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THE URUGUAY ROUND**

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Negotiating Group on Subsidies
and Countervailing Measures

COMMUNICATION FROM THE UNITED STATES

The following communication has been received from the United States with the request that it be circulated to members of the Group.

I. Introduction

The Ministerial Declaration launching the Uruguay Round calls for subsidy negotiations "based on a review of Articles VI and XVI and the MTN Agreement on Subsidies and Countervailing Measures, with the objective of improving GATT disciplines relating to all subsidies and countervailing measures that affect international trade."

The United States considers that the Subsidies and Countervailing Measures negotiations are of fundamental importance to the Uruguay Round. We believe that the negotiations must result in clear and precise GATT disciplines over all trade-related subsidies and other substantially equivalent forms of government assistance. These new disciplines must be backed up by a credible and effective system of GATT dispute settlement remedies to ensure compliance.

It has become increasingly apparent that the Tokyo Round Subsidies Code suffers from fundamental weaknesses. There appears to be little or no international consensus regarding the meaning of key GATT and Code rules. Some rules, particularly those relating to agricultural, domestic, and developing country subsidies, are ineffective and impose inadequate levels of discipline with respect to subsidies that distort international trade flows. Finally, because the dispute settlement provisions of the Code permit the losing party to block adverse panel reports, the Code has failed to resolve a single contested dispute.

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In our view, it is imperative that the subsidies negotiations move forward. The proliferation of trade-distorting subsidies and accompanying subsidy disputes has already severely undermined the credibility of the GATT and the international trading system. The provision of subsidies, moreover, has not expanded trade or opened new markets, but instead has precipitated matching subsidies and countermeasures under GATT Article VI by other governments. This self-defeating spiral of subsidization has imposed severe financial burdens on governments and undermined the fundamental principle of GATT that trade flows should be determined by comparative advantage and market forces, rather than government intervention. Without major progress in the Uruguay Round, the current paralysis can only continue, with detrimental long-term consequences for GATT and the trading system and increasing resort to Article VI countermeasures and matching subsidies.

All governments have a common interest in moving toward a trading system in which international subsidy disciplines are substantially strengthened. Subsidies distort the allocation of resources and reduce total world wealth and income. In contrast, effective anti-subsidy disciplines generate support for liberal trade policies by giving efficient firms a stake in keeping markets open. The ultimate goal of the negotiations therefore should be to achieve rigorous discipline over subsidies and substantially equivalent forms of government assistance. Since this objective will be difficult, the first priority should be the development of common principles to guide the negotiations.

While the Tokyo Round Subsidies Code illustrates the difficulties facing this Group, it also provides an outline of the issues that must be tackled in order to build an effective system of international subsidies discipline.

First, the Negotiating Group must develop a clear, objective, and precise set of GATT subsidies rules. These rules must strengthen existing disciplines and clarify or extend disciplines to other practices not sufficiently addressed at present.

Second, the Group must develop a credible new approach to GATT subsidies dispute settlement. The Tokyo Round Code failed because it lacked dispute settlement mechanisms sufficient to overcome the political sensitivity of international subsidy issues. Accordingly, any agreement on disciplines must be accompanied by strengthened dispute settlement remedies that ensure compliance with the rules. The continuing absence of effective GATT dispute settlement procedures in the subsidies area can only increase the already dangerous pressures on governments to respond unilaterally to unfair trade

distortions. While the U.S. has been compelled to deal with certain measures bilaterally in recent years, we have only done so because of the absence of credible GATT alternatives. We recognize that it would be far preferable to develop a long-term multilateral solution in GATT.

To this end, the United States is providing the following preliminary views regarding new subsidies disciplines and GATT remedies. 1/

II. Discussion

A. Export Subsidies

The United States believes that the Uruguay Round agreement should provide that export subsidy disciplines apply, regardless of the product or the level of development of the country providing the export subsidy. As discussed more fully below, we believe that the artificial distinctions in GATT and the Subsidies Code between primary and non-primary (i.e. primary farm, forest, and fishery) export subsidies should be eliminated.

B. Domestic Subsidies

While GATT recognizes that domestic subsidies can have negative effects, the U.S. believes the current rules are inadequate and should be replaced by clear and precise prohibitions with respect to the use of domestic subsidies that result in import substitution losses or displacement in third country markets. The rules must also cover substantially equivalent forms of government assistance so as to prevent governments from replacing a prohibited subsidy with other equally trade-distorting practices.

In our view, the primary source of the problem is GATT Article XVI:1, which imposes insufficient discipline and inadequate rights of recourse with respect to domestic subsidies. Under GATT Article XVI:1 and Article 11 of the Subsidies Code, a party must "seek to avoid causing serious prejudice" through the use of domestic subsidies and engage in consultations with a view to examining the possibility of limiting the subsidization. This provision has been described as a "rule without an obligation."

1/ The U.S. intends to submit a further paper elaborating on this proposal and addressing several issues not dealt with here.

It is plain that domestic subsidies have the potential to seriously distort trade and injure the interests of other trading nations. The problems experienced by the steel and agriculture sectors are proof of the injurious consequences of unchecked domestic subsidies.

There are a number of potential approaches to this problem, which can be discussed and evaluated in terms of whether they move the world trading system toward the ultimate goal of rigorous subsidies discipline. One approach, of course, would be to ban domestic subsidies completely. While theoretically attractive, this approach would appear impractical at this time. We must recognize that governments, as a practical matter, are for political and policy reasons unlikely to completely forgo the use of domestic industrial subsidies, particularly since many subsidies are relatively small, have other aims, or have a limited relationship to trade.

A second approach would be to attempt to define "serious prejudice" to provide clearer guidance to dispute settlement panels. This approach would focus on the "effects" of domestic subsidies and would essentially build upon the concepts used in the Tokyo Round. This approach also has major drawbacks. As the Tokyo Round Code showed, judgments as to "serious prejudice" or "more than an equitable share" are inherently subjective and necessarily open to different and conflicting interpretations. They create tremendous difficulties for international panels, are hard to enforce in practice, and do not result in credible discipline.

A third approach, sometimes referred to as the "red light/yellow light/green light," would attempt to define permitted and prohibited subsidies that are "trade-distorting" or, by way of contrast, have "legitimate" purposes. The U.S. has grave reservations about this approach as well. First, by placing undue emphasis on labels, it permits governments to simply redirect or relabel injurious subsidy programs so as to shift them from the prohibited to the permitted category. Second, because money is essentially fungible, it is unclear why the ostensible aims of a subsidy should determine its status under the GATT. Consider, for example, a rule which prohibits production subsidies, but permits research subsidies. A government seeking to subsidize production could assume an industry's research expenses, with the aim of allowing it to spend more money on production, and indirectly achieving the prohibited result. In this respect, such a system of rules appears nonsensical. Finally, many subsidy programs arguably have "legitimate" purposes, but nevertheless have the potential to injure the interests of other trading partners. Consequently, it is impossible to fashion clearcut distinctions between prohibited and permitted subsidies on the basis of the ostensible legitimate aims of the subsidy program.

Instead, we believe that the SCM Group should explore new approaches that would prohibit certain domestic subsidies on the basis of objective and verifiable criteria. The criteria would serve to identify and prohibit subsidies that are likely to have a significant effect on competitiveness or trade. This approach avoids the reliance on subjective judgments, or impractical prohibitions, that are inherent in the other subsidy approaches. It would minimize the potential for trade frictions by limiting the scope for trade-related subsidization.

There are a number of approaches the Group could explore that might serve in some combination to provide a solution. The following criteria are some that could be considered initially by the Group --- the U.S. intends to develop and submit additional criteria for consideration. The Group, for example, could look at prohibiting domestic subsidies that exceed a specified size or amount. This approach would cap the maximum amount of a domestic subsidy program, so that any domestic subsidy that exceeds a particular level would be deemed to cause import substitution or 3d country displacement and generate rights to compensation. While the approach would require an obligation on the part of the subsidizing government to supply information, similar obligations have been established under GATT Article VI and could be applied here. This approach would limit the potential for trade friction by prohibiting large and egregious domestic subsidy programs that limit imports or distort trade in 3d country markets.

Second, with respect to 3d country displacement, the Group could prohibit domestic subsidies on the basis of the level of export activity of the industry. One relatively straightforward approach would be to bar an industry from receiving domestic subsidies if a specified percentage of its production is exported. Thus, domestic subsidies to industries that are significantly engaged in exporting can be assumed to have a trade impact and treated as analogous to export subsidies, which are already prohibited under GATT. Alternatively, along these lines, the Group could seek to bar domestic subsidies if an industry is significantly more heavily engaged in exporting than the average industry within the territory of the subsidizing government. Recognizing that there are major problems associated with the calculation of the 3d country displacement losses, agreed methodologies must be developed to determine the trade impact of the subsidy, identify the country which would have obtained the sale but for the subsidy, and assess the amount of compensation. These rules must be precise, both to minimize the scope for disagreement and to make clear the carefully circumscribed situations in which these considerations would apply so as to prevent abuse of GATT rights.

Similar objective criteria would be developed on the import substitution side, which is of equal importance. They must be equally objective and verifiable and give rise to a flat prohibition in the event of any inconsistency.

These or similar criteria could be used to develop a class of prohibited subsidies that would be deemed to give rise to a right of compensation under GATT. By eliminating the most egregious subsidies and other forms of substantially equivalent government assistance, these approaches, singly or in combination, would limit the potential for trade friction. While governments could continue to provide domestic subsidies falling outside the precise classes determined by these criteria, the subsidies would of course remain subject to countervailing duties under Article VI.

C. "Industrial Targeting"

Since the Tokyo Round, concern has been voiced in the United States about the issue of industrial targeting policies aimed at promoting and assisting specific export-oriented industries. We recognize that most targeting practices fall outside even the most expansive international definitions of a "subsidy" and, as a result, Article VI and XVI rights and remedies do not cover industrial targeting per se.

The United States believes, however, that the Uruguay Round SCM Group should examine the targeting issue, with a view to determining whether some forms of government industrial policies aimed at promoting export-oriented industries have effects analogous to those of a subsidy and result in economic damage to the legitimate interests of other trading nations. While we recognize that there are philosophical differences with respect to the appropriate level of government intervention in structuring domestic economic activity and fostering exports, we believe that the Group should examine whether at a certain point such policies can go beyond the bounds of appropriate government involvement in promoting exports.

The following issues also merit examination:

Whether targeting can have delayed effects in that government practices can be separated from their market effect by time. Some studies have argued that the effects of targeting can persist after the practices themselves have been abolished.

Whether targeting has "multiplier effects". Once an industry has been targeted by a government, commercial banks and other service institutions may give the targeted industry preferential treatment because of its government backing.

What are the effects of industrial policies to promote high technology industries such as computers and electronics. Complaints about excessive government involvement have been particularly pervasive in these sectors.

Accordingly, we believe that the SCM Negotiating Group should review the targeting issue with a view to determining whether greater disciplines are necessary to ensure conformity with principles of free and fair trade.

D. Agricultural Subsidies

The U.S. believes that the Negotiating Group should prohibit the use of all domestic and export subsidies that directly or indirectly affect trade in agricultural products, i.e. eliminate the artificial distinction in present GATT rules between primary and non-primary products and apply this obligation to domestic agricultural subsidies that affect trade. 2/

The trade problems generated and compounded by agricultural subsidies are acute and there is a pressing need to seek permanent long-term solutions. Present GATT rules and disciplines on agricultural subsidies have been notoriously ineffective in dealing with subsidy problems. GATT has failed to restrain a proliferation of trade-distorting export subsidies, and ambiguous GATT rules have led to a breakdown in the dispute settlement process on agricultural subsidies.

Accordingly, one of the highest U.S. priorities for the Uruguay Round is to fulfill the Ministerial Declaration's mandate to achieve greater agricultural trade liberalization under more effective GATT rules and to increase disciplines on all subsidies that directly or indirectly affect agricultural trade.

Our ultimate goal is to create a international trading environment which allows the market to adjust production to demand without government intervention through a multilateral comprehensive reform of agricultural policies and elimination of export subsidies as a policy instrument for disposing of surplus production. This could be accomplished in part by extending the GATT rules for non-primary product export subsidies to primary products and by strengthening domestic agricultural subsidy discipline.

2/ As set forth in the U.S. agricultural negotiating proposal submitted to the Agriculture Negotiating Group in July 1987 (MTN/GNG/NG.5/W/44), bona fide food aid and income payments unrelated to production would be excluded. An elaboration of the U.S. proposal was provided in MTN/GNG.NG.5/W/44 (1988).

The United States therefore seeks improvements in GATT subsidy provisions that would lead to:

- (1) the phased elimination of all direct and indirect agricultural subsidies having an effect on trade;
- (2) stronger GATT rules based on trade liberalizing principles (rather than market management principles); and
- (3) stronger GATT subsidy rules and disciplines.

The need for such improvements is demonstrated by the unfortunate history of dispute settlement panels in the agricultural subsidies area. In Wheat Flour, the Panel was unable to apply Article 10 of the Subsidies Code, which prohibits export subsidies on primary products that result in a country gaining more than an equitable share of world export trade, taking into account shares in a previous representative period and special factors affecting trade. The Panel stated that it could not apply this rule, because the term "more than an equitable share" was undefined and specifically suggested the development of a clearer and common understanding of the concept.

Similarly, Article 8 of the Subsidies Code states that subsidies should not cause serious prejudice to the interests of other countries, and that serious prejudice can arise when subsidized exports displace the exports from another country in a third market. Here, the Wheat Flour Panel claimed that it could not make a finding that export subsidies caused "serious prejudice" because of the lack of clarity regarding the demonstration of adverse effects in third countries.

Subsequently, in Pasta, a Panel held that export subsidies for non-primary processed agricultural products violated Article 9 of the Subsidies Code. Despite a clear panel ruling on an important Code issue, the losing side blocked adoption of the report.

In the so-called "Seven Samurai" paper, an informal group of Subsidies Code experts sought to address the problems arising from the Wheat Flour and Pasta Panel reports. It suggested common interpretations and understandings of Subsidies Code Articles 8, 9 and 10 that might be accepted by the Subsidies Code Committee in order to facilitate clearer Panel findings. Discussions of the Samurai proposals were never concluded, and one key signatory refused to participate in any discussions on agriculture in the Subsidies Code. Accordingly, these problems remain outstanding today. While the primary forum for the discussion of agriculture is currently the Agriculture Negotiating Group, it is important that the Subsidies Negotiating Group be prepared to tackle these issues as well. We note that the Agriculture Group is working to reach an agreement on negotiating a market-oriented trade environment that will provide the direction of policy changes, which will in any case need to be reflected in GATT Article XVI, the Subsidies Code, or any Uruguay Round instrument.

E. Natural Resource Subsidies

At the October 29-30, 1987 meeting of the S/CM Group, the U.S. indicated its intention to table the issue of natural resource subsidies as a topic for examination and discussion. We recognize that this issue may also be addressed within the broader context of discussions undertaken in the Negotiating Group on Natural Resource-Based Products. However, we believe that the natural resource issue deserves equal attention in the S/CM Group. While many natural resource practices can already be addressed under existing GATT provisions, e.g. Article VI, there is a compelling need to develop and enforce greater subsidy disciplines.

Government measures and practices affecting the natural resource sector have been the cause of considerable trade friction in recent years. It has become increasingly evident that government intervention in the pricing and allocation of resources can often lead to distortions of trade. In some circumstances, such actions can create artificial competitive advantages for domestic producers which use the resource as a major input in their own production of intermediate or downstream products. As such, they appear to run counter to a fundamental principle of the General Agreement that trade flows should be determined through comparative advantage and market forces.

The United States believes it is imperative that this Negotiating Group agree on strong and enforceable disciplines concerning natural resource practices that, through government intervention in the marketplace, create artificial competitive advantages for domestic producers and lower production costs. By lowering costs, the government intervention can channel benefits to certain industries using the resource as a major input into the production of their final product. Thus, by benefiting specific industries rather than providing general assistance for economic development or growth in the country concerned, such actions can have consequences analogous to a traditional subsidy.

Government intervention in the natural resource sector has taken a variety of forms. Not all forms of such intervention may warrant study by this negotiating group. However, there are several general practices of direct concern to the United States which merit the special attention of this group because they may provide subsidies or produce subsidy-like effects. We believe that the following areas need to be addressed.

Dual Pricing: Dual pricing generally refers to Government programs or actions that establish domestic prices for

natural resources at some level below the value they would have if determined solely by market forces. Normally, this results in one price for the world market and a different price (or prices) for resources destined for domestic consumption. Such government intervention in the marketplace bestows an artificial competitive advantage to domestic producers who have access to the lower priced resource over foreign producers who do not have that same access. This advantage clearly does not reflect any comparative advantage that would otherwise be freely determined by market forces and production efficiencies. It is therefore critical that we develop enforceable disciplines over the use of such market distorting practices.

Subsidies: Direct subsidies for natural resource-based products also provide an unfair competitive advantage to exporters. We believe this Negotiating Group should review the extent to which existing subsidy disciplines are operating effectively in the natural resource-based product sectors. For example, in the Natural Resource-Based Products Negotiating Group, the United States has expressed its concern over grants, loans, research assistance and export subsidies, among other practices, in the non-ferrous metals and minerals and the fish and fisheries products sectors. Such practices are likely to exist in other natural resource-based product areas and should properly be addressed by the S/CM Negotiating Group.

Government Ownership Practices: Government ownership practices are often closely tied to dual pricing and subsidy practices that are intended to provide assistance to producers and exporters. Government ownership per se is not necessarily a cause for concern. However, it is often the case that government ownership leads to or is accompanied by governmental control over access to the resource, governmentally-imposed restrictions over foreign investment in the natural resource sector, cross-subsidization of otherwise non-competitive firms, sales to certain producers at less than the cost of providing the resource, and other artificial trade advantages to firms under their jurisdiction. In these instances, the government's presence in the natural resource marketplace has a measurable, distortive effect identical or akin to the direct provision of subsidies. Accordingly, we believe the S/CM Negotiating Group should review government involvement in natural resource production, sales and investment with a view toward determining whether greater disciplines are necessary to assure conformity with the principles of free and fair trade.

F. Countervailing Measures

While the countervailing duty provisions of GATT Article VI and the Subsidies Code have provided governments with a reasonably effective remedy against subsidized imports, the United States believes that the effectiveness of such measures would be enhanced by an internationally agreed expansion of the practices that can be subjected to countermeasures.

In addition, we believe that it would be useful to clarify that "benefit to the recipient" is the appropriate standard of measurement for a countervailable subsidy. We also believe that the Group should examine the relationship between primary and processed agricultural product producers in certain agricultural industries where production of the primary product in question is wholly or primarily dedicated to the production of the processed product. Finally, as we have previously proposed with respect to antidumping, we believe that the Group should examine the problem of certain diversionary practices in the countervailing duty area.

G. Greater Integration of Developing Countries

The United States believe that developing countries must adhere to basic GATT disciplines if they are to take advantage of the benefits that derive from GATT. A feature which distinguishes the Uruguay Round from earlier GATT negotiations is the recognition that the long-run viability of the global trading system is dependent on the direct involvement of the developing countries in the trade liberalizing process.

National policies providing subsidies which directly or indirectly affect trade create false incentives to producers, isolating them from the signals of the market. This has led to inefficient use of resources and costly budgetary outlays. In the view of the U.S., the elimination of export subsidies and greater adherence to GATT rules and disciplines regarding domestic subsidies would lead to more efficient use of resources, improved market access, and greater economic growth. For this reason, we believe that the Group should reexamine Subsidies Code Article 14 with a view to formulating a framework for greater participation on the part of developing countries in normal GATT subsidies disciplines.

Recognizing that many adjustment measures, however sound economically, cannot be accomplished overnight, we would be receptive to firm commitments to scheduled phase-outs. Such commitments (as well as existing commitments) should of course be subject to multilateral surveillance, and dispute settlement procedures should apply in the event of an inconsistency.

I. Dispute Settlement

The United States believes that the Group must develop new and credible GATT dispute settlement remedies. The current system is fundamentally flawed. It offers no assurance that GATT subsidy rights can be enforced in a timely and effective manner. The continuing absence of effective GATT procedures can only increase the already dangerous pressures on governments to respond unilaterally to unfair trade distortions and barriers. We believe that it would be far preferable to develop a multilateral dispute settlement mechanism in GATT for resolving subsidy disputes.

Because the GATT dispute settlement mechanism has been notably ineffective in handling subsidy disputes, it is important that the new mechanism deal decisively with the problem of delay and the potential for the losing party to block an adverse ruling. Given the political sensitivity of subsidy matters, any weaknesses in the new procedures would inevitably generate major frictions.

Two potential approaches to the dispute settlement problem that the United States believes the SCM Group should consider are as follows. First, we believe that the Group should consider a special strengthened GATT procedure for subsidies disputes. A special procedure is appropriate in view of the political sensitivity of subsidy disputes and the history of problems in this area. The new procedure must make rights to compensation for import substitution and 3d country displacement losses clear and timely. The procedure must encompass procedures to prevent delay and assurance of a GATT ruling by a date certain, in effect guaranteeing a ruling by a panel by a specified time. If the panel finds a GATT-illegal subsidy, it would go on to determine the amount of compensation. With respect to a prohibited subsidy, proof of nullification or impairment would not be required. Instead, the only issue would be the amount of the trade loss. After a further time-limited period for exploration of agreed compensation, the aggrieved party must have a right to rebalance the level of concession. These actions cannot be subject to blocking.

In addition, we believe that the Group should examine closely the Swiss proposal with respect to subsidies dispute settlement. As we understand it, Switzerland would replace the current "nullification and impairment" remedies of GATT Article XXIII and Subsidies Code Article 18 with a new procedure that would transfer the initial responsibility for action to national governments. Thus, within a framework of agreed rules and procedures, national governments would be authorized to calculate the compensation owed from violations of the rules

and rebalance the level of concessions. Proof that a prohibited subsidy result in nullification or impairment would not be required, but instead would be presumed per se. As we understand it, this procedure would work in a manner roughly analogous to the right to compensation for trade-restricting actions under GATT Article XIX. Because such actions would take place within a framework of clear multilaterally agreed procedures and rules, the Swiss approach would ensure that the scope for such actions would be subject to agreed multilateral disciplines. In addition, to assure conformity with the multilaterally agreed rules and procedures, a subsidizing government would have a right to seek multilateral review of the action. Thus, if a government believed that another government's response to a subsidy was unjustified, it could challenge the action in a standing GATT body, thus ensuring tight multilateral surveillance and discipline. Such actions presumably would not be subject to delay or blocking.

While the U.S. has questions and reservations about many elements of the Swiss proposal, we believe that the basic approach to dispute settlement is one way to restore the credibility of GATT subsidy remedies. We note that any approach which gives responsibility for action to national government must be accompanied by clear and precise rules as to prohibited anti-subsidy practices and a tight framework of agreed procedures. Otherwise, the potential exists for abuse of the rules through unjustified subsidy actions by national governments. The approach therefore makes all the more important the establishment of precise GATT guidelines and disciplines with respect to subsidization. Nevertheless, it offers the prospects for a new approach to dispute settlement.

From the standpoint of the United States, resolution of the dispute settlement issue is an essential element of any Uruguay Round subsidies agreement. The creation of an effective multilateral dispute settlement mechanism for subsidies will go far to restore the credibility of international subsidy disciplines and reduce or eliminate existing pressures to engage in unilateral actions.

Conclusion

As described above, the United States believes that the Negotiating Group should seek to reach a working consensus on principles to guide the negotiations with respect to subsidies disciplines and dispute settlement remedies. A consensus on first steps is essential to progress in the negotiations. The problems confronting this Group are enormous and time is of the essence. It is of the utmost importance that the negotiations move forward and offer real prospects of constructive

multilateral solutions. A working consensus on the outlines of future GATT subsidy rules and remedies would provide a structure for the negotiations and demonstrate that GATT has the political will and determination to tackle aggressively a problem that is today undermining the credibility of the international trading system.