of export prices. Critics objected, fairly enough, that the credibility of witnesses arguing to preserve a tax benefit is not sufficient to entitle it to weight in an international proceeding.

As noted above, the panel ruling on the bi-level pricing defense, flimsy as it was, worked. Indeed, the fact that it was so very flimsy makes the power of the underlying consensus all the more impressive. Had it wanted to, the United States could certainly have demolished the panel's reasoning on this point.⁶⁴ Yet, despite its quite vigorous resistance to accepting the panel's legal ruling over the next six years, the United States never once uttered a word in criticism of this finding.

In the end, it is tempting to believe that the United States itself was ultimately persuaded to shape its own litigating conduct in accord with the underlying policy consensus. The author has always suspected that the tactical gamble taken by the United States was really intended as a surrender of the bi-level pricing defense. A rigorous bi-level pricing requirement was not really consistent with long-term United States policy objectives on export subsidies. At the same time the DISC case was being argued, the United States was also setting out to lead the GATT's Tokyo Round negotiations toward adoption of new Subsidies Code that would strengthen the legal prohibition against export subsidies. A rigorous bi-level pricing requirement would have had the opposite effect.

c. The Outcome

To put this part of the story into proper perspective, the eventual outcome of the DISC panel report should be stated briefly here, with a more detailed autopsy to follow. The United States took the position that it was willing to accept the finding of DISC was in violation of Article XVI:4, provided that the other three panel reports, finding the French, Belgian and Netherlands tax systems

⁶⁴ Professor Jackson's criticism of the panel's logic, *supra* note 36, at pp. 768-71, gives a good account of what the United States could have argued.

also GATT-illegal, were accepted at the same time. The United States held this position on and off, for five years. Finally, in December, 1981, the United States agreed to accept all four reports subject to an "understanding" that overruled the finding of violation in the three counterclaims. The understanding stated that the territorial provisions of the three European tax laws were consistent with Article XVI:4, but said nothing to disturb the finding of violation with respect to DISC.

While the 1981 understanding did not exonerate DISC, it did narrow the finding of violation to the domestic character of the DISC tax haven. In the end, the United States complied with the GATT ruling in a 1984 law which merely restructured the DISC tax subsidy so that it required a foreign-based tax-haven corporation. Despite considerable grumbling about the fictional character of the new law's "foreign" requirements, no government has filed a GATT legal complaint challenging the new law.

6. The Panel Ruling on the Counter-complaints

The panel wrote three virtually identical reports concerning the United States counter-complaints against the tax laws of France, Belgium and the Netherlands. In each case, the panel ruled that tax advantages made possible by the territoriality principle -- the practice of not taxing foreign-earned income -- were an export subsidy. With regard to the bi-level pricing issue, the panel found, in the same words used in the DISC report, that the subsidy "in some cases had effects which were not in accordance with [the defendant's] obligations under Article XVI:4."⁶⁵

⁶⁵ GATT, BISD 23d Supp. 126, paragraph 53 (France); *id.*, at 136, paragraph 40 (Belgium); *id.*, at 136, paragraph 40 (Netherlands).

Given that the three European defendants had actually waived the bi-level pricing defense by asserting their "presumption" theory in the DISC case, the only real issue in the three counter-complaints was whether the failure to tax foreign earnings was an "export subsidy" in the first place. The panel's key finding on this point was a decision to treat the two parts of the tax-haven transaction (the exporter's initial export to its foreign alter ego and the alter ego's resale to the ultimate buyer) as a single export transaction. The panel stated this conclusion quite elliptically by referring to the sale-resale process as an "economic process originating in the country" -- the implication being that what went on outside the country was also part of the same "process." The panel stated this key conclusion as follows:

The panel noted that the particular application of the [territoriality principle by the defendant country] allowed some part of the export activities, belonging to an economic process originating in the country, to be outside the scope of [its] taxes. In this way [the defendant] had forgone revenue from this source and created a possibility of a pecuniary benefit to exports in those case where income and corporation tax provisions were significantly more liberal in foreign countries.⁶⁶

In other words, by not taxing the income from the second half of the exporting process, the governments in question were subsidizing it.

The three findings of Article XVI:4 violation were never accepted by the Contracting Parties. The three defendants, with broad support from other governments, refused to approve the reports and asked that they be overruled. After blocking such an overruling for five years, the United States finally relented in 1981, and the panel decisions were disposed of by a Council decision which accepted the three reports in form, but then added an "understanding" which overruled their main legal finding. The three cases then disappeared from the GATT agenda.

⁶⁶ Id., at 125, paragraph 47 (France); id., at 135, paragraph 34 (Belgium); id., at 145, paragraph 34 (Netherlands), (emphasis added).

The ruling against the territoriality principal is generally considered one of the most prominent failures in the DISC case. The blame is usually attached to the panel itself, and to some extent its Secretariat advisors, for making a finding of legal violation that virtually no government was prepared to support. It is worth looking carefully at the nature of the legal issue involved in order to explore why this failure occurred.

The United States argument for treating the territoriality principle as an export subsidy was based on its actual economic effects.⁶⁷ The economic analysis was difficult to refute. Everyone in the tax business knew that a territorial tax system could be manipulated to make the taxation of many export operations significantly lower than the taxation of identical domestic operations. The economic effect of that lower taxation would be just the same as any other export subsidy; it would induce a greater allocation of resources to exporting than would otherwise be the case. Even if this were not the purpose of the territoriality principle, this was demonstrably its actual economic effect. In reality, most governments appreciated and welcomed the stimulative effect on exports.

Although the European defendants offered a number of conclusory arguments denying both the intent to subsidize and the occurrence of any harmful economic effects, they never made a serious effort to dispute the United States' economic argument as such.⁶⁸ Their only real answer to the U.S. position was that governments had clearly intended Article XVI:4 to permit territorial tax systems, and that economic effects just did not matter in the face of such clear intent. The argument about intent was based primarily on the general and longstanding acceptance of the territoriality

⁶⁷ The full United States argument is summarized in each of the three panel reports. For the key points in this economic analysis, see paragraphs 18, 19 and 33 of the report on France, *id.*, at 117-18, 122.

⁶⁸ The Netherlands government actually agreed with the economic characterization, arguing that the territoriality system had the advantage of not interfering with the efforts of other governments, especially developing countries, to attract foreign businesses by offering a subsidy in the form of lower tax rates. *Id.*, at 141, paragraph 19.

principle in world tax circles. The principle had been well established in 1955 when Article XVI:4 was adopted, and many GATT members, including the three defendants, had been employing that principle for decades. It was simply impossible to believe, the European defendants argued, that GATT Article XVI:4 had meant to require what would have been a revolution in world tax practice. There was not the slightest evidence that any such consequences were envisioned by any of the signatory governments.⁶⁹

In retrospect, both arguments appear to have been correct. The drafters of Article XVI:4 clearly did not intend to change world tax practice. But, it was also true that, in leaving territoriality in place, they had left a wide gap in what was supposed to be an absolute prohibition against industrial export subsidies.

The loophole made interpretation of Article XVI:4 quite difficult. Given the territoriality exception, it was not possible to read Article XVI:4 as expressing a straightforward policy against export subsidies. Moreover, since the exception for territorial tax systems was a matter of historical accident rather than policy, there was no economic policy explanation of why the line was drawn at territorial tax systems rather than somewhere else. In other words, there was no economically rational answer to the repeated United States question, "If territoriality, why not DISC?"

With the benefit of hindsight it is possible to see that GATT was willing, after years of conflict, to accept a rule that did draw a line between territoriality and DISC. Although the line is arbitrary in economic terms, there is a legal policy rationale that explains what GATT did. The GATT had no choice but to accept territorial tax systems, for governments simply would not agree to change them. Being forced to start from this position, GATT still had an interest in keeping the

⁶⁹ Id., at 118, paragraph 20 (France); id., at 131, paragraph 20 (Belgium); id., at 141, paragraph 21 (Netherlands).

scope of that concession as narrow as possible, simply to keep the volume of trade-distorting export subsidies as low as possible. Requiring that only foreign tax havens be employed may have been arbitrary in economic terms, but it did serve the policy of limiting the subsidy, simply by making it more difficult for exporters to earn it. DISC was over the line because it allowed exporters to obtain subsidies more easily.

Should the DISC panel have been expected to make such a ruling? Current GATT opinion might be divided about what objective legal analysis actually required in this case. One school of thought, reflecting Continental jurisprudence, would probably frown on decisions that subordinate the legal text to the negotiating history and to the pragmatic sort of legal policy rationale presented above. That point of view would have found no fault with the DISC panel's largely economic analysis concluding that Article XVI:4 covered territorial tax laws. A more expansive view of legal analysis would disagree, arguing that negotiating background and legal policy are relevant sources of law that should be taken into account, particularly in an institution like GATT in which enforcement of legal norms largely rests on voluntary obedience to commitments undertaken in the past. The more realistic the panel's appraisal of what the commitment was, the more powerful its ruling will be. Under this more expansive view, the panel's ruling on the European tax laws would be faulted for not taking account of the background to Article XVI:4.

If one accepts the broader view of GATT legal analysis, it remains to ask why the panel did not arrive at such a ruling. The actual reasons for the panel's ruling are not known. Speculation at the time centered on the assumption that the panel felt it had to rule DISC illegal to maintain the credibility of GATT legal discipline over export subsidies, but could not do so while exonerating the three European laws because the United States would not accept a ruling that singled out DISC

alone. If that was the reasoning, the problem with the decision lay in its starting point assumption that it was not possible to devise a legal theory distinguishing DISC that would be strong enough to withstand the expected United States resistance. The missing ingredient in that case would have been a more sophisticated legal imagination.

Alternatively, the panel may not have given enough attention to the historical background. It may also have attached too much importance to the apparent economic policy suggested by the words of Article XVI:4. This latter type of miscalculation could well have been induced by the parties' decision to appoint tax experts to the panel, a departure from normal GATT practice suggesting that the legal problem turned on the sort of objective analysis tax experts could do.

Tracing the problems involved in the DISC ruling leads to one central conclusion. Finding the right answer to the nasty interpretative problem presented by Article XVI:4 would have required legal work of the highest order. The quality of GATT legal work has to begin with the quality of government presentations. Government advocates should have been able to provide the panel with a broad and sophisticated exploration of the issues, the data, the possible solutions and the ramifications of those solutions. In 1976, however, GATT litigation procedure was simply not ready to operate at this level. Governments were not in the habit of arguing cases this way, and even when lawyers were sent to Geneva they did not have the background to offer the sort of sophisticated analysis that was needed. Part of the reason, no doubt, was that the panels and their Secretariat assistants were no closer to these skills. Most panelists and Secretariat officials were not lawyers, and the Secretariat had no central source of legal expertise to draw on.

One of the most important legacies of the DISC case in this regard was the creation of a separate legal staff within the GATT Secretariat. The problems of the DISC case, repeated in

several other cases over the next few years, led the Secretariat to reexamine the "no lawyers" policy established by its first Director General, Sir Eric Wyndham White, and followed by his successor, Olivier Long. When Arthur Dunkel became Director General in 1980, he decided that the old policy could no longer be followed. The creation of a Secretariat legal office in the early 1980s had a major impact in raising both the quality of GATT panel decisions, and the quality of the legal practice before those panels.

C. FROM LEGAL RULING TO FINAL OUTCOME: 1976-1984

1. The Initial Impasse: 1976-1978

As noted above, the four panel reports were issued simultaneously on 2 November 1976. The reports were then reviewed in six meetings of the GATT Council -- November of 1976, March, May, July, and November of 1977, and March of 1978.⁷⁰ The first five meetings up to the end of 1977 ended in complete impasse.

The United States indicated it was prepared to accept the finding that DISC was in violation of GATT, provided that the findings against France, Belgium and the Netherlands were accepted at the same time. The three European defendants refused to accept the rulings against themselves. They argued that Article XVI:4 had never been intended to outlaw territorial tax laws.⁷¹ The

⁷⁰ The summary records of the meetings are: C/M/117 (meeting of 12 November 1976); C/M/119 (meeting of 2 March 1977); C/M/120 (meeting of 23 May 1977); C/M/122 (meeting of 26 July 1977); C/M/123 (meeting of 11 November 1977); C/M/124 (meeting of 14 March 1978).

⁷¹ The defendants' positions were stated in carefully drawn memoranda -- almost legal briefs. For France: C/97/Rev.1 (21 March 1977); C/97/Add.1 (21 July 1977). For Belgium: GATT Docs. C/98 (15 March 1977); C/98/Add.1 (21 November 1977). For the Netherlands: C/99 (15 March 1977).

The defendants argued that the panel's treatment of the two parts of the tax-haven transaction as a single transaction constituted an incorrect definition of "export." Their argument never addressed the economic reasons for treating it as a single transaction. Their argument was linguistic, and historical ("This is where government jurisdiction has always ended"). It ultimately rested on an assertion about the intent that lay behind the rule of Article XVI:4.

European Community called for adoption of the DISC report, and proposed what amounted to a Council decision overruling the other three reports.⁷² The United States refused to separate the cases, repeating on every occasion that the European laws had the same economic effects as DISC.⁷³

The refusal of the four defendants to accept the respective panel reports presented a problem that GATT had not confronted before. Legally, the rulings of GATT panels are not binding legal interpretations; they are merely reports to the GATT Contracting Parties or to its agent, the GATT Council, which alone have power to make authoritative rulings. In the approximately twenty third-party legal rulings GATT had made prior to 1976 the GATT Council had always approved the ruling -- except for one minor case by then generally forgotten.⁷⁴ This tradition of more or less automatic approval was regarded as critical to the objectivity of GATT's adjudicatory processes, for it seemed unlikely that the institutions like the GATT Council or the Contracting Parties could make legal rulings free from political influences. At the same time, however, governments had to recognize that errors do occur in every legal system, and that some mechanism for appeal was probably necessary.

The five deadlocked Council meetings which took place up to the end of 1977 represented a certain kind of appellate process in response to the various claims of error. As time went on, a

⁷² There were no precedents for this sort of action. Initially, the Belgian delegate had proposed calling the panel back into session in order to ask it to elaborate on the basis of its decision -- a suggestion that sounded a bit like a court martial. C/M/119 (meeting of 2 March 1977). The European Community finally settled on asking the GATT Council to authorize its Chairman, after consulting with experts, to give an opinion about the legal conclusions disputed by the three defendants. C/M/123 (meeting of 11 November 1977). The procedure that was finally adopted five years later, in December of 1981, was to negotiate the text of an "understanding" that would state a conclusion contrary to the report, and that would be adopted at the same time the panel reports were "adopted."

⁷³ See, e.g., C/102 (24 November 1977).

⁷⁴ The one exception was a 1956 panel ruling that Greece had impaired a tariff concession on phonograph records by classifying a new type of record (LPs) under a different heading with a higher rate. Appendix, Complaint 42. The ruling was not adopted, due to objections by a number of developing countries. The matter was settled bilaterally twelve months later by agreement on a compromise tariff rate for LPs.

consensus began to emerge among the countries who participated in the debate -- mainly the developed countries who had signed Article XVI:4. Virtually every delegation that spoke called for immediate adoption of the DISC report. Most also took the position that the other three cases required more time for reflection, a diplomatic way of saying they were wrong.⁷⁵ No one spoke in support of the United States position. By the end of the year, the United States was "isolated."

This process appeared to be the only way to reconcile the need for some error-correcting procedure with the practice of consensus decision making. The claims of error would simply have to be debated until a consensus developed among the countries not party to the dispute. Where there was broad agreement that an error had been made, the pressure of that consensus would hopefully bring about some sort of correcting action. Where the claim of error had no support, on the other hand, the pressure of that consensus would hopefully persuade the losing party to comply. Either case, of course, meant waiting until the isolated party was ready to give up.

If the DISC case had been resolved by this consensus-building process within the first year or so, the adjudication procedure would probably have been considered successful. But the three counterclaims were not in fact settled until December 1981, and the ruling on DISC did not produce an undertaking to comply until October 1982. There is no way to escape the label "failure" for this much delay. There are always reasons for failure, however, and they can be instructive. If one retraces the agony of the DISC case step by step, it will be seen that the long delay was due to a series of rather unusual political circumstances.

⁷⁵ Canada, Japan, Switzerland, and Austria took the position that DISC alone should be changed. The Nordic countries stood aside, taking the rather vague position that normal procedures should be followed in all four cases.

2. Three Efforts to Resolve the Issues: 1978-1980

At the very beginning of the review process, the possibility of repeal due to opposition in Washington emerged once again. President Carter had promised to repeal DISC during his 1976 election campaign,⁷⁶ and in January 1978 he had formally requested the Congress to do so.⁷⁷ At the GATT Council meeting of March 1978,⁷⁸ the United States announced the President's action, and also stated it was presenting some new proposals to France, Belgium and the Netherlands to resolve the counterclaims, implying that the United States might concede the legality of the territoriality principle. The United States delegation was still not willing to agree to formal GATT acceptance of the DISC report, however.

The United States initiative took the DISC cases off the GATT Council agenda while the legislation was pending. The legislative effort was eventually aborted in mid-1978 when it became clear that the prospects for Congressional approval were nonexistent.⁷⁹ By then, however, the GATT was now entering the closing days of the five-year negotiating effort known as the Tokyo Round, and negotiations over the new Tokyo Round Subsidies Code promised some progress toward a solution.

⁷⁶ The promise occurred in a televised debate with President Ford. N.Y. Times, 24 September 1976, at A21, col. 3. The fact that such legislation was being considered was confirmed by the U.S. delegate in the GATT Council meeting of 26 July 1977. C/M/122, at p. 10.

⁷⁷ For the President's proposal, see President's Message to Congress on Tax Reduction and Reform, 14 Public Papers 172 (21 January 1978).

⁷⁸ C/M/124 (meeting of 14 March 1978).

⁷⁹ See N.Y. Times, 27 June 1978, at D6, col. 1.

The Subsidies Code, adopted in early 1979, carefully took no position on the DISC case.⁸⁰ But it did tend to affirm DISC's illegality by abolishing the bi-level pricing requirement, by including interest-free "deferral" in the illustrative list of tax subsidies, and by expressing a general policy to tighten the prohibition against export subsidies.⁸¹ With respect to the three cases involving European tax systems, the Code also suggested a settlement of sorts. It affirmed the arm's length pricing requirement, a key U.S. concern in those cases, while on the other hand it affirmed that the prohibition of export subsidies was not intended to limit "measures to avoid . . . double taxation," an indirect way of saying that the territoriality principle was GATT-legal.⁸²

Shortly after the Subsidies Code was adopted, in June of 1979, a U.S. Treasury official took the process one step further by negotiating a confidential settlement of all four cases. Although the principles of the settlement had already been established in the Subsidies Code provisions, it was still deemed advisable to keep the settlement confidential, no doubt because approval of the Tokyo Round agreements was then pending before Congress. The confidential settlement involved the following points: (1) the United States agreed that DISC as presently structured was GATT-illegal; (2) while the President's 1978 initiative to repeal DISC had failed and could not be brought up again until after the 1980 Presidential election, the United States would undertake to submit conforming legislation in 1981; (3) until then, the Community would agree to leave the DISC report on the table, and would not retaliate for lack of progress; (4) in the Spring of 1980, the United States would agree

⁸⁰ The disclaimer appears in Annex A to the Subsidies Code, in footnote 2 to the Illustrative List of Export Subsidies, first paragraph. GATT, BISD 26th Supp. 82, note 2 (1980).

⁸¹ The bi-level pricing requirement was abolished by being left out of the export subsidy prohibition in Article 9:1 of the Code. *Id.*, at 68. Deferral is mentioned in item (e) of the Illustrative List in the Code's Annex. *Id.*, at 81.

⁸² The provisions appear in Annex A of the Subsidies Code, in footnote 2 to the Illustrative list, second and third paragraphs, immediately following the disclaimer regarding the DISC report. *Id.*, at 82, note 2.

to a GATT decision overturning the panel's ruling against the territorial tax systems; (5) the Community would agree to a strong statement in the decision on the importance of adherence to arm's length pricing rules.⁸³

Now it was the turn of officials in the United States Trade Representative's office (USTR) to disrupt the Treasury Department's handling of the case. In early 1980, the United States administration repudiated the 1979 settlement agreement as unauthorized.⁸⁴ The main reason for repudiating the settlement was probably a political problem with the Congress. The Carter Administration had just persuaded the Congress to enact a substantial liberalization of the U.S. countervailing duty law,⁸⁵ in exchange for assurances that the new Tokyo Round Subsidies Code would bring about more effective GATT legal regulation of subsidies at their source. It just would not do, as the first demonstration of GATT's new legal rigor on subsidies, to ask the Congress for legislation to implement a settlement surrendering a United States export subsidy while agreeing to do nothing about three European laws found to be GATT-illegal subsidies in the same lawsuit.

There was quite possibly also a deeper concern about the Subsidies Code behind the United States repudiation. Notwithstanding the glowing claims made for the Subsidies Code, the Code was in fact a only a slightly dressed-up restatement of pre-1979 GATT subsidies law, with a new and more forceful-looking adjudication procedure to back it up.⁸⁶ The Code negotiations had revealed

⁸³ The agreement is generally known as the Hufbauer agreement. The text of the confidential GATT minutes recording the agreement was published in 16 Tax Notes 453 and 473 (2 August 1982).

⁸⁴ C/M/160 (meeting of 21 July 1982).

⁸⁵ Title I, Trade Agreements Act of 1979, Public Law No. 96-39, 93 Stat. 144 (1979), codified as amended in 19 U.S.C. 1671-1671f, 1675-1677g (1982). The chief liberalizing amendment in 1979 was to add a material injury requirement.

⁸⁶ The differences between appearances and reality in the Subsidies Code negotiations are explored in detail in Robert E. Hudec, "Transcending the Ostensible": Some Reflections of the Nature of Litigation Between Governments, 72 Minnesota Law Review 211 (1987).

very strong opposition to greater discipline. European Community export subsidies on agriculture, long a priority target of United States agricultural interests, had been labeled nonnegotiable by the Community. A prudent diplomat might well have wanted to delay playing the DISC card until the Community had given some token of its intent to comply with the new Subsidies Code.

Repudiation of the 1979 settlement agreement meant that the two-year effort at informal settlement had come up empty. A second round of formal proceedings had become necessary.

3. DISC's Last Stand: 1980-1984

Formal consideration of the DISC cases returned to the agenda of the GATT Council in December of 1980. France, Belgium and the Netherlands requested the Council to recognize that a de facto settlement had already been reached in the three counter-complaints, and asked the Council to formalize the settlement in a Council decision. They proposed a decision that would "adopt" those three panel reports, subject to an "understanding" which would say that Article XVI:4 does not prohibit territorial tax systems.⁸⁷ The understanding would, of course, constitute a GATT Council decision overruling the central finding of GATT inconsistency in the three reports.

The United States asked for more time to consider the proposal. During the next twelve months, the European proposal was raised and then deferred for further discussion at six more Council meetings.⁸⁸ Part of the delay was due to requests by other countries to study the proposed decision more carefully, but the main problem throughout was a renewed United States effort to

⁸⁷ On 8 December 1980, the three governments circulated substantially identical memoranda, C/114, C/115, and C/116. The memoranda were discussed at the GATT Council meeting of 18 December 1980, C/M/145.

⁸⁸ C/M/146 (meeting of 10 March 1981); C/M/148 (meeting of 11 June 1981); C/M/149 (meeting of 15 July 1981); C/M/151 (meeting of 6 October 1981); C/M/152 (meeting of 3 November 1981); and C/M/153 (meeting of 6 November 1981).

defend DISC. The position seemed to have hardened with the change of administration in early 1981.

The new Reagan Administration undoubtedly had its own distinct political problems with accepting the proposed settlement. Its campaign position on trade policy had been a "get tough," "No-More-Mister-Nice-Guy" pledge.⁸⁹ A one-sided surrender of DISC was not the way to start. There were additional considerations. The Reagan Administration had an extensive legislative agenda which came first, and which left no time or political capital to spend on DISC repeal. And, in GATT, it was beginning to look like the European Community would not deliver on the Subsidies Code.

In December 1981, the United States finally appeared ready to put all these problems aside. It agreed to support a GATT Council decision that would approve all four panel reports, including the DISC report, subject to an understanding which would overrule the three European rulings.⁹⁰ The final text of the understanding read,

The Council adopts these reports on the understanding that with respect to these cases, and in general, economic processes (including transactions involving exported goods) located outside the territorial limits of the exporting country need not be subject to taxation by the exporting country and should not be regarded as export activities in terms of Article XVI:4 of the General Agreement. It is further understood that Article XVI:4 requires that arm's length pricing be observed Furthermore, Article XVI:4 does not prohibit the adoption of measures to avoid double taxation of foreign source income.⁹¹

⁸⁹ See, e.g., the international economic policy plank of the 1980 Republican Party platform, in National Party Platforms of 1980 (1982) at p. 218.

⁹⁰ The decision was adopted at the Council meeting of 7-8 December 1981, C/M/154.

⁹¹ GATT, BISD 28th Supp. 114 (1982).

The December 1981 decision marked the end of the three counter-complaints. The DISC case was far from over, however. It soon became clear that the United States had a much different interpretation of the December 1981 decision than everyone else. Most governments assumed that, while the decision clearly exonerated the three European laws, it did not exonerate DISC, because DISC was not a "territoriality" law. But nothing was actually said about DISC before the decision was approved. Then, moments later, the United States rose and offered a unilateral interpretation of the understanding: Article XVI:4 did not require governments to tax any more income from exports than would be taxed under a territorial system. The implication, of course, was that DISC met that test, because DISC did in fact tax as much export income as would be taxed if the exporter were engaged in tax haven operations under a territorial system. The European Community and Canada, who must have known this was coming, rose to indicate disagreement, but did not pursue the matter. The colloquy appears to have been a bit of stagecraft, with the purpose of announcing that United States agreement to this decision had not resolved the impasse over the legality of DISC itself. The United States had merely agreed to free the hostages; it had not agreed to lay down its arms.

It took only ten months to persuade the United States to abandon this final rear-guard position. But it was a rather interesting ten months as both sides began treating the case with new energy. In March of 1982, the European Community and Canada started pressing the United States to implement the DISC report by repealing the law.⁹² In May, the European Community proposed that the GATT Council adopt formal decisions declaring DISC to be in violation, ordering the United States to comply, and finding the situation ripe for retaliatory measures.⁹³ Under GATT's

⁹² SCM/18 (29 March 1982).

⁹³ See C/M/157 (meeting of 27 May 1982) (text of decision proposed in C/W/384); C/M/160 (meeting of 21 July 1982)

practice of consensus decision making, these proposed decisions had no chance of being adopted over United States opposition, but they did create new events that gave governments a new opportunity to express their views in a focused manner.

In June of 1982, the United States finally presented a really full defense of its position that the December 1981 understanding had exonerated DISC as well. The GATT Council was subjected to a long and highly technical legal brief on tax theory and practice, presented in eye-glazing detail by a Deputy U.S. Trade Representative.⁹⁴ The United States argued that the profits from every export transaction involves some profit due to "economic processes" outside the country, even if the exporter does not act through a separate foreign entity. The DISC exemption, it said, was just a fair rule-of-thumb way of separating out the average foreign-earned part of export income and not taxing it. The United States supported its argument by citing (and, alas, explaining at length) numerous other provisions of U.S. corporate income tax law that allocated income between foreign and domestic jurisdictions in situations where no separate foreign entity existed.

No other GATT government supported the United States. Most had probably not even understood the June 1982 defense, but that did not matter. Governments had understood what they had voted for in the 1981 understanding, and it wasn't this. They had meant to exonerate territorial tax systems, but not DISC.

This final round of U.S. resistance provoked new efforts to increase the pressure. In the July Council meeting, the majority tried to bend the rules of consensus decision making a little. Several

(description of decision proposed in C/W/392).

⁹⁴ The arguments were presented in the GATT Council meeting of 29-30 June 1982, GATT Doc. C/M/159. According to document C/M/159, the text of the U.S. statement "in extenso" is preserved in GATT document C/W/389/Supp.1, a document series which has not been derestricted. The full text of the U.S. statement is also available in Tax Notes Microfiche Data Base, Doc. 82-7501 (19 July 1982).

delegations accused the United States of abusing the consensus practice, and when these statements had no effect the chairman adjourned the meeting to see if informal hammering in the corridors might produce some movement. When the meeting resumed, the chairman read a statement saying that "it was the opinion of the majority of the Council members that the United States should take appropriate action to ensure that the DISC legislation was brought into conformity with the provisions of the General Agreement."⁹⁵ The majority was angry enough to use its majority status to record its views formally in the Council minutes, although it stopped short of forcing an actual Council decision over a United States veto.

By October of 1982, the United States was ready to give up and to promise a new statute. Part of the reason for its retreat was simply its complete and utter isolation on this issue. Another reason was probably the forthcoming GATT Ministerial Meeting in November 1982, at which the United States was hoping to establish a new agenda of GATT negotiations. Perhaps the most important reason was an emerging crisis in the functioning of GATT adjudication procedures. By October 1982, the United States was locked in five other bitterly contested GATT lawsuits against the European Community, three of which involved important issues of GATT subsidy law.⁹⁶ The Community was using the United States blockage of the DISC decision as a justification for similar blocking and foot-dragging behavior in each of these five United States lawsuits. The DISC was no

⁹⁵ C/M/160 (meeting of 21 July 1982).

⁹⁶ Subsidies on Exports of Wheat Flour, Appendix, Complaint 103; Subsidies on Exports of Pasta Products, Appendix, Complaint 105; Production Aids Granted on Canned Peaches, Canned Pears, Canned Fruit Cocktail and Dried Grapes, Appendix, Complaint 107; Tariff Treatment of Citrus Products from Certain Mediterranean Countries, Appendix, Complaint 113; Value-Added Tax (VAT) and Threshold, Appendix, Complaint 114.

longer a bargaining chip that could be held out to influence EC behavior. It had become a stone around the neck of the entire United States policy to improve GATT legal discipline.⁹⁷

In the GATT Council meeting of 1 October 1982, the United States, still asserting DISC's legality, announced it would nonetheless seek legislation to correct the complaints made about DISC.⁹⁸ Nearly two years later, in July of 1984, the United States announced that DISC had been replaced by a new type of tax-haven export subsidy, FSC, that was consistent with the territoriality principle.⁹⁹ A final round of skirmishes took place over the new FSC law, involving both challenges to the GATT legality of forgiving some \$10 billion of "deferred" DISC taxes, and questions as to whether FSC's requirements were compatible with the concept of extra-territorial activity in the 1981 understanding.¹⁰⁰ But these protests eventually faded away without further litigation. As the silence lengthened, it became clear that the DISC case had at long last ended.¹⁰¹

4. Evaluating the Outcome

⁹⁷ The Reagan Administration's explanation to Congress claimed that the DISC deadlock was undermining efforts to regulate subsidies, and efforts to improve dispute settlement procedures. Foreign Sales Corporation Act: Hearings on S. 1084 Before the Senate Committee on Finance, 98th Cong., 2d Sess. (1984) at p. 61 (testimony of Deputy U.S. Trade Representative Robert E. Lighthizer). The Senate Finance Committee's explanation of the reasons for changing DISC began by noting the GATT majority's view against the legality of DISC, and then cited (1) the possibility of retaliation by the Community, (2) the danger of causing a breakdown of GATT dispute settlement procedures, and (3) the general diplomatic isolation of the United States. See 1984 Senate Report, *supra* note 3, at 634.

⁹⁸ C/M/161.

⁹⁹ C/M/180 (meeting of 11 July 1984). "FSC" stands for Foreign Sales Corporation, the statutory name of the new tax haven corporation replacing DISC.

¹⁰⁰ Questions about the GATT legality of FSC began to be raised even before the FSC law was passed. C/M/171 (meeting of 3 October 1983). In late 1984, the European Community invoked Article XXII consultations on FSC; see C/M/183 (meetings of 6, 8 and 20 November 1984). The parties met and exchanged views in early 1985; SR.41/3 (meeting of 26 November 1985).

¹⁰¹ The last mention of DISC or FSC in GATT documents that the author has been able to find was an oral report on the 1985 Article XXII consultations by the European Community in November 1985, SR.41/3 (meeting of 26 November 1985).

What did the twelve years of litigation in the DISC case accomplish? The 1984 FSC law¹⁰² is in many respects the tangible embodiment of that accomplishment. There are several different ways to measure its significance.

If publicly acknowledged respect for GATT law is the measure, the enactment of the FSC law was a considerable achievement. For once the United States Congress passed a law whose only purpose, openly stated, was to bring United States law into conformity with GATT legal obligations. Even if the law made no significant change in the underlying export subsidy it was a precedent affirming the political legitimacy of GATT-required legislative change -- a substantial contribution.

If the significance of the FSC law is measured by the sweat and toil expended on behalf of GATT legal demands, again the FSC law earns high marks. Legislation restructuring tax advantages requires a long and painful process, and DISC-FSC was no exception. Businesses benefitting from DISC were very reluctant to agree to any modification of benefits, and had to be brought along inch by inch. The Congress itself had little or no active interest in the law, for legislators would gain nothing politically by voting for it. Endless sloggng was required to assemble the necessary support.

If, on the other hand, significance is measured by the policy change effected by the FSC law, the accomplishment has to be considered mediocre at best. The announced purpose of the FSC law was to change the form of the DISC subsidy to make it GATT-legal, while changing its substance as little as possible.¹⁰³ This was accomplished.

¹⁰² The legislation establishing FSC is Title VIII, Sections 801-805, of the Tax Reform Act of 1984, which is in turn Division A of the Deficit Reduction Act of 1984, 98 Stat. 985-1103 (1984). FSC is codified as Internal Revenue Code 921-997 (Supp. III 1985).

¹⁰³ In the cover letter accompanying the Administration's technical explanation of its FSC proposal, the U.S. Treasury Department announced: "The bill was drafted with four objectives: to meet U.S. GATT obligations; to be revenue neutral with the DISC; to preserve to the extent possible the position of existing DISC users; and to provide incentives for small business." Treasury

First, the value of the subsidy remained nearly the same. The change from DISC to FSC was revenue neutral; FSC would grant the same dollar amount of tax subsidy as DISC would have done.¹⁰⁴ Individually, the percentages of total export income subject to exemption under the FSC's administered pricing rules came remarkably close to the DISC percentages.¹⁰⁵

Second, although GATT's territoriality exemption applies only to income from extraterritorial economic activity, the Congress made the FSC's foreign activity requirements so easy to meet that they are largely a sham. The FSC does not have to be a separate foreign business operation, as is required under most territorial systems.¹⁰⁶ All of the FSC's income-earning activities could be performed by an "agent" under contract, and in most cases the agent is the parent corporation doing its export business as usual.¹⁰⁷ The FSC itself does not need to have foreign records, a foreign bank account, one nonresident director, and management meetings abroad, but these can all be done with minimal effort. The FSC's business location need only be a desk, a filing cabinet and a telephone, and nothing prevents other FSCs occupying the same room.¹⁰⁸ Even the foreign

Explains Foreign Sales Corporation Proposal, Tax Notes, 6 February, 1984, at 440-41.

¹⁰⁴ 1984 Senate Report, *supra* note 3, at 661.

¹⁰⁵ Generally the minimum tax saving under FSC is 15-16% of export income. See 7 Federal Taxes (Prentice-Hall) ¶ 30,681, at 30,700.13 (1988). The 1984 version of DISC sheltered about 17-18%, see note 3 *supra*.

¹⁰⁶ During the meeting at which the GATT Council adopted the December 1981 understanding, the delegate of Belgium, speaking for all three European defendants, expressed the following unilateral understanding of the exemption:

[T]he understanding does not exclude from the provisions of Article XVI the operation of differential tax practices based on the establishment of fictitious companies located abroad but where all their activities are directed from within the borders of the country of the parent company and where the tax legislation of the country of the parent company does not provide for full taxation of these activities.

C/M/154 (meeting of 7-8 December 1981) (quotation from summary record).

¹⁰⁷ See 1984 Senate Report, *supra* note 3, at pp. 640, 646-47.

¹⁰⁸ Treasury Regulations, §§ 1.922-1, 1.924(c)(1)(1987).

expenditures required of the FSC or its agent-parent can be satisfied rather easily, because the allocation rules for many expenditures such as transportation, risk insurance and advertising made it possible to structure rather routine export practices so that their costs will be classified as "foreign" spending.¹⁰⁹ And, finally, "small FSCs" (those with under \$5 million in export receipts) didn't need to satisfy the foreign expenditure requirement at all.¹¹⁰ The provision for small FSCs certainly did not comply with the territoriality exception stated in the 1981 understanding, and, viewed objectively, neither do the law's general criteria of extraterritorial economic activity.

In substance, then, the DISC lawsuit changed very little in the substance of U.S. law. The United States ultimately won its major point -- that tax laws based on the territoriality principle constituted a form of export subsidy, and that the United States was therefore entitled to create some sort of compensating export subsidy in return. The European Community prevailed to the extent of requiring that the compensating subsidy comply, at least in form, with the territoriality principle. Compliance with that principle, even if only in form, is something more of a limitation that existed under the wide-open domestic model for DISC, but not much more, especially when subsidies to smaller exporters are excused. The difference hardly seems worth twelve years of litigation.

One school of thought would suggest that the final substantive result wasn't that important for the European Community. The Community's primary interest in bringing and maintaining the lawsuit, this viewpoint argues, was to inflict a humbling legal experience on the United States. United States lawsuits against the Community throughout this period were uncomfortably numerous

¹⁰⁹ See The Making of a Subsidy, 1984: The Tax and International Trade Implications of the Foreign Sales Corporation Legislation, 38 Stanford L. Rev. 1327, 1344-47 (1986).

¹¹⁰ Internal Revenue Code, § 924(b)(2); see 1984 Senate Report, *supra* note 3, at pp. 657-59.

and irritatingly self-righteous. Without the occasional chastisement of its DISC failures, the United States legal policy would have been unbearable, particularly with regard to the Community's Common Agricultural Policy. There is probably something to this hypothesis. But even if relief from U.S. legal pressure was not in fact the Community's main objective in the DISC case, it certainly ended up being the main payoff.

It remains to ask why the substantive result of the DISC lawsuit wasn't any better. The result can, of course, be explained simply in terms of United States legislative politics. Once a tax benefit is created for a broad segment of United States industry, the combined lobbying strength of all those industries makes it next to impossible to pass legislation taking the benefit away. The cost-benefit argument against DISC -- the huge revenue loss in exchange for a highly problematic impact on exports in a world of floating exchange rates -- was a vastly more powerful political argument against DISC than were its GATT legal problems, and yet even this more powerful argument was repeatedly defeated.

It must also be noted, however, that the forces on the GATT side were never very strong. There may have been consensus that DISC was wrong, but once the territoriality exception to Article XVI:4 was recognized, that concession necessarily sapped the force behind the demand to root out the underlying subsidy in DISC. Most governments understood perfectly well that FSC gave the United States a somewhat larger export subsidy than it was entitled to under the 1981 understanding, but no further legal complaint was forthcoming. The GATT no doubt found it difficult, after all this time, to work up much enthusiasm about the precise manner in which roughly similar export subsidies are being granted.

In the background was a larger problem with GATT subsidy law generally. Attitudes toward DISC notwithstanding, the general lack of consensus over subsidies had been a long-standing problem. The substantive disarray has gotten even worse in the decade following the DISC decisions. One of the paradoxical facts about the DISC legal ruling is that, since 1975, it is the only legal complaint about export subsidies in which the GATT has been able to make a ruling of legal violation, and to have that ruling accepted and implemented.¹¹¹

D. THE LESSONS OF THE DISC CASE

¹¹¹ The following are the export subsidy complaints filed following the DISC case, to the end of 1989, and their outcomes;

European Community: Export Refunds on Malted Barley, Appendix, Complaint 82 (Complaint by Chile; not pursued).

European Community: Refunds on Exports of Sugar, Appendix, Complaint 86 (Complaint by Australia; panel unable to find violation, EC required to consult about "serious prejudice," but not required to change anything).

European Community: Refunds on Exports of Sugar, Appendix, Complaint 87 (Complaint by Brazil; similar panel finding, and identical result as in preceding complaint by Australia).

European Community: Subsidies on Export of Wheat Flour, Appendix, Complaint 103 (Complaint by United States under Subsidies Code; panel unable to reach a conclusion, U.S. blocked adoption of report).

European Community: Subsidies on Exports of Pasta Products, Appendix, Complaint 105 (Complaint by United States under Subsidies Code; panel votes 4-1 for ruling of violation, adoption of ruling blocked by EC).

European Community: Subsidies on the Export and Production of Poultry, Appendix, Complaint 106 (Complaint by United States under Subsidies Code; many discussions, provisionally settled with pricing agreement).

European Community: Export Subsidies on Sugar, Appendix, Complaint 109 (Complaint by United States under Subsidies Code; not pursued)

European Community: Sugar Regime, Appendix, Complaint 110 (Complaint by ten smaller countries; not pursued).

United States: Subsidies on the Export of Flour to Egypt, Appendix, Complaint 123 (Complaint by EC under Subsidies Code; not pursued).

Brazil: Subsidies on the Export and Production of Poultry, Appendix, Complaint 126 (Complaint by United States under Subsidies Code; same result as in Complaint 106 above).

European Community: Export Subsidy on Boneless Manufacturing Beef, Appendix, Complaint 134 (Complaint by Canada; withdrawn in favor of CVD action).

United States: Export Enhancement Program (EEP) Subsidy, Appendix, Complaint 190 (Complaint by Brazil; not pursued, but still pending).

The DISC case presented four major problems seldom found in ordinary GATT litigation. The first, which exerted considerable influence in the early stages of the case, was the fact that DISC had its roots in an area outside the GATT's customary realm of trade policy. The tax policies underlying DISC had not been part of the GATT bargain, and the government custodian of that tax policy, the U.S. Treasury Department, did not view itself as answerable to the GATT's writ.

The second problem was a GATT legal norm that left a great deal to be desired in terms of coherence. On the one hand, Article XVI:4 contained an explicit bi-level pricing limitation that no one really believed in, while on the other hand its seemingly broad prohibition of export subsidies was subject to a major exception for territorial tax systems that was nowhere advertised. Heroic efforts were required to overcome the bi-level pricing limitation, only to have the basic prohibition against export subsidies reduced to a quibble about the geographic form that income tax export subsidies must take.

The third problem in the case was the deep schism within GATT over subsidy policy. The disagreement, which had been masked during the early postwar years, became progressively more prominent as the DISC case progressed. By the end, the fate of the DISC case had become a pawn in the much larger policy battle swirling around the 1979 Subsidies Code.

The final problem was the unsettled state of the GATT legal system at the time the case was adjudicated. The early 1970s were a time of legal uncertainty. The tight little club of the 1950s was gone, and so were many of the conditions that permitted the early GATT's adjudication machinery to work so well. The legal traditions of the 1950s had become rusty with disuse, unfamiliar to the new generation of trade policy officials, and not necessarily suitable to the new GATT of the 1970s anyway. Every point of decision in the operation of the dispute settlement procedure had to be

confronted again, if not as a new issue, at least as one open to argument. In this setting, the DISC litigation was a kind of learning experience, a test case that allowed the new GATT to begin hammering out the kind of legal order it wanted.

That the DISC case was thrown off course by all these problems is, of course, obvious. What really ought to be remembered, however, is the contributions it made to the new GATT's legal order by eventually overcoming them.

First, by hanging on through year after year of frustrating defeats, the DISC litigation did establish the GATT's commitment to adjudicating legal claims. The entire edifice of GATT dispute settlement rests on this commitment. Establishing it was undoubtedly the most important contribution the DISC case made.

Next, although it was not appreciated at the time, the DISC case helped to demonstrate that even the less cohesive GATT of the 1970s could perform some pretty sophisticated legal decision making. The panel's ability to circumvent the explicit bi-level pricing requirement showed that GATT governments could still shape basic agreement over policy into an effective legal consensus.

As for the procedural elements of GATT's adjudication machinery, the most important contribution of the DISC case was a long list of object lessons, based on the long list of bullying tactics used by the United States, all of which were made to look doubly wrong by the dramatic failures that followed. The procedural improvements stimulated by the DISC case have come slowly, but one by one they have been put in place.

Finally, on the institutional side the DISC case provided the first of several demonstrations that a stronger dispute settlement procedure would need a stronger and more reliable source of legal expertise. It introduced the idea that lawyers as well as diplomats have a role to play in these cases.

Hudec - DISC

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The eventual consequence of this lesson, and one of the DISC case's most important contributions, was the GATT legal office which came into being about six years later.