

**GENERAL AGREEMENT ON
TARIFFS AND TRADE**

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Sub-Committee of the Committee
on Trade in Civil Aircraft

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ELEMENTS OF THE FRAMEWORK FOR NEGOTIATIONS

Communication from Japan

The following communication, dated 11 February 1993, has been received from the Permanent Mission of Japan.

The objective of the paper is to raise and explore issues in connection with the effort to multilateralize the commitments contained in the bilateral Agreement Concerning the Application of the GATT Agreement on Trade in Civil Aircraft (hereinafter "the Bilateral Aircraft Agreement") between the European Economic Community (hereinafter, the "EC") and the Government of the United States of America (hereinafter "US"). Where appropriate, the paper also presents the preliminary position of the Government of Japan (hereinafter "Japan") on the issues discussed. The right to make changes will be reserved.

I. The Relationship of a New Agreement on Trade in Civil Aircraft and the GATT Agreement on Subsidies and Countervailing Measures

A. POINTS TO BE EXAMINED

There are two types of Codes under GATT. One is a sector-specific Code (for example, Civil Aircraft Code) and the other is a general Code (for example, the Agreement on Subsidies and Countervailing Measures (hereinafter "Subsidies Code")).

Sector-specific Codes under the GATT necessarily raise the issue of the status of such Codes relative to existing disciplines of general application. Considering the Bilateral Aircraft Agreement which is discussed under the Civil Aircraft Committee, there appear to be three possible approaches for the relationship between the Sector Code and Subsidies Code.

First, a new Agreement on Trade in Civil Aircraft will be developed based on the existing Subsidies Code in terms of disciplines and enforcement. Both a new Agreement on Trade in Civil Aircraft and Subsidies Code are applicable to the aircraft industry in parallel.

Second, a new Agreement on Trade in Civil Aircraft could be limited to an agreement which provides for certain special disciplines unique to civil aircraft, but which does not address issues beyond those special disciplines. Therefore, a new Agreement would be regarded as creating "special rules" on those specific disciplines.

A third alternative is to create a self-contained and self-standing new Agreement on Trade in Civil Aircraft, which contains both the special disciplines unique to the aircraft industry and disciplines of the existing GATT Code applicable to the aircraft industry. Therefore, a comprehensive agreement on civil aircraft would build upon specific "special" disciplines for civil aircraft which would be unique to the sector.

B. DISCUSSION

The civil aircraft industry, particularly the industry producing large civil aircraft with 100 or more seats, is characterized by a set of economic factors which make government involvement, direct and indirect, both likely and, in many cases, important. However, this government involvement can distort the economics of both product development and production. The objective of any agreement on trade in civil aircraft would be to provide disciplines on government intervention in the civil aircraft sector which balance considerations favouring government intervention with the potentially trade-distorting effects of such intervention, and to secure free trade. The motivation underlying government involvement in the sector is largely attributable to the unique economic structure of the civil aircraft industry, including:

- (1) High risks associated with huge product development costs;
- (2) High risk because of low unit volumes for products, a small number of end-users within a limited sector, and the consequent vulnerability of the end-user market to shifts in broader economic conditions; and
- (3) High risk because of the substantial lag between the beginning of product development and the break-even point in the production cycle.

Because of this unique group of characteristics, it has been properly recognized in the existing Civil Aircraft Code that the aircraft sector necessitates specific and special disciplines on government intervention. In addition, as is discussed below, the unique characteristics of both the civil aircraft industry and the consuming industries require different approaches to the same issues than are provided in existing GATT Codes.

The high risks involved in this sector, a sector which is already oligopolistic and could become monopolistic, tend to encourage government involvement. The important point is the balance between the aforementioned unique characteristics which tend to encourage government involvement and the principle of free trade.

It is meaningful to consider the following three points.

First, a new Agreement on Trade and Civil Aircraft would impose, wherever necessary, far more extensive disciplines on government interventions, including prohibition of interventions which are permissible under the Subsidies Code.

Second, any new Agreement on Trade in Civil Aircraft would also likely change some of the substantive standards of the new Subsidies Code. One obvious example is that Code's standard for determining serious prejudice. The serious prejudice standard of the new Subsidies Code is based on government intervention as a portion of turnover. As is evident from the Bilateral Civil Aircraft Agreement, defining supports in terms of product development costs is a more appropriate benchmark for the civil aircraft sector than defining support in terms of turnover as is prescribed in the new Subsidies Code. Two factors in particular make turnover an inappropriate measure of serious prejudice for the aircraft sector. First, the small number of customers within the limited sector purchasing civil aircraft and the sensitivity of these customers, principally airlines, to the business cycle make turnover an unreliable and widely fluctuating basis for measurement. Second, government support relative to turnover is generally unrepresentative of the relationship between supports and the distorting effects of such supports since government supports are more likely to depend on the size of the project and its development costs rather than on turnover at any given point in time.

Third, for civil aircraft industries, indirect support plays an important part in developing civil aircraft. Special disciplines will be required.

C. PRELIMINARY POSITION OF JAPAN

In order for a new Agreement on Trade in Civil Aircraft to be effective, it is under consideration whether it may be appropriate to create a comprehensive agreement on disciplines for trade in civil aircraft which basically builds on disciplines required by other GATT Codes, but is not restricted by the terms of those Codes. In that case, parties are expected to make it easier to draft disciplines which are effective in addressing the unique characteristics of the civil aircraft industry, by not confining disciplines in a new Agreement on Trade in Civil Aircraft to those contained in existing Codes.

II. Product Coverage of a New Agreement on Trade in Civil Aircraft

A. POINTS TO BE EXAMINED

The Bilateral Aircraft Agreement covers only trade in large civil aircraft which are defined as aircraft designed for passenger or cargo transportation and have 100 or more passenger seats or its cargo equivalent. In contrast, the existing GATT Agreement on Trade in Civil

Aircraft covers all civil aircraft, their engines, parts, components and sub-assemblies, and ground flight simulators and their parts and components. While the restricted product coverage of the Bilateral Aircraft Agreement may be appropriate in the context of a bilateral solution to trade frictions between the US and EC over the Airbus consortium, this product coverage may not be appropriate in the context of a multilateral agreement intended to promote disciplines on an increasingly multinational industry.

B. DISCUSSION

The Bilateral Aircraft Agreement was intended to resolve trade frictions arising out of competition between producers of large civil aircraft in the US and EC. As such, the Agreement appropriately limits the product coverage to the products and producers of large civil aircraft within those two jurisdictions. However, this narrow product coverage would appear inappropriate for a broader new Agreement on Trade in Civil Aircraft. Specifically, many of the issues which were raised in the context of the negotiations of the Bilateral Aircraft Agreement are, in principle, equally applicable to an industry which is more broadly defined. For example, several governments appear to have a considerable involvement in efforts to develop a civil aircraft industry, or sub-assembly for civil aircraft, in a number of countries around the world. Thus, the objective of a new Agreement on Trade in Civil Aircraft should not be to simply multilateralize the solutions which the US and EC have agreed to in the context of a bilateral trade dispute, but rather to create a framework which attempts to balance government involvement in the aircraft sector with the legitimate need to limit the trade distortive effects which may result from such involvement.

The particular economic circumstances which have led to government involvement in the large civil aircraft sector are as applicable, and in some cases more important with respect to smaller civil aircraft and other items. For instance, it is not clear that the financial risks of developing and launching production of a small civil aircraft are proportionately any smaller than those risks associated with large civil aircraft, despite the fact that the pricing of smaller aircraft diminishes proportionally to size. In other words, as some statistics show, development costs do not necessarily decline parallel to the decline in prices between large and small civil aircraft. Similarly, the risks associated with the development of small civil aircraft may be greater than for large civil aircraft simply because the purchasers are generally smaller and financially weaker corporations even more subject to fluctuations in economic conditions than the purchasers of large aircraft. Finally, while a single large "launching" customer can quickly reduce the risks in the large aircraft industry - even before product development has been completed - there are no large volume "launching" customers in the small aircraft sector.

While the production of large civil aircraft is likely to be dominated by the US and EC producers in the foreseeable future, competition and potential distortions of competition through government intervention may include additional parties. Government intervention in a small civil aircraft industry may have the same effect, at least in relative terms, in distorting competition in this market as such intervention in the large civil aircraft industry.

The ability of the signatories to expand the disciplines of the existing Agreement on Trade in Civil Aircraft, however, is likely linked to the extent to which flexible terms can be negotiated for products other than large civil aircraft. As already indicated, the economic circumstances for smaller civil aircraft and other items are similar, but not always the same, as those for large aircraft. As such, if disciplines in excess of those currently provided for in the existing Agreement on Trade in Civil Aircraft and the Subsidies Code are to be incorporated in a new Agreement on Trade in Civil Aircraft, the Agreement may have to address certain disciplines in a different manner which is more appropriate for small civil aircraft and related sub-assembly and components than for large civil aircraft. Absent such an approach, participation in any new Agreement on Trade in Civil Aircraft may be limited and, therefore, of marginal benefit to the signatories.

C. PRELIMINARY POSITION OF JAPAN

The objectives of the Bilateral Aircraft Agreement are different from those of the new Agreement on Trade in Civil Aircraft. The Bilateral Agreement attempts to resolve trade distortions arising from bilateral disputes related to very specific companies and facts. If parties intend to multilateralize the results of the bilateral agreement, parties should try to develop rules of general application which attempt to balance trade-distorting government interventions and adequate market competition. Based on the above discussion, the negotiating parties should attempt to include in any new Agreement on Trade in Civil Aircraft the same products as are presently covered by the existing Agreement on Trade in Civil Aircraft.

III. The Definition and Treatment of Direct Government Support

A. POINTS TO BE EXAMINED

In addressing the definition and treatment of direct government support, the negotiating parties need to consider three issues: (1) what forms of government support should be included within the prohibitions or limitations on direct government support; (2) what limitation and prohibitions on direct government support are appropriate and necessary; and (3) whether the limitations on support should vary according to the product receiving such support.

B. DISCUSSION

(1) Prohibited Government Support

Direct government support needs to be adequately defined in any new Agreement on Trade in Civil Aircraft. The Bilateral Aircraft Agreement negotiations focused on certain categories of support because those negotiations were addressing very specific problems related to identified producers. Under certain conditions government equity infusions, loans and loan guarantees can be as trade-distorting as direct grants. The negotiating parties need to consider whether and under what conditions government support in the form of equity infusions, loans and loan guarantees should be prohibited under any new Agreement on Trade in Civil Aircraft.

(2) Limitations and Prohibitions

It is necessary to improve the direct support prohibitions and limitations in the Bilateral Aircraft Agreement, including that Agreement's special provisions for equity, for multilateralization. In general, there is no reasonable rule to consider a certain government direct support to be prohibited.

There is no apparent rationale for distinguishing between various types of direct government support in terms of whether these should be prohibited or limited when such government supports have adverse or distorting effects on trade. For example, equity infusions typically are not project specific. However, they can have the same adverse or trade-distorting impact as can grants, particularly if used to offset product development and production-related losses. Thus, to the extent that an equity investment is necessitated by the product development or production costs, a parallel standard would appear to be appropriate if the objective of the disciplines is, in fact, to limit trade-distortive direct government support. Similarly, any agreement should address either other forms of direct support such as project loans, general purpose loans and loan guarantees which, under certain circumstances, may be trade-distortive. In so doing, however, there must be recognition that the effects of, and therefore, the limitations on, these other forms of support may be different than the effects and limitation on grants and equity infusions. Fixed cost loans and loan guarantees will have little trade distortive effect. Loans where repayments are conditioned on project success or cash flow, and guarantees which enable companies to get loans at a lower cost can and do distort trade. Thus, the limitations and prohibitions likely should vary depending on the form of direct support and the extent of its distortive effect.

While it may be appropriate to impose disciplines on all forms of direct government support, broadening the scope of prohibitions and limitations beyond those existing in the Bilateral Aircraft Agreement may also necessitate alterations in the form and timing of the repayments

required. For example, under the New Aircraft Agreement repayment terms for loans may vary substantially from the grant/royalty model of the Bilateral Aircraft Agreement. Grace periods may or may not be tied to the beginning of production. Similarly, return on equity does not fit within the royalty concept contained in the Bilateral Aircraft Agreement and also has certain other inherent problems. It is unlikely, for example, that any return on equity would be made until after the break-even point in production and this return could be delayed because profits on one project are absorbed by losses on other projects which have not reached the break-even point.

The formulation of the direct support prohibitions and limitations in the Bilateral Aircraft Agreement, including that Agreement's special provisions for equity, would appear to require additional development in order to increase the effectiveness of disciplines on government support. A broader approach would appear to be appropriate for a multilateral agreement.

(3) Limitation on each product

As indicated above, it should be examined whether different standards should be established for different products within the overall scope of any agreement. For example, small civil aircraft might be permitted direct government support at a higher percentage of a programme's total development cost rather than the 33 per cent ceiling in the Bilateral Aircraft Agreement applicable to large civil aircraft. As already mentioned, the small civil aircraft sector appears to have relatively higher risks. Thus, the level of permitted support may have to be adjusted to reflect the higher level of risk associated with small civil aircraft development and production.

C. PRELIMINARY POSITION OF JAPAN

Japan believes that the new agreement should address all forms of direct support which have adverse or trade-distortive effects. However, in addressing forms other than grants, the parties must recognize that the various forms of support are not identical in terms of their effects.

IV. The Definition and Treatment of Indirect Government Support

A. POINTS TO BE EXAMINED

Indirect government support presents problems in terms of:

- (1) defining those supports which are within the scope of the agreement;
- (2) valuing the benefits of any such supports to determine whether they distort trade; and (3) obtaining adequate information to apply any standards in an agreement to specific supports (i.e., transparency). The issue of transparency is by far the most crucial, since without adequate transparency any disciplines on indirect support are meaningless.

B. DISCUSSION

Any indirect supports which have the effect of either lowering the costs or providing a competitive technological advantage to a producer of civil aircraft might provide an unfair advantage or distort trade. In countries where the research and development is done widely - and not only defence-related research and development - either the cost savings or the technological advantages conferred on civil aircraft production from this research and development could be substantial. In addition to that, production experience alone might confer an advantage, even if that production experience is based on production for not only civil but military purposes. An overly broad definition of the relationship between the indirect support received and the development or production of civil aircraft could include virtually any defence contractor within its scope. Too narrow a definition could provide an avenue for easy circumvention. It is important, therefore, to define the effect of the indirect support which could or would distort trade in terms of the cost reduction of civil aircraft development and production.

Indirect support which results in technological or production knowledge which is central to the development or production of civil aircraft clearly should be within the scope of any agreement, if it has a significant effect on reducing the costs of developing or producing the aircraft or provides the producer with a competitive product in terms of technology. At the other end of the spectrum, indirect support which is minimal in terms of its effect on development and production costs or in terms of providing a technological advantage which can be exploited in the market, should clearly not be proscribed in any agreement. The dividing line must be based on the effects of the indirect support on costs of development and/or production and the value of any technological benefit in terms of the competitive position of the aircraft. A quantitative threshold for technological advantage should be carefully examined.

A crucial problem will be the valuation of indirect support. The valuation of know-how and trade secrets may provide some guidance as to method of valuation.

While the determination of when indirect support distorts trade and the valuation of that trade-distortion effect are extremely difficult issues, the most difficult issue is the issue of transparency. Without transparency, any agreement will lack enforceability.

However, if there is a reduction effect on the development and production cost of the civil aircraft from the indirect support to technological development on the military side, there may - for reasons of national security - be some limitation on the transparency requirement in terms of quantifying the cost reduction.

C. PRELIMINARY POSITION OF JAPAN

Japan is of the opinion that indirect supports should be subject to regulations with a view to eliminating trade distortions, and that adequate transparency must be kept for these regulations to be enforceable. It is important to study concrete ground rules for quantifying identifiable profits from indirect supports accorded to the industry and to promote the study of a mechanism for keeping adequate transparency.

The position of Japan on the issue of indirect supports is yet to be fully developed and Japan will further it, taking into account discussions to be held in the Committee.

V. Existing Disciplines Applicable to Civil Aircraft

A. POINTS TO BE EXAMINED

Whether the rights and obligations in the existing Agreement should be incorporated in any new Agreement on Trade in Civil Aircraft.

B. DISCUSSION

Since the objective of any new Agreement on Trade in Civil Aircraft is to improve the disciplines of the existing Agreement, at a minimum any new Agreement should incorporate the disciplines of the existing Agreement.

C. PRELIMINARY POSITION OF JAPAN

Japan believes that there are many GATT-related Agreements which should be incorporated into a new Agreement on Civil Aircraft, including improved market access, removal of technical barriers to trade and government intervention in aircraft purchases.

VI. Dispute Settlement and Remedies

A. POINTS TO BE EXAMINED

The following two threshold issues need to be examined in the context of addressing dispute settlement and remedies: (1) whether the standards applicable should be specified in this Agreement and (2) whether remedies unique to the civil aircraft sector should apply.

B. DISCUSSION

As a general rule, regarding GATT/MTO Agreements, the general dispute settlement provisions of the MTO should apply to disputes under the new Agreement on Trade in Civil Aircraft as much as possible. The aforementioned disciplines in the civil aircraft sector imposed by

such an Agreement would seem to require dispute settlement provisions specific to trade in civil aircraft. There need to be legitimate reasons to include special/additional dispute settlement provisions.

C. PRELIMINARY POSITION OF JAPAN

As a rule, the general dispute settlement procedures should apply. However, Japan is reflecting on some aspects unique to this industry to see whether there is a need to have special or additional dispute settlement provisions.

VII. Signatories

A. POINTS TO BE EXAMINED

Two issues need to be explored. First, whether extant special and differential treatment will be provided for less developed signatories and/or countries in transition from market to non-market economies. Second, what the obligations of signatories will be with respect to civil aircraft programmes in non-signatory countries.

B. DISCUSSION

With respect to the issue of special and differential treatment for less developed signatories, it may be possible to provide for such treatment by simply providing different standards for civil aircraft and for other items. In addition, any differential treatment which is provided should take into account not only the stage of development of the less developed country signatory but, more importantly, the stage of development of the civil aircraft industry in such country. A negotiated phase-in of obligations may be appropriate.

It is unclear to what extent an Agreement will cover, or will need to cover, countries in transition from non-market to market economies. The negotiations should anticipate these developments and make appropriate provisions to address this development. It would appear that a negotiated phase-in of obligations may be necessary in order to accommodate the transitional period.

Finally, there is the issue of treatment of non-signatories to the Agreement. The disciplines of any Agreement should apply to any joint or co-production involving entities as well as signatory countries.

C. PRELIMINARY POSITION OF JAPAN

Japan believes that the above issues should be addressed in the course of negotiation of a multilateral agreement under the auspices of the GATT; however, Japan has not finalized its position on how to set a discipline to cope with those issues in the most effective manner.