F SUBSIDIES AND THE WTO

1. INTRODUCTION

We have discussed the economic arguments for and against different kinds of subsidization earlier in the Report. Economic analysis tells us that market failures of various kinds can sometimes be addressed efficiently with subsidies. It also tells us that subsidies can distort trade flows if they give an artificial competitive advantage to exporters or import-competing industries. Whether a subsidy is viewed as a desirable intervention for correcting a market failure or as an undesirable trade distortion depends sometimes upon who is making the judgement. But economic analysis ought to be able to help, both in determining the desirability of an intervention from a welfare perspective, and in assessing the merits of alternative forms of intervention. Governments may, however, decide to grant certain kinds of subsidies that have little to do with efficiency considerations, and in such cases economic analysis based on a simple welfare analysis may be of limited use. Also in these cases, the analysis is probably most helpful in ensuring that policy-makers are aware of the costs of pursuing particular objectives and of alternative, lesser-cost ways of doing so. We also know that judgements about what to subsidize, by how much and for how long are complex technical questions on which governments frequently lack adequate information.

These are among the issues that have influenced the shaping of GATT/WTO subsidy rules over the years, although of course these are trade rules rather than general economic rules, or competition rules, and thus have a trade focus. The next subsection (Section 2) discusses the evolution of the disciplines and introduces the three principal subsidy-related agreements that are currently administered by the WTO – the Agreement on Subsidies and Countervailing Measures (SCM Agreement), the Agreement on Agriculture (AoA), and the General Agreement on Trade in Services (GATS). Aspects of how subsidies are defined and various attempts by the WTO's legal organs to interpret these definitions are presented in Section 3, where the focus is on the SCM Agreement. Section 4 examines the developmental aspects of subsidies in relation to the WTO rules. Section 5 discusses subsidy disciplines in the context of the Doha negotiations. Section 6 contains some concluding observations.

2. EVOLUTION OF SUBSIDY RULES IN THE GATT/WTO

(a) GATT Article XVI

From the beginning, multilateral subsidy rules have focused on the potentially distortive effects of subsidies on trade flows, with any given subsidy disciplined or tolerated in direct relation to its trade-distortive potential. In the early years of GATT, however, the subsidy rules, which were contained in Article XVI, were neither well developed nor imposing.[296] The entirety of the first multilateral subsidy discipline was contained in Paragraph 1 of Article XVI of the GATT, which was taken from the Havana Charter. All Paragraph 1 required was that signatories should notify "any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory…". The notification was required to specify the extent and nature of the subsidization, its estimated effects on exports and imports, and the circumstances making the subsidization necessary. If the subsidization was deemed to cause serious prejudice to the interests of any other party, the subsidizing contracting party was only required to discuss the possibility of limiting the subsidization. Thus, no form of subsidization was prohibited, but instead the focus was on the demonstration of trade effects – namely, serious prejudice to other countries' interests. Over the years, subsidy disciplines have become much more specific and imposing.

The first modification to the rules came in the 1955 Review Session of the GATT with the introduction of Section B of Article XVI, entitled "Additional Provisions on Export Subsidies". Section B reflected increasing concern about the potentially trade-distortive effects of certain subsidies – specifically export subsidies, as reflected in its preambular paragraph (Article XVI:2), which reads:

[296] Other original GATT provisions relevant to subsidies, and countervailing duties, are to be found in: (i) Article II:2(b), which allows anti-dumping and countervailing duties that exceed tariff bindings; (ii) Article VI, regulating countervailing duties; and (iii) Article III:8(b), which exempts subsidies from the non-discrimination obligations of national treatment.

> "The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement [the GATT]."

With this new focus on export subsidies came the first differentiation of the subsidy rules in respect of primary versus non-primary products.[297] In the case of primary products (which included agricultural products), contracting parties were to "seek to avoid" using export subsidies, and if they did use them, not to do so in a way that would garner for the subsidizing party "more than an equitable share of the world export trade in the product" in question, taking into account representative historical trade shares and any special factors. This was, therefore, not a prohibition, but a trade effects test. Indeed, only now, in the Doha negotiations, are WTO Member governments poised to declare all export subsidies on agricultural products illegal, as the AoA only prohibits, under Articles 3.3 and 8, export subsidies that are in excess of budgetary outlays and quantity commitment levels which have been specified in Members' Schedules.

As for export subsidies on non-primary products, Paragraph 4 of Section B of Article XVI decreed a prohibition as from 1 January 1958, or as soon as practicable thereafter, on export subsidies that resulted "in the sale of [a non-primary] product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market". Most GATT contracting parties did not comply promptly with this prohibition, leading to the establishment of a Working Party on Provisions of Article XVI:4 which reported in 1960[298] and produced a draft Declaration Giving Effect to the Provisions of Article XVI:4.[299] In its report, the Working Party developed a non-exhaustive list of measures considered to be export subsidies of the type that would be prohibited pursuant to Article XVI:4.[300] Only 17 contracting parties accepted the Declaration, which came into force for them on 14 November 1962. While the subsequent Tokyo Round Subsidies Code extended the prohibition of export subsidies on non-primary products to additional contracting parties, it was not until the Uruguay Round Agreement on Subsidies and Countervailing Measures entered into force in 1995 that the prohibition on export subsidies on non-agricultural products became fully institutionalized, albeit with certain exceptions and implementation periods for developing and transition economy countries.

This asymmetry in the treatment of subsidies on primary and non-primary products reflected the interests of dominant GATT contracting parties at the time, and has been a source of contention ever since. No economic logic supports the notion that subsidies on primary products are intrinsically more justified than subsidies on non-primary products. If anything, the logic may go in the opposite direction, considering the infant industry argument for protecting manufacturing activities in the early stages of industrial development. We shall return to this issue below.

(b) The Tokyo Round Agreement (Subsidies Code)

After the modifications to Article XVI of the GATT in the 1955 Review Session and the 1960 Declaration Giving Effect to the Provisions of Article XVI:4, the next big step forward in subsidy rule-making emerged from the Tokyo Round, in the form of the Agreement on Interpretation and Application of Articles VI, XVI and XXXIII, known as the Subsidies Code, which entered into force on 1 January 1980. The Code only applied to those contracting parties that decided to sign it.[301] More contracting parties accepted the Code than had accepted the 1960 Declaration.

297 For purposes of Article XVI, primary products were defined as "any product of farm, forest or fishery, or any mineral, in its natural form or which has undergone such processing as is customarily required to prepare it for marketing in substantial volume in international trade". See Interpretative Note 1 to Section B of Article XVI of the GATT.

298 GATT BISD 9S, 185.

299 GATT BISD 9S, 32.

300 This list was the precursor to the Illustrative List of Export Subsidies, contained in Annex I to the WTO SCM Agreement.

301 Twenty-four countries ratified the Code. Some of these did so with reservations and exceptions.

The Subsidies Code confirmed the prohibition of export subsidies on non-primary products, the scope of which excluded mineral products. In addition, the Code introduced an illustrative list of export subsidies. This list, which built on the list contained in the 1960 Working Party report, represents the first explicit attempt to define subsidies in GATT treaty text, albeit only in respect of export subsidies, and only via a non-exhaustive itemization of certain interventions. The Code also elaborated certain rules pertaining to adverse effects, and contained special and differential treatment (S&D) provisions for developing country signatories.

The Subsidies Code introduced more detailed rules pertaining to countervailing measures (the basis of which is Article VI of GATT), notably in respect of procedures associated with countervailing duty investigations and standards for determining whether subsidies were a cause or threat of material injury.

(c) The Uruguay Round Agreements relevant to subsidies

(i) The Agreement on Subsidies and Countervailing Measures

The SCM Agreement had far-reaching implications, both in its substantive modifications to subsidy disciplines and in the fact that, by virtue of the "Single Undertaking", the new Agreement applied to the entire WTO membership. The new Agreement defined subsidies for the first time and further elaborated on subsidy disciplines, classifying subsidies into three categories (prohibited, actionable and non-actionable).[302] It also developed definitions, concepts and methodologies relating to adverse effects, and established procedural rules for multilateral remedies. The Agreement expanded and developed existing procedural and substantive rules on the use of countervailing measures.

Members hoped that this added precision would increase the certainty and predictability of the rules, and thus help to constrain the use of trade distortive subsidies. Similarly, they hoped that the clarifications to the countervail rules would help to ensure that such measures were only used when warranted. As an integral component of these disciplines and rules, Part VII of the SCM Agreement sets out enhanced provisions on notification and surveillance – that is, transparency provisions (a feature of the WTO rules in all policy areas). As discussed in some detail in Section E, available information on subsidies has oftentimes been incomplete or non-existent, notwithstanding the obligations set out in this area. This represents a serious lacuna in WTO practice in an important policy area.

As noted above, by virtue of the "Single Undertaking", the subsidy rules applied to all Members, implying considerable additional obligations for developing countries, particularly for those that had not been parties to the Tokyo Round Code. To modulate this impact, the SCM Agreement contains extensive S&D provisions. As we shall see in the discussion below, these provisions have received attention in the broader debate about "development space" under the trading rules.

Turning to the basic structure of the Agreement, it should be noted, first, that the concepts of "subsidy" and "specificity", which are found respectively in Articles 1 and 2, are key to the entire Agreement. They define which measures are subject to the multilateral subsidy disciplines, including remedies. Article 1 of the SCM Agreement states that a subsidy is deemed to exist if a financial contribution or income or price support is provided by a government, and a benefit is thereby conferred, and that such subsidy is subject to the Agreement if it is "specific". Article 2 defines the concept of specificity, which is deemed to exist when access to the subsidy is limited, explicitly or in fact, to certain enterprises.[303]

As noted above, the SCM Agreement had three categories of specific subsidies when it entered into force: prohibited, actionable (permitted, but potentially subject to action) and non-actionable (permitted, and shielded from action). Prohibited subsidies (see below) are irrebuttably presumed to distort trade. Certain kinds of subsidies within the actionable category were deemed, via a rebuttable presumption, to cause serious prejudice. In addition to the actionable subsidies in respect of which serious prejudice was presumed, other subsidies in the

[302] The so-called "traffic light" approach of red, amber and green light subsidies.

[303] Article 2.1(c) sets down the parameters for determining when subsidies that are not explicitly specific are specific *de facto*.

actionable category could be subject to remedial action by trading partners if they were demonstrated to cause defined kinds of adverse trade effects – namely serious prejudice, injury to the industry of an importing Member, or nullification or impairment of benefits. The difference between actionable subsidies rebuttably presumed to cause serious prejudice and other actionable subsidies turned on the question of where the burden of proof fell. Non-actionable subsidies were deemed to be non-specific within the meaning of Article 2 or to meet certain other specified requirements relating to their form and purpose. The latter encompassed certain research-related subsidies, regional subsidies and environment-related subsidies.

The provisions in the SCM Agreement on the rebuttable assumption of serious prejudice ("deeming" provisions) in the actionable category and on the non-actionable subsidy category were subject to review after five years. The provisions were not renewed and therefore lapsed on 1 January 2000, leaving only two categories of specific subsidies covered by the Agreement – prohibited and actionable.

Both these categories of subsidy may be challenged either through multilateral dispute settlement or through the imposition of countervailing duties. For multilateral challenges through dispute settlement, the complaining party must demonstrate either that the measure is a prohibited subsidy, in which case it must be withdrawn, or that the measure is an actionable subsidy that has caused adverse trade effects, in which case the measure must be withdrawn or its adverse effects removed. For countervailing measures, the importing Member must conduct an investigation which demonstrates that the subsidized imports are causing injury to its domestic industry.

Two types of subsidies are prohibited by the SCM Agreement: (1) export subsidies, and (2) local content or import substitution subsidies. Export subsidies are those that are contingent, in law or in fact, whether solely or as one of several conditions, on export performance. An illustrative list of certain export subsidies is annexed to the Agreement. Local content subsidies are those that are contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

These prohibitions are not new. As discussed above, developed countries had already accepted the prohibition on export subsidies in the 1960s under GATT Article XVI. Similarly, the ban on local content subsidies can be traced back to Article III:4 of GATT, on national treatment, specifically the prohibition on measures favouring the use of domestic goods. The main changes introduced in this regard by the SCM Agreement relate to the extension of these prohibitions (although subject to considerable S&D treatment) to all developing country Members and Members in transition, as well as the creation of a rapid (three-month) dispute settlement mechanism for complaints regarding prohibited subsidies. The prohibitions did not take effect immediately. For export subsidies, developed Members were allowed three years from the date on which the SCM Agreement entered into force to phase out prohibited subsidies, while developing countries and countries in transition were permitted longer transition periods.

These and other S&D treatment provisions for developing countries are set out in Part VIII of the Agreement, which consists of one article (Article 27) with 15 paragraphs. Concerning export subsidies, developing country Members that meet the criteria spelt out in Annex VII are exempted from the prohibition of export subsidies as set out in Article 3. These include Least-Developed-Countries (LDCs) as defined by the United Nations and a group of countries below a per capita GNP threshold as set out in paragraph (b) of Annex VII. Other developing country Members were allowed to retain their export subsidies for a period of eight years from the entry into force of the Agreement and subject to further conditions as spelled out in SCM Article 27.4. SCM Article 27.4 also contains a mechanism for developing country Members to seek extensions from the Committee on Subsidies and Countervailing Measures to the period for the use of export subsidies with annual reviews by the Committee of any extensions, and a final grace period of two years to phase out the measure if an extension is not granted after a review. By contrast, the longest transition period for local content subsidies, seven years, was not extendable, and thus all Members are now fully subject to the prohibition on these subsidies.

The S&D provisions on export subsidies described above were the subject of Ministerial Decisions on Implementation-Related Issues adopted in November 2001 at the Fourth WTO Ministerial Conference held in Doha. In one of these decisions, Members agreed to streamlined procedures for extensions under SCM Article 27.4 for certain developing countries.[304] These procedures are contained in a document[305] adopted via paragraph 10.6 of the Doha Ministerial Decision on Implementation-Related Issues and Concerns. The SCM Agreement is not silent on the impact of permissible export subsidies. SCM Articles 27.5 and 27.6 provide that the permitted export subsidies of developing Members (including those permitted by virtue of Article 27.4 extensions) must be phased out in respect of a particular product if the subsidizing Member achieves "export competitiveness" in that product. In another implementation decision by Ministers, Members reinterpreted the GNP threshold in Annex VII, and created a mechanism for Members listed in Annex VII to re-enter that Annex after graduation if their GNP level falls below the threshold.

Since the focus of this Report is on subsidies, we do not analyse further the countervailing duty remedy available to Members under these agreements. Suffice it to say that countervailing duties may be imposed on a subsidized product up to the estimated amount of the subsidy, provided that it is established, via a properly conducted investigation, that the subsidization causes or threatens material injury to an established domestic industry or materially retards the establishment of a domestic industry. As already noted, these provisions have been modified over the years. Much of the discussions and negotiations leading to these modifications have been conducted in the context of anti-dumping duties and then extended by agreement to countervailing duty provisions. Changes to the rules have included the elaboration of the requirements of an investigation, the calculation of the benefit amount from different forms of subsidization, the existence or threat of injury, and the establishment of causal links between subsidization and its effects on domestic industries.

(ii) The Agreement on Agriculture

The Agreement on Agriculture (AoA) that emerged from the Uruguay Round was the most complete attempt to date to frame explicit multilateral rules for agricultural trade. Separate provisions dealt with each of the three policy pillars defined in the Agreement – market access, domestic support and export subsidies. The latter two of these categories are relevant to subsidies as defined in this Report. Domestic support reduction commitments are expressed in terms of an aggregate measure of support (AMS) and entered into Members' Schedules of Annual and Final Bound Commitment Levels, with the exception of the subsidies in blue and green boxes. Export subsidies are simply defined as subsidies contingent upon exports, under Article 1(e). Article 9 of the Agreement does, however, make specific reference to particular measures such as stock disposal at non-commercial prices, marketing subsidies, subsidies to transport charges, and subsidies on agricultural products that are inputs to exported products.

The subsidy provisions on agriculture differ from those applying to non-agricultural products in two important ways. First, the AoA envisages reduction commitments on both domestic support measures and export subsidies. These commitments are conceptually comparable to the commitments traditionally made in negotiating rounds on import tariffs and have no counterpart in the non-agricultural sector, nor for that matter in the services area. Second, the reduction commitments on export subsidies underlie the reality that unlike subsidies on manufactures, the original efforts at disciplining agriculture protection did not contemplate the possibility of completely eliminating export subsidies. At the Sixth WTO Ministerial Meeting held in Hong Kong in December 2005, however, Members agreed to the elimination of export subsidies in agriculture by 2013.

In the detail of the AoA, a number of unique features are present in what many regard as a highly complex agreement. Domestic support commitments are distinguished in terms of the degree to which they are deemed to distort markets. There are so-called green, amber and blue boxes that determine subsidy reduction commitments. Green box subsidies are those that are the most divorced from production decisions – such as direct income payments – and are therefore not subject to reduction commitments under the AMS. The green

[304] Decision on Procedures for Extensions Under Article 27.4 for Certain Developing Country Members. See para 10.6 of WTO documents WT/MIN(01)/17 and G/SCM/39.

[305] G/SCM/39.

box subsidies must be funded out of government revenue (rather than charges to consumers) and must not involve any element of price support. The notion that they should be decoupled from production leads in the direction of non-specificity – a concept that is central to the SCM Agreement definition of subsidies, and as we argue elsewhere, crucial to an economic appreciation of the effects of subsidies.

Amber box subsidies are those that are regarded as the most directly trade-distorting and beyond a certain *de minimis* level, are subject to AMS reduction commitments. The blue box subsidies are a sub-category of amber box measures, but treated differently in terms of liberalization commitments. Blue box subsidies are those that may be deemed trade-distorting, but are contingent upon limitations in production. These subsidies are not included in the AMS. Much discussion is going on in the negotiations about how these different categories should be defined and what limitations should be placed on the exemption of measures from reduction commitments. The present Report does not attempt to provide a systematic analysis of these or other aspects of what is a complex and highly contentious negotiating process in the Doha Round.

The AoA also contains a range of S&D provisions, involving lesser liberalization commitments and higher *de minimis* thresholds. Least-developed countries have been exempted from making any trade liberalization commitments. Developing countries have been anxious to ensure that a situation of high dependency on agriculture is not complicated in any way by liberalization commitments and have therefore been emphasizing the desire for flexibilities in commitments. As regards trade liberalization by major agricultural production centres in developed countries, the developing countries face a mixed probable outcome. To the extent that trade liberalization, particularly involving subsidies, raises world prices, this will represent new profitable production opportunities for some and perhaps terms-of-trade losses for others (net food importers), at least in the short term. The latter risk is recognized by reference to the Uruguay Round Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net food-importing Developing Countries in Article 16 of the AoA.

Many commentators have noted the disparity in the treatment of subsidies in agriculture and the non-agriculture sector – for example the different treatment of export subsidies – and have questioned the rationale for the differences, particularly as they are perceived to work against developing country interests. From an economic perspective, it is far from obvious that agriculture subsidies in rich countries are any more defensible than subsidies on manufactures in developing countries. The different treatment is therefore probably most easily understood in terms of asymmetries in negotiating power. This problem, however, is being lessened as industrial countries adopt additional subsidy reduction and elimination obligations.

As far as subsidy remedies are concerned, the AoA had a "due restraint" clause (commonly referred to as the "Peace Clause") in Article 13, which exempted green box measures from countervail and multilateral challenge under the SCM Agreement, and which exempted domestic support measures and export subsidies in conformity with the Agreement from multilateral challenge under the SCM Agreement during the implementation period.[306] The remedies available in agriculture on the countervailing side are derived from the SCM Agreement and are no different from the remedy for non-agricultural products.

(iii) The General Agreement on Trade in Services

The General Agreement on Trade in Services (GATS) has adopted a very different approach to subsidy disciplines than that found on the goods side. In the first instance, it should be noted that Article XV of the GATS, which deals with subsidies, is primarily a negotiating mandate, not a set of rules. The Article calls for negotiations in recognition both that subsidies may distort trade and that they may have a role to play in development. The Article calls for recognition of the need for flexibility in this area. The negotiating mandate is also to consider the appropriateness of countervailing procedures. Members are required to exchange information on all subsidies related to trade in services that they provide to their domestic service suppliers. A right is also established under Article XV to seek consultations with another Member if its subsidy practices are considered to be the source of adverse trade effects.

[306] The implementation period for the purposes of the AoA was nine years from the beginning of 1995 (six years in respect of the rest of the Agreement).

In the absence of explicit subsidy disciplines, the question arises as to how far subsidy disciplines in fact exist as a result of the structure of the GATS.[307] The main point here is that a certain discipline on subsidies exists by virtue of the rules on non-discrimination – the most-favoured-nation and national treatment provisions. National treatment is particularly relevant, since Members can schedule national treatment commitments with respect to particular service activities in specified modes of supply. If these commitments do not contain explicit exemptions that permit subsidies to be granted in a discriminatory manner, then the national treatment principle will require that "like" foreign and national services and service suppliers must be given the same treatment in relation to subsidies. While this discipline does not directly regulate the granting of subsidies, it would arguably impose some restraint on the willingness of governments to subsidize.

This regulatory structure under GATS is different from the GATT, since Article III:8(b) of the GATT excludes goods subsidies from the purview of national treatment. What on the face of it might look like stronger GATS discipline than that on goods will not in fact amount to a significant difference unless Members have chosen to assume national treatment commitments in important sectors without any carve-out for subsidies.

Discussions on possible approaches to subsidy disciplines have not gone very far, although several delegations have recently suggested that an acceptable approach might be to use the SCM Agreement definition of subsidies, appropriately modified, as a working basis upon which to carry forward the negotiations.[308] This would certainly advance discussions. Another issue that has been of growing concern to some Members is the widespread disregard of the obligation under Article XV to engage in an information exchange on subsidies. This is a matter we have already referred to in this Section and in Section E. The absence of information on subsidy practices hampers the ability of governments to take informed decisions and renders progress in negotiations more difficult. In the particular case of services, some Members have proposed linking the adoption of a working definition of subsidies based on the SCM Agreement with an agreed format for submitting information on subsidy practices. This would certainly facilitate the task of preparing information for the information exchange exercise.

3. DISCIPLINING THE USE OF SUBSIDIES IN THE MULTILATERAL TRADING SYSTEM – THE SCM AGREEMENT

The discussion in Section C of this Report has shown that while subsidies can be welfare-diminishing distortive measures not necessarily motivated by purely economic considerations, they can also respond to less than perfect market conditions and market failures such as economies of scale, externalities and strategic interaction among monopolistic producers. How far do the WTO subsidy rules ensure that when subsidies are used, they serve an economically sound policy objective? And do the rules acknowledge the existence of other policy options to pursue the same objectives? These are the two questions this subsection looks at.

What the WTO subsidy rules do is to delimit particular aspects of a certain kind of government intervention and build a set of rights and obligations around this definition on the basis of the trade distortive impact of the measures. If one were to attempt to assess the utility of the definition in isolation, the result would look very different from an analysis that takes account of the wide range of other defined policies and rule sets that make up the WTO Agreement. The point is that the definition of a subsidy needs to be understood in the context of all the other rules that address Member governments' behaviour, the consequences of which could theoretically be defined, at least in part, as a subsidy outcome if broader subsidy definitions were employed.

As discussed in Section B, the SCM definition of subsidies does not cover subsidization resulting from border protection and from regulatory measures. This makes sense in the context of the multilateral legal framework as both of these other types of policy options are dealt with in other Agreements. This Section therefore provides a discussion of how the SCM Agreement deals with the potential trade-off between trade-distorting and welfare-enhancing effects of subsidies and compares this approach with the one taken in the other

307 See WTO document S/WPGR/W/9 of 6 March 1996 for a detailed analysis of this issue.

308 See, in particular, WTO documents Job(05)/4, Job(05)/5 and Job(05)96.

relevant Agreements. The discussion will also make reference to relevant provisions in the AoA and related case law.

Particular attention is paid in this Section to the objective of developing countries to encourage industrial development, and the question is asked whether and how the Agreements grant sufficient "policy space" to developing countries in this respect. The literature has already emphasised the possible negative effects of an unbalanced relationship between the disciplines on different policy options within the multilateral legal framework. Bagwell and Staiger (2004) have argued that tighter rules on subsidies introduced in the 1995 SCM Agreement might have done more harm than good to the multilateral trading system. The argument is based on the welfare theoretic proposition we discussed in Section C concerning optimal intervention. The proposition is that policy interventions should take place as close as possible to the source of the problem (market failure) they seek to address in order to minimize the generation of additional distortions in the market. If we abstract from import tariffs as a revenue source for a moment, the argument is that a tariff to protect an infant industry is an inferior policy intervention to subsidizing firms. Bagwell and Staiger argue that stronger disciplines on subsidies make them harder to use and may therefore have a "chilling" effect on additional market access commitments via reduced tariffs. Such an outcome implies welfare costs. That said, it is not clear that either form of prohibited subsidies would necessarily be the best or the only form of subsidy that could be used as an alternative to a tariff, nor is it clear that the actionable subsidy rules have reduced the incidence of actionable subsidies. The extent to which stronger subsidy rules have inhibited commitments to reduce tariffs is obviously an empirical matter in respect of which we have no evidence. But the essential point that choices among policy alternatives can matter is well taken.

(a) The identification of potentially trade distorting subsidies

Within the two categories of subsidies that are covered by the SCM definition of subsidies, i.e. different forms of government monetary transfers and the public provision of goods and services, not all subsidies are considered to be of concern for the multilateral legal system. Indeed, as discussed above, one would expect and it is in fact the case that only subsidies that create a certain level of trade distortion need disciplining. The SCM Agreement attempts to identify such subsidies first on the basis of the recipients, via the specificity rules, and second on the basis of how direct their impact is on trade flows, with the prohibition applying to those – export subsidies and import substitution subsidies – with the most direct such impact.

Although the definition of subsidies in the SCM Agreement is similar to definitions commonly found in the relevant literature and in national and international data sources, the WTO case law illustrates that it is not straightforward in practice to determine whether a given government policy falls under this definition or not. The concept of "specificity" is unique to the WTO Agreements and not commonly used in the relevant literature or statistics. This subsection therefore not only provides a discussion of the problems encountered in practice when identifying specificity, but also compares the term to related concepts in economic analysis.

(i) The definition of subsidies

Article 1.1 defines a subsidy in terms of "a financial contribution by a government or any other public body within the territory of a Member" either in the form of a direct transfer of funds or other forms discussed in Section B, including potential transfers of funds or liabilities, revenue foregone as a result of tax exemptions, the provision of goods and services by a government, other than general infrastructure, or the purchase of goods by a government. Finally, a subsidy would also be deemed to exist if a government entrusted or directed a private entity to carry out these functions or made payments to a funding mechanism. The approach taken in Article 1 indicates an intention to cover all possible forms in which governments can make financial contributions under the definition of subsidies. The difficulties of identifying subsidies in practice remain significant, given the variety of instruments governments can use to make "financial contributions". A subsidy is only deemed to exist if in addition to constituting a financial contribution, a measure also confers a benefit as specified in Article 1(b). Again, the establishment of the existence of such a benefit may pose difficulties, as illustrated in the relevant case law.

Various aspects of the list of financial contributions contained in Article 1.1(a)(1)(i)-(iv) of the SCM Agreement have been subject to dispute. For instance, a normative benchmark was found to be necessary in order to determine what constituted foregone tax revenue that is "otherwise due" as defined in Article 1.1(a)(1)(ii) of the SCM Agreement. Here, the Appellate Body held that the fiscal treatment of income subject to the contested measure needed to be compared with the treatment of legitimately comparable income. Importantly, for the purposes of this comparison, the Appellate Body confirmed that it might not always be possible to identify a general tax rule that would apply to the revenues in question in the absence of the contested measure.[309]

Also determining whether the granting body constitutes a government or other public body in the sense of the SCM Agreement has been the matter of dispute. This question was, for instance, taken up in *Korea-Commercial Vessels*, where certain granting bodies were government-owned financial institutions. The Panel in this case took the view that control of a body is an important criterion in determining whether an entity is a public body in the sense of Article 1.1(a)(1) of the SCM Agreement, and thus whether the SCM Agreement applies.[310]

In addition to the criteria for defining a financial contribution, the reference in Article 1.1(a) to any form of income or price support in the sense of Article XVI of the GATT 1994 merits further consideration. This is a reference to any support operating directly or indirectly to increase exports of any product from, or reduce imports into, a Member's territory. The precise definition of the notion of income and price support in this context has never been clearly specified.[311] However, the issue has been discussed at various points in relation to subsidy elements in domestic support prices, subsidies financed by a non-governmental levy, export credit programmes, internal transport charges, tax exemptions, multiple exchange rates and border tax adjustments.

A number of cases have dealt with the question of how to establish that a benefit has been conferred.[312] In *Canada–Aircraft*, the Appellate Body confirmed the Panel's finding that a financial contribution had to make the recipient "better off" than it would have been, and that the appropriate basis for comparison in this regard was the marketplace in order for a "benefit" in the sense of SCM Article 1.1(b) to exist, and thus for the measure to have trade-distorting potential.[313] That interpretation led the Appellate Body in *US–Lead and Bismuth II* and in *US–Countervailing Measures on Certain EC Products* to conclude that assets of a state-owned enterprise which the latter might have previously acquired with a "financial contribution" by the government, and then sold at fair market value in the course of privatization may be presumed not to confer a benefit on the purchasing firm. In *US–Countervailing Measures on Certain EC Products*, the Appellate Body further stated that "once a fair market value is paid for the equipment, its market value is redeemed, regardless of the utility the firm may derive from the equipment" (para. 102). However, in paras. 126-127, it cautioned that privatization at arm's length and for fair market value might result in extinguishing the benefit, but did not necessarily do so in every case – i.e. there was only a rebuttable presumption that the benefit ceased to exist after privatization.

309 "There must, therefore, be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised "otherwise". We, therefore, agree with the Panel that the term "otherwise due" implies some kind of comparison between the revenues due under the contested measure and revenues that would be due in some other situation. We also agree with the Panel that the basis of comparison must be the tax rules applied by the Member in question." Appellate Body Report, *US –FSC,* paras. 89-91.

310 "If an entity is controlled by the government (or other public bodies), then any action by that entity is attributable to the government, and should therefore fall within the scope of Article 1.1(a)(1) of the SCM Agreement." Panel Report, *Korea–Commercial Vessels,* para. 7.50.

311 An important exception here is the 1958 case brought by Australia against France alleging export subsidization of wheat and wheat flour (BISD 7S/46, paras. 8-14). The Panel concluded that the French regime, which included elements of price support, constituted a subsidy.

312 Article 14 lays down guidelines for the calculation of the "benefit". This Article has been important for cases related to countervailing measures.

313 "We also believe that the word "benefit", as used in Article 1.1(b), implies some kind of comparison. This must be so, for there can be no "benefit" to the recipient unless the "financial contribution" makes the recipient "better off" than it would otherwise have been, absent that contribution. In our view, the marketplace provides an appropriate basis for comparison in determining whether a "benefit" has been "conferred", because the trade-distorting potential of a "financial contribution" can be identified by determining whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market." Appellate Body Report, *Canada–Aircraft,* para. 157.

(ii) The specificity of subsidies

As indicated above, the SCM Agreement only aims at disciplining the use of subsidies that are "specific" according to the definition given in Article 2 of the Agreement. Most notably, a subsidy is to be considered "specific" if access to it is explicitly limited to certain enterprises. Conversely, if eligibility of enterprises is based on objective criteria and neutral conditions, which are economic in nature and horizontal in application, such as size,[314] and if eligibility for the subsidy is automatic, specificity does not exist.[315] Article 2 of the SCM Agreement acknowledges, however, that a subsidy programme may appear non-specific according to these principles, but may turn out to be specific in the way it is implemented. Thus, Article 2.1(c) illustrates some of the factors to be examined in that regard, such as the use of a subsidy programme by a limited number of certain enterprises or the manner in which discretion has been exercised by the granting authority in making the awards.

The Agreement does not say explicitly whether specificity refers to the recipients or the beneficiaries of subsidies. As discussed in Section B, the direct recipients of a subsidy are not necessarily its sole beneficiaries. Instead, some of the benefit may be "passed through" to others according to the legal terminology used in this context. This issue arose in *US–Softwood Lumber IV*:

> "Where a subsidy is conferred on input products, and the countervailing duty is imposed on processed products, the initial recipient of the subsidy and the producer of the eventually countervailed product, may not be the same. In such a case, there is a direct recipient of the benefit—the producer of the input product. When the input is subsequently processed, the producer of the processed product is an indirect recipient of the benefit—provided it can be established that the benefit flowing from the input subsidy is passed through, at least in part, to the processed product."[316]

Another issue that arises with respect to specificity is how to establish in practice that the range of beneficiaries of a subsidy is "specific" to "certain enterprises" or to a particular region, as opposed to "non-specific". The term "certain enterprises" refers to "an enterprise or industry or group of enterprises or industries". As a consequence, the identification of an "industry" may be important in establishing specificity in particular cases,[317] but the term industry is not defined in the Agreement. In *US–Subsidies on Upland Cotton* the fact that eligibility for a certain government programme was *de facto* limited to a subset of basic agricultural crops played a role in the determination of specificity with respect to Article 2 of the SCM Agreement. In *US–Softwood Lumber IV* the "wood products industries" were considered by the Panel to constitute at most a limited group of industries. *De facto* specificity also can be determined on the basis of the number of companies that actually use a government programme, as in the case of *EC–DRAMs Chips*, where the use of a subsidy programme by only six out of 200 eligible companies was the basis for a finding of specificity.

In the context of the discussions in Sections C and D, the question also arises how the term "specificity" relates to the concepts of trade distortiveness and welfare enhancement. The SCM text is predicated on the potential of specific subsidies to be trade distorting. Indeed, the more closely targeted a subsidy in terms of intended beneficiaries, the more concentrated will be its relative price effect. In many circumstances, this could be taken to imply a higher probability that the subsidy is distorting and less justifiable economically. A subsidy to a single industry, for example, rather than to many industries could impart a narrow advantage that does not reflect action in the face of a well defined market failure. The more broadly based subsidy recipients are defined, then, the more "spread out" and shallower will be the likely subsidy impact.

On the other hand, the discussions in Section D have shown that governments may wish to target subsidies as precisely as possible in order to correct for given market failures while avoiding undesired side-effects. At first

314 However, Article 2.2 of the SCM Agreement makes it clear that a subsidy that is limited to certain enterprises located within a designated geographical region is to be seen as specific.

315 Footnote 2 of the SCM Agreement clarifies that the conditions should be economic in nature and horizontal in application.

316 WTO document WT/DS257/AB/R paragraph 143.

317 The question of "industry" does not arise in all cases, as specificity also can be established on an enterprise basis, or on a regional basis.

glance, there appears to be a conflict. Yet, the SCM Agreement leaves room for targeting subsidies, depending on the criteria governments use for targeting. As the following discussion will show, certain criteria, i.e. export performance, are considered to be clearly linked to trade distortiveness, hence prohibited, while other criteria, i.e. objective criteria, may entirely exclude a given subsidy from the scope of the SCM Agreement. .

(iii) Prohibited subsidies: subsidies linked to export performance or the use of domestic goods

Definitional issues are also central to the concept of prohibited subsidies, since Article 2.3 of the SCM Agreement states that all prohibited subsidies listed under Article 3 – i.e. subsidies contingent on export performance or on the use of domestic over imported goods – are deemed to be specific. Once a panel has established that a government measure is a financial contribution that provides a benefit and falls within the scope of Article 3, then that measure is automatically specific. In practice, such subsidies can either be countervailed or challenged as illegal measures.

The Agreement thus takes the approach that subsidies directly targeting exports or import competition are by definition distortive and should therefore not be used. This makes economic sense, given that market failures are typically not related to the activity of exporting or of competing against imports. The economic literature discussed before, however, indicates that exceptions to this rule may exist. In particular, there seems to be evidence of the existence of spillovers from exporting and of information asymmetries specifically related to the activity of exporting. Export promotion policies have been justified in the literature on the basis of these market failures. In addition, as pointed out before, in the case of developing countries the use of export-oriented policies is sometimes defended on practical grounds if alternative instruments are not available or are too difficult to use. The question thus arises whether the approach of prohibiting export subsidies restricts developing countries in their possibilities to pursue certain policy objectives. This will be discussed in more detail below.

Article 3.1(a) of the SCM Agreement prohibits export subsidies contingent on export performance in "law or in fact". Where the wording of the relevant legislation expressly makes a subsidy contingent on exporting, a perhaps unlikely occurrence in practice, no detailed analysis of the situation is required.[318] Consequently, a considerable amount of the jurisprudence relating to Article 3.1(a) has focused on an interpretation of *de facto* contingency, especially since footnote 4 states that "the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision".

Establishing whether subsidies are contingent in fact on exporting is not a straightforward exercise in practice, as the extensive case law on this question illustrates. The view that a measure should not be classified as an export subsidy simply because it is a financial contribution to a firm with high export propensity was expressed by both the Panel and the Appellate Body in *Canada-Aircraft*.[319] Instead, the Panel proposed a "but for" test for *de facto* export contingency, namely that if a subsidy would not have been paid "but for" the anticipation that exports would flow therefrom, then that subsidy was contingent in fact on exportation.[320] A similar view was held by the panellists in *Australia-Automotive Leather II*, where the measure at issue was a grant by the Australian government to a firm on the condition that it meet specified sales targets. Since the total domestic market was far smaller than the size of the sales targets, the Panel concluded that the grant was, in fact, contingent on exporting, as international sales constituted the only means by which the firm could meet the sales targets. The panellists referred to this link as one between the grant of the subsidies and the government's "anticipation" of exportation.[321] Furthermore, the

[318] One example is the *Brazil-Aircraft* dispute, which involved below-market financing by the government for aircraft export transactions. Brazil did not contest that the measure was, explicitly, an export subsidy. Brazil's defence instead was that, as a developing Member, it had the right to provide such subsidies. This aspect of the case is discussed in more detail below.

[319] "Putting this into more concrete terms, we consider that the factual evidence adduced must demonstrate that had there been no expectation of export sales (i.e. "exportation" or "export earnings") "ensuing" from the subsidy, the subsidy would not have been granted. To us, this implies a strong and direct link between the grant of the subsidy and the creation or generation of export sales." Panel Report, *Canada–Aircraft,* para 9.339.

[320] "[W]e consider that the factual evidence adduced must demonstrate that had there been no expectation of export sales (i.e., "exportation" or "export earnings") "ensuing" from the subsidy, the subsidy would not have been granted." Panel Report, *Canada–Aircraft,* para. 9.339.

[321] Australia – Subsidies Provided to Producers and Exporters of Automotive Leather, Panel Report, WT/DS126/R, adopted 16 June 1999, DSR 1999: III, 951.

decision in *US-FSC* showed that it does not matter for export contingency that foreign produced goods are also eligible for a certain subsidy. Instead, it does matter that among the domestically produced goods, only those that are exported are eligible.

(b) Acknowledging domestic policy objectives

As described above, the Uruguay Round SCM Agreement originally contained what became known as the "traffic light approach" to disciplining different kinds of subsidies. The red light referred to the prohibited subsidies discussed above.[322] The amber light covered subsidies that, although permitted, could be challenged if they caused specified kinds of adverse effects, with a sub-category (dark amber) of subsidies that were rebuttably presumed to cause one kind of adverse effects, i.e. serious prejudice.[323] These latter subsidies were: subsidization in excess of 5 per cent of the value of a subsidized product; subsidization to cover operating losses (other than certain one-time payments), and subsidies in the form of direct forgiveness of debt.

Finally, green light subsidies were certain subsidies which, while specific[324], were non-actionable, i.e. they could not be countervailed or subject to multilateral challenge. These subsidies were: certain assistance to research activities; certain assistance to disadvantaged regions; and certain assistance to promote the adaptation of existing facilities to new environmental requirements.[325] The conditions and criteria for obtaining non-actionable status for subsidies of these types were detailed and demanding, and in fact the provisions were never used.

That said, the original structure of the SCM Agreement, and in particular its special treatment of these three socially "good" types of subsidies, reflected a recognition by the negotiators of three of the policy objectives discussed in Section D for which a case in favour of subsidization can be made. For analytical purposes two aspects are worth noting. The first is the choice of objectives that find explicit mention. R&D activities are covered in this list, in a rather comprehensive way. In contrast, only a certain type of environmental subsidy is covered. Regional support is also covered, which this Report considers to be an instrument to pursue redistribution. The objective to pursue industrial development is not explicitly mentioned, but it could be argued that it was taken into account in both the non-actionable provision for regional assistance and in the S&D provisions of the Agreement which will be discussed in more detail below.

Nevertheless, Members' ability to use these kinds of "benign" subsidies was not completely unconstrained. While no countervailing measures or WTO dispute settlement could be used against such subsidies, there was nevertheless, in SCM Article 9, a provision for consultations and eventual referral to the SCM Committee, to address cases in which a non-actionable programme caused serious adverse effects to the domestic industry of another Member, in spite of being in full conformity with the rules for non-actionability. Thus, even here the trade-distortive potential of subsidization was taken into account in the rules. This is similar to the rules in other areas, where the WTO provisions tend to require Members to use various measures in the least trade-distortive way possible. Article 2.2 of the Technical Barriers to Trade Agreement, for instance, specifies that: "technical regulations shall not be more trade-restrictive than necessary to fulfil a legitimate objective, taking account of the risks non-fulfilment would create". The same Article explicitly mentions the objectives of national security, the prevention of deceptive practices, protection of human health or safety, animal or plant life or health and the environment.

More generally, according to Article XX of the GATT, Members can pursue a number of specified policy objectives as long as the measures they use are not "applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where the same conditions prevail, or a disguised restriction on international trade". The protection of human, animal or plant life or health figures among the objectives explicitly

322 These provisions did not, however, override the AoA.

323 The red and amber categories were relevant for purposes of multilateral remedies, the relevant provisions for which are found in Article 4 in respect of prohibited subsidies, and Articles 5, 6 and 7 in respect of adverse effects, defined as injury, serious prejudice and nullification or impairment of benefits. Since the lapse of the non-actionable category, countervailing measures can be applied to any specific subsidy, whether categorized as prohibited or actionable, pursuant to the applicable rules and procedures.

324 The provisions on non-actionable subsidies also referred to the fact that non-specific subsidies were non-actionable, but this was simply confirmation of what is in any case provided in Article 1.2.

325 Article 8.2 of the SCM Agreement.

mentioned in this Article and so does the conservation of exhaustible natural resources.[326] While Article XX in principle would appear to apply to subsidies, the more specific rules of the SCM Agreement in any case are explicitly geared to remedying trade distortions arising from subsidization.

The SCM Agreement's special treatment of certain subsidies aimed at socially beneficial policy objectives ended as of 1 January 2000, with the lapsing of the non-actionable subsidy category.[327] Thus, since that time all specific subsidies covered by the SCM Agreement that are not prohibited are actionable. Thus, the formerly non-actionable subsidies, while still permitted, now can be challenged, either through WTO dispute settlement or through the imposition of countervailing duties, provided the complaining Member can show that they are causing adverse effects to its interests. The implication is that while certain domestic policy objectives could explicitly be used as a justification for, and protection of, the use of certain specific subsidies before January 2000, after this date policy objectives no longer give rise to special treatment for any type of specific subsidy. Instead, the only way at this point for a subsidy (i.e. a financial contribution that confers a benefit) to be beyond the reach of countervailing measures or WTO dispute settlement is to be non-specific. All specific subsidies, while remaining permitted, can be countervailed (subjected to a border measure in an importing country) or subject to multilateral remedies (withdrawal, or removal of the adverse effects) if they give rise to adverse trade effects. In particular, no reference is made to the need to balance the effects on trading partners with Members' interests in pursuing certain policy objectives.

Concerning the feasibility of designing subsidies for particular policy objectives (e.g. environmental) as non-specific, it is worthwhile recalling the SCM Agreement's pertinent requirements. In particular, SCM Article 2.1(b) provides that specificity shall not exist where "the granting authority, or the legislation pursuant to which the granting authority operates, establishes *objective criteria* or conditions governing the eligibility for, and the amount of, a subsidy, ..., provided that the eligibility is *automatic* and that such criteria and conditions are *strictly adhered to*." Footnote 2 to this Article defines such objective criteria or conditions as "criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as the number of employees or size of enterprise". These are the conditions that would need to be strictly respected for any subsidy with a particular policy objective to be free of the risk of counteraction by other Members.

(c) Challenging actionable subsidies

Actionable subsidies, like prohibited subsidies, can either be challenged via WTO dispute settlement (although with different burdens of proof and different remedies),[328] or subjected to countervailing measures if they can be shown to cause or threaten injury to the domestic industry in the importing country. The existence of these remedies seems likely to inhibit the use of illegal subsidies and to restrain the amount of subsidization that might otherwise be provided via permitted subsidies. Depending on the particular situation, this reduced subsidization as well as any remedies imposed to offset subsidization that is granted, might have either positive or negative welfare effects. Where a countervailing measure is the chosen remedy, the subsidy in effect is simply converted into a transfer from the treasury of the exporting country to the treasury of the importing country – in other words, a waste of resources from the national perspective of the exporting country.

326 The measures must besides be "necessary to" or "related to" the policy objective, which imposes further restrictions on the use of such measures.

327 The non-actionable provisions (SCM Articles 8 and 9), as well as the dark amber presumed serious prejudice provisions (SCM Article 6.1) applied for a provisional period of five years from the entry into force of the WTO Agreement, per SCM Article 31. These provisions could have been extended, in their original form or with modifications, by consensus of the SCM Committee. The Committee did not reach such a consensus, and the measures therefore lapsed at the end of the five years.

328 For a prohibited subsidy, no adverse effects need to be proven in dispute settlement. Rather all that is required is to prove that the measure falls within the definition of a prohibited subsidy. The mandatory multilateral remedy for a prohibited subsidy is that the subsidizing Member must withdraw the subsidy, without delay. For an actionable subsidy, however, it is necessary to prove adverse trade effects in respect of a particular product in a particular market where the subsidized goods compete. The multilateral remedy for an actionable subsidy, in contrast to that for a prohibited subsidy, is that the subsidizing Member must, at its option, either withdraw the subsidy or remove its adverse effects. In the latter case, the Member would take some corrective action to address the adverse trade effects that have been found (which as noted are in respect of a particular product in a particular market) while leaving in place the subsidy itself (which might also operate in respect of other products and/or markets about which no adverse effects have been alleged or proven).

The countervailing measure provisions, like the anti-dumping rules, seek to strike a compromise between producer and consumer interests. From the consumer's perspective a countervailing duty raises import prices and represents a cost. That said, the permissible level of countervailing is not unlimited. The maximum level is the amount of estimated subsidization of the product. For producers, countervailing duties offer an additional margin to raise domestic prices. Standard economic analysis would question why producers should enjoy the protection implicit in the countervailing duty action, since on the face of it this imposes a welfare loss on the economy. The defence of countervailing duties therefore requires an argument as to why the deadweight losses to the economy of a trade restriction should be accepted. The standard argument for justifying such an intervention turns on the presence of some kind of externality or market failure. In the case of measures taken against dumping or subsidization, an additional consideration might be that sales are occurring at below cost with the strategic intention of eliminating competition in order to be able to exercise monopolistic pricing practices in the future. The arguments around these issues have been well developed in the literature and widely written about. For our purposes, it is sufficient to note that the potentially inhibiting effect of anti-subsidy remedies (both multilateral and countervail) can mean more or less welfare in both exporting and importing countries, and that the welfare effects may or may not go in opposite directions for the exporting and importing countries.

In order to obtain a multilateral remedy against an actionable subsidy, the existence of an adverse effect in the sense of Article 5 SCM needs to be established, i.e. injury to the domestic industry of another Member (the same standard as applies for countervailing measures), or serious prejudice to the interests of another Member, or nullification or impairment of benefits accruing directly or indirectly to other Members under GATT. Furthermore, pursuant to SCM Article 6.3, there are four bases on which serious prejudice can be established: displacing or impeding imports of another Member into the subsidizer's market; displacing or impeding exports of another Member from a third country market; significant price suppression or depression, significant price undercutting, or significant lost sales, in any market; and an increase of a subsidizing Member's world market share for a primary product or commodity.

WTO case law illustrates that establishing the existence of such adverse effects is not a straightforward matter in practice. Given the reliance on quantification in this Article, and the information-gathering process for serious prejudice provided for in Annex V to the SCM Agreement, data and quantitative analysis have played an important role in the panel process. One of the key cases to date addressing "serious prejudice" in the form of price suppression (Article 6.3 (c)) and increases in world market share (Article 6.3 (d)) was *US–Subsidies on Upland Cotton*. In this case, Brazil alleged that several of the US government support programs for US cotton producers seriously prejudiced Brazil's interests in respect of cotton. The Panel in this case, in analysing the situation, took the view that the empirical effects of the government support programs should be taken in their entirety as opposed to individually.[329] By conducting such a cumulative assessment of the subsidies at issue, the Panel acknowledged that a multiplicity of subsidies may affect any given product, and that from the perspective of the trade interests of other Members it is their total effect that matters.

4. SUBSIDIES TO PURSUE DEVELOPMENT STRATEGIES AND THE WTO PROVISIONS

The S&D provisions contained in Article 27 of the SCM Agreement include a specification of conditions under which some developing countries are permitted to apply export subsidies to manufactured goods, longer phase-out periods for non-complying export subsidies and subsidies contingent on the use of domestic inputs, restrictions on use of multilateral remedies against developing Members' subsidies, special minimum thresholds for subsidy levels and trade volumes in the context of countervailing duty actions against developing country exports, and exemption from the provisions of Part III of the Agreement (actionable subsidies) in respect of debt forgiveness, subsidies to cover social costs and liability transfers, when associated with privatization.

[329] The panellists were also of the view that when examining the impact of the measures, they were allowed to combine prohibited subsidy measures with actionable subsidy measures – the difference simply was that an offending measure had different options for remedy.

It is clear from the preambular language in Article 27.1 – "[s]ubsidies may play an important role in economic development programmes of developing country Members" – that the motivation for the S&D provisions in the Agreement is to allow developing Members the flexibility to use subsidies as a tool of development. The adequacy of these S&D provisions nevertheless continues to be debated. One side of the debate argues that the provisions are too lenient in regard to the use of trade-distorting subsidies. The other side argues they are too stringent and restrict the ability of developing countries to meet their development objectives, particularly as certain transition periods have expired.

The call by certain developing Members for expanded and prolonged flexibility to use subsidies, particularly export subsidies, was the subject of considerable attention in the lead-up to the Fourth WTO Ministerial Conference in Doha. In November 2001, at Doha, Ministers took a set of decisions in response to this call. One set of decisions pertains to Annex VII, which lists certain developing Members that are allowed to use export subsidies until they graduate from the Annex on the basis of specified economic criteria. The other set of decisions established a special "fast track" mechanism that could be used by certain developing Members not listed in Annex VII to obtain extensions of the transition period for the use of export subsidies pursuant to SCM Article 27.4.

On Annex VII, the decisions by Ministers interpreted the per capita GNP threshold such that it is measured in constant 1990 dollars and must be exceeded for three consecutive years before a listed Member graduates from Annex VII. Thus graduations would tend to be somewhat later, and somewhat less abrupt than before this decision. In addition, the decisions allow Members that have graduated from Annex VII to be readmitted, and thus to become re-eligible to use export subsidies, in the event that their per capita GNP falls below the specified threshold.

Concerning extensions under Article 27.4 of the transition period for the elimination of export subsidies, the decision adopted by Ministers at Doha established fast-track procedures aimed at providing additional time and more predictability for certain (non-Annex VII) developing Members to use specified export subsidies. The export subsidies of particular concern were tax incentives offered in export processing zones (EPZs) and the Members seeking extensions had argued that the year-by-year extension process envisaged in SCM Article 27.4 was simply too uncertain for their investors to be able to make longer-term investment decisions. The fast-track procedures responded to these concerns by simplifying the substantive criteria for demonstrating the need for an extension, and by establishing a quasi-automatic annual continuation of extensions granted for a period of five years.

Pursuant to Article 27.4, the last date on which any developing Member could have requested an extension was 31 December 2001,[330] and the extensions that have been granted by the Committee on Subsidies and Countervailing Measures are in respect of particular, identified subsidy programmes. The extensions were made subject to annual review by the Committee. Taken together, the extensions that have been granted by the Committee can be divided into three major categories, according to their legal basis:

- First, some decisions were based only on the special fast-track procedures adopted by Ministers in November 2001 (document G/SCM/39). As noted above, these decisions provide for quasi-automatic annual extensions of the eight-year transition period of Article 27.2(b) to the end of 2007.[331] Only developing Members with a trade share and GNP below specified thresholds were eligible to use these procedures, and only in respect of export subsidies taking the form of full or partial exemptions from internal taxes and import duties.

- Second, a decision taken in respect of a single Member was based on the special procedures in G/SCM/39 and sub-paragraph 10.6 of the Doha Ministerial Decision on Implementation-Related Issues and Concerns. The decision provides for annual extensions of the transition period of Article 27.2(b) to the end of 2004, with calendar years 2005 and 2006 constituting the final two year period referred to in Article 27.4.

[330] Specifically, under this provision, any Member deeming it necessary to use export subsidies beyond the eight year transition period (which ended 31 December 2002) that was allowed for non-Annex VII developing Members, had to enter into consultations with the SCM Committee not later than one year before the expiry of that period, i.e. 31 December 2001.

[331] The procedures in G/SCM/39 provide that if a continuation of the extension of the transition period beyond 2007 is either not requested or not granted, the Member in question shall have the final two years referred to in the last sentence of Article 27.4 to phase out the subsidies.

- Third, some decisions were adopted on the basis of Article 27.4 alone. These decisions provided for a one-year extension for the specified programmes, with calendar years 2004 and 2005 constituting the final two-year period referred to in Article 27.4.

Table 40 lists the WTO Members that have been granted extensions pursuant to each of the three categories defined above. It also lists the programmes for which these extensions have been granted. The use of this mechanism is certainly an indication of the importance of S&D provisions to developing countries.

Table 40
Summary of approved extensions of export subsidies

Member	Measure	Document
Extensions on the basis of the procedures in G/SCM/39		
Antigua and Barbuda	Fiscal Incentive Act Cap 172 (December 1975); Free Trade and Processing Zone Act No. 12 of 1994	G/SCM/50; G/SCM/51
Barbados	Fiscal Incentive Program; Export Allowance; Research & Development Allowance; International Business Incentives; Societies With Restricted Liability	G/SCM/52; G/SCM/53; G/SCM/54; G/SCM/55 G/SCM/56
Belize	Fiscal Incentives Act; Export Processing Zone Act; Commercial Free Zone Act; Conditional Duty Exemptions Facility under Treaty of Chaguaramas	G/SCM/57; G/SCM/58; G/SCM/59; G/SCM/60
Costa Rica	Duty Free Zone Regime; Inward Processing Regime	G/SCM/61; G/SCM/62
Dominica	Fiscal Incentives Program	G/SCM/63
Dominican Republic	Law No. 8-90 to "Promote the Establishment of New Free Zones and Expand Existing Ones"	G/SCM/64
El Salvador	Export Processing Zones and Marketing Act, as amended	G/SCM/65
Fiji	Short-Term Export Profit Deduction; Export Processing Factories/Export Processing Zones Scheme; The Income Tax Act (Film Making and Audio Visual Incentive Amendment Decree 2000)	G/SCM/66; G/SCM/67; G/SCM/68
Grenada	Fiscal Incentives Act No. 41 of 1974; Statutory Rules and Orders No. 37 of 1999; Qualified Enterprises Act No. 18 of 1978	G/SCM/69; G/SCM/70; G/SCM/71
Guatemala	Exemption from Company Tax, Customs Duties and Other Import Taxes for Companies under Special Customs Regimes; Exemption from Company Tax, Customs Duties and Other Import Taxes for the Production Process Relating to Activities of Managers and Users of Free Zones; Exemption from Company Tax, Customs Duties and Other Import Taxes for the Production Process of Commercial and Industrial Enterprises Operating in the Industrial and free Trade Zone	G/SCM/72; G/SCM/73; G/SCM/74
Jamaica	Export Industry Encouragement Act; Jamaica Export Free Zone Act; Foreign Sales Corporation Act; Industrial Incentives (Factory Construction) Act	G/SCM/75; G/SCM/76; G/SCM/77; G/SCM/78
Jordan	Partial or Total Exemption from Income Tax of Profits Generated from Exports under Law No. 57 of 1985, as amended	G/SCM/79
Mauritius	Export Enterprise Scheme; Pioneer Status Enterprise Scheme; Export Promotion; Freeport Scheme	G/SCM/80; G/SCM/81; G/SCM/82; G/SCM/83
Panama	Official Industry Register; Export Processing Zones	G/SCM/84; G/SCM/85
Papua New Guinea	Section 45 of the Income Tax	G/SCM/86
St. Kitts and Nevis	Fiscal Incentives Act No. 17 of 1974	G/SCM/90
St. Lucia	Fiscal Incentives Act No. 15 of 1975; Free Zone Act, No. 10 of 1999; Micro and Small Scale Business Enterprises Act, No. 19 of 1998	G/SCM/87; G/SCM/88; G/SCM/89
St. Vincent and Grenadines	Fiscal Incentives Act No. 5 of 1982, as amended	G/SCM/91
Uruguay	Automotive Industry Export Promotion Regime	G/SCM/92
Extensions on the basis of G/SCM/39 and Paragraph 10.6 of WT/MIN(01)/17		
Member	**Measure**	**Document**
Colombia	Free-Zone Regime; Special Import-Export System for Capital Goods and Spare Parts (SIEX)	G/SCM/93; G/SCM/94
Extensions on the basis of SCM Article 27.4 alone		
Member	**Measure**	**Document**
Barbados	Export Grant and Incentive Scheme; Export Rediscount Facility; Export Credit Insurance Scheme; Export Finance Guarantee Scheme	G/SCM/95; G/SCM/96; G/SCM/97; G/SCM/98
El Salvador	Export Reactivation Law	G/SCM/99
Panama	Tax Credit Certificate	G/SCM/100
Thailand	Industrial Estate Authority of Thailand; Board of Investment Programme	G/SCM/101; /SCM/102

Note: Many of the documents cited in the Table also have relevant addenda attached to them.

As already noted, EPZ-related subsidy measures figure prominently in the approved extensions. The use of export subsidies as a tool for development has long been controversial. Many developing country Members are reluctant to eliminate export-linked investment incentives that they offer via EPZs and other vehicles, both on developmental grounds and because of concerns over investment flight to locations with better incentive packages. A good number of developing countries believe that EPZs have played an important role in their development.[332] There are examples of EPZs which, in the past, have contributed to job creation and income generation in developing countries (Madani, 1999). For this reason alone, developing countries see merit in EPZs even if net exports have often remained low (given that a large portion of inputs is imported), backward linkages limited and investment concentrated in low-tech operations. In certain cases, EPZs did indeed entail positive spillovers owing to demonstration effects of entrepreneurial skills that were copied and transferred to other industries.

Such positive outcomes are not always forthcoming, however. As we have already noted, export subsidies can be significantly distorting, contributing little or nothing to development, and at the same time possibly attracting nullifying remedies by trading partners which turn subsidy outlays into wasted resources. One should also note the risk that if enough countries are pursuing the same subsidization policies, competition among subsidizers can lessen or eliminate any benefits that might otherwise accrue. Hoekman et al. (2004) note that such competition for investment can lead to the transfer of rents to powerful companies that can play governments off against each other. Moreover, subsidy practices may harm poorer countries, which are less able to afford the financial outlays involved.

Although the case for development benefits from export subsidization is mixed, a number of developing countries have advanced S&D proposals in various fora for full flexibility in applying such subsidies, in part with a view to allowing the expansion of export subsidization via EPZ programmes. One argument in support of such proposals is based on the objective of diversification of economic activity. While, as noted above, in certain cases positive spillovers may arise from EPZs, the more general question is whether export subsidies represent the least costly policy measure for this purpose. This is probably not the case. Panagariya (2000) reviews cases in Asia and Latin America where scanty results did not seem to warrant the costs incurred during decades of export subsidization. Conversely, he finds that as soon as trade liberalization and sound macro-economic policies were pursued, good progress on exports was made despite a simultaneous and sharp reduction of export subsidies. He cites Nogues (1989) who reviewed a large number of country experiences and concluded that the diversification of exports towards manufactures occurred when more open import regimes and relative stability in real exchange rates prevailed. In contrast, the provision of export subsidies was not a common element among successful countries. He found that subsidizing countries faced large opportunity costs and an additional waste of resources through rent-seeking activities induced in the private sector.

It is difficult to discount at least some of the empirical evidence against using EPZs as a vehicle for export subsidization. This need not be interpreted as arguing for the elimination of EPZs, but rather for assessing alternative ways to retain the EPZ concept, but ensuring that the instruments and incentives used are supportive of development and consistent with WTO rules. Keck and Low (2004) review some of the issues related to the disciplining the export subsidy aspects of EPZs through the WTO rules and are optimistic about the possibilities available to policy-makers to identify alternative measures less likely to fall foul of WTO rules.

Returning to the SCM Agreement's S&D provisions, it is important to note that although they provide considerable flexibility to developing Members to use subsidies, that flexibility is not unlimited. This is demonstrated by the fact that exemptions provided for in Article 27 have twice been subject to the dispute settlement process. In *Indonesia-Autos* the Panel held that Article 27.3 provided immunity (during a specified transition period) for developing countries from challenges to import substitution subsidies under the SCM Agreement. However, whereas this immunity in respect of import substitution subsidies was unconditionally available to developing country Members, the immunity in respect of export subsidies was subject to additional conditions. In particular, Article 27.4 established development-related conditions for the use of export subsidies and placed a standstill on the level of export subsidies that could be maintained during the specified transition period. In *Brazil-Aircraft* the Panel held that if these conditions were not met, then the Article 3.1(a) prohibition would apply.

[332] See Radelet (1999), which includes references to country case studies in Africa, Asia and Latin America.

This line of reasoning also placed the burden of proof on the complaining party to demonstrate that the conditions were not met. In *Brazil–Aircraft*, Canada (the complaining party) was able to prove that Brazil had not complied with its obligation to refrain from increasing the level of its export subsidies and to phase out its export subsidies by the end of the eight-year transition period. But Canada could not prove that the subsidy programmes were "inconsistent" with Brazil's development needs, and that Brazil thus should have eliminated them in less than eight years. The Panel's recommendations based on these conclusions were subsequently upheld by the Appellate Body. The Panel's language on this issue mirrors much of what was presented in Section D of this Report. In particular, the Panel noted that:

> "There could be any number of reasons why the provision of export subsidies might be consistent with a Member's development needs in such a case. For example, a developing country Member might be interested in the possible technological spin-off effects from the development and production of the product in question, or the need to establish a strong market presence and reputation in foreign markets as a stepping stone to introducing products with greater national value-added." (Panel Report, *Brazil–Aircraft,* para 7.92).

5. SUBSIDIES AND THE DOHA DEVELOPMENT AGENDA

In Doha at the Fourth WTO Ministerial Conference, WTO Ministers agreed to the following mandate for negotiations contained in paragraph 28:

> "In the light of experience and of the increasing application of these instruments by Members, we agree to negotiations aimed at clarifying and improving disciplines under the Agreements on Implementation of Article VI of the GATT 1994 and on Subsidies and Countervailing Measures, while preserving the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives, and taking into account the needs of developing and least-developed participants. In the initial phase of the negotiations, participants will indicate the provisions, including disciplines on trade distorting practices that they seek to clarify and improve in the subsequent phase. In the context of these negotiations, participants shall also aim to clarify and improve WTO disciplines on fisheries subsidies, taking into account the importance of this sector to developing countries. We note that fisheries subsidies are also referred to in paragraph 31."

By January 2006 Members had undertaken three overlapping negotiating processes. First, they indicated in general terms the provisions within these two agreements they thought should be the subject of clarification and improvement in the next phase of negotiations. Second, they submitted and discussed elaborated proposals identifying and explaining in concrete terms the problems that they perceived with the identified provisions, and their suggested approaches to resolving them. Third, they are now in the process of submitting, and considering, specific legal drafting proposals to address the problems that they are seeking to solve.

The latest report of the Chair of the Negotiating Group on Rules on 30 November 2005 highlighted the relatively slow pace of negotiations on horizontal subsidies issues compared to the negotiations on anti-dumping and countervailing measures. As of that date, only four out of a total of 55 proposals to the Group addressed the horizontal subsidy rules. Since that time, some additional proposals have been submitted and the issues identified for possible negotiation include aspects of the definition of a subsidy, specificity, prohibited subsidies, serious prejudice, export credits and guarantees and the allocation of benefits, and special and differential treatment.

The thrust of SCM-related proposals made in the negotiations is similar to much of the argumentation in this Report – striking the right balance between strong disciplines on trade distortive subsidies and flexibility to use subsidies to achieve national objectives in the face of market failures. Some Members consider that the disciplines in the SCM Agreement should be strengthened to make it more difficult for national governments to use subsidies. Other Members, especially developing country Members, argue for more flexibility to use subsidies.

The provisions relating to prohibited subsidies, and to certain aspects of countervailing methodology, are the topics that have attracted the most attention to date. In the area of prohibited subsidies, one issue is whether or not to extend the list and if so, to which instruments. The United States has argued that such an expansion would be "an obvious next step in the deepening of subsidy disciplines".[333] The EU argued that consideration should be given to clarifying SCM Article 3.1(b) on local content subsidies, especially with regards to "value added" programmes. Australia and Brazil have raised issues with regard to the interpretation of a *de facto* export contingency,[334] and Brazil with respect to the treatment of export credits and guarantees.[335] One concern in this regard is to ensure that the export propensity of a subsidy recipient should not be the sole or a determining factor in whether or not a subsidy is contingent on exporting.[336] On countervail, the proposals relate to pass-through of benefits,[337] and certain procedural and methodological issues.[338]

There are some proposals that lament the expiration of Article 6.1 on "Serious Prejudice". Views differ, however, as to where the various provisions contained in that Article should be placed if reinstated in the SCM Agreement. One view is that the listed subsidies should be prohibited outright on the grounds that they are already recognized as highly trade-distortive. Another view is that the provisions should be reinstated more or less as they were, including the rebuttable presumption of serious prejudice.[339]

Special and differential treatment proposals relating to the Rules negotiations relate to Articles 3.1, 27.1, 27.3, 27.4, 27.8, 27.9, 27.13 and 27.15.[340] The overall gist of these proposals is to allow developing countries more room to use subsidies. For example, a proposal to change SCM Article 27.4 seeks to remove the time frame for seeking an extension to use export subsidies and raise the threshold for having to eliminate them.

Finally, the specific negotiating mandate on fisheries subsidies in Paragraph 28 of the Doha Ministerial Declaration recognizes that uniform disciplines on all subsidies may not work in relation to the specific problems associated with the fisheries industry. According to a report of the Chair of the Negotiating Group, work on developing disciplines in the area continues to progress at a slow pace. The Chair has also reported that there seems to be broad agreement among negotiators that disciplines on subsidies in the fisheries sector should be strengthened, including through the prohibition of certain forms of fisheries subsidies that contribute to overcapacity and over-fishing, and that any new disciplines should include appropriate and effective special and differential treatment provisions.[341] It nevertheless seems clear that moving from such a broad agreement to more precise and detailed text on the scope of new disciplines will not be easy. Among the complexities are the degree of uniqueness that should be assigned to fisheries subsidies, especially in the context of "adverse effects", and whether or not the definition and interpretation of this concept needs to be broadened.

333 WTO document TN/RL/W/78.

334 WTO document TN/RL/W/30.

335 WTO document TN/RL/W/86.

336 WTO document TN/RL/GEN/34.

337 WTO document TN/RL/GEN/86.

338 WTO documents N/RL/GEN/93, TN/RL/GEN/96, TN/RL/GEN/45.

339 WTO document TN/RL/GEN/14.

340 See 20-21 of WTO document TN/CTD/W/3/Rev.2.

341 WTO document TN/RL/15.

6. SUMMARY

The subsidy-related agreements of the WTO try to strike a balance between justified subsidy intervention to meet national objectives and to offset various market failures, and the trade distortive potential of subsidies. Views differ as to whether or not the correct balance has been struck. To some the disciplines may have gone too far and constitute too great a handicap for national governments, especially those of developing countries. To others, the various attempts to account for different circumstances in which subsidy policies are applied has created a porous set of rules without any significant bite. This debate will continue both within the context of the current round of negotiations and in academic circles.

One thing, however, is certain. The subsidy provisions of the WTO agreements have done much to increase the transparency of subsidy policies and their impact on international trade flows. Notification requirements, when adhered to, provide a window on the operation and impact of subsidies policies. The rules have also brought greater predictability and stability to subsidy policies.

As with all WTO Agreements a key criterion in determining the overall contribution of the subsidy rules is the extent to which they allow developing countries the opportunity to meet their national objectives. We have argued here that continued pressure by some developing countries for extensions of the right to subsidize manufactures might be looked at in terms of broader questions about the potential development contribution of certain subsidy practices, particularly perhaps those that are less firm-specific and more infrastructure-oriented. If this were to be done, it would need to be against very strong cautions about the dangers of destructive subsidization. Governments would need to confront the real risk that subsidy policies may be espoused which contribute nothing to development, and may even compromise development opportunities.