

**MULTILATERAL TRADE
NEGOTIATIONS
THE URUGUAY ROUND**

RESTRICTED

MTN.GNS/W/98

20 April 1990

Special Distribution

Group of Negotiations on Services

SUBSIDIES AND INTERNATIONAL TRADE IN SERVICES

Note by the Secretariat

I. Introduction

This note focuses on international price and cost differentials due to the subsidization of domestic production and trade in services. The goal is to identify a number of issues participants in the GNS might usefully wish to consider. The note is structured as follows. After a brief review of the peculiarities of services that are relevant when considering subsidies and trade in services, the implications of applying Articles VI and XVI of the GATT to such trade are addressed. Throughout, relevant discussions in the Uruguay Round group on subsidies and countervailing measures will be mentioned where appropriate. This is followed by a general discussion of possible criteria for instigating procedures to deal with instances of subsidization, and various measures that might be taken to offset the injurious effect in those instances where remedial action was considered to be warranted. The note concludes with a list of suggested questions that participants in the GNS may wish to address.

II. General considerations: differences between goods and services

1. While some services are sold across national boundaries, the non-storability of services often implies that to be provided or sold, the producer and the consumer (or receiver) need to be in physical proximity to each other. Thus, for certain services to be marketed internationally requires a local presence of foreign firms in the market of the consumer. Further, as many services are sold through the interaction of the producer and consumer (or receiver) of the service, the consumers may be able to demand that the services satisfy individual preferences. Thus, services may frequently be tailored to the specific needs of the consumer, implying that there may be more scope for service products to be differentiated than in the case of goods. Non-storability also implies that service products cannot be re-sold; the lack of the possibility for arbitrage increases the scope for price differentiation of similar services products.

2. In principle, price differences for similar services may be reduced if foreign providers are permitted to operate in the domestic market.¹ If the importing government restricts the participation (market access) of competing service providers, this enhances the likelihood that price differentiation will occur. Thus, government policies may impose additional barriers to arbitrage that further increase such price differentials. Many service industries tend to be highly regulated, and differences in regulatory regimes exist.

3. The characteristics of services may make it difficult to determine how large such price differentials are in practice. Cross-country comparisons are hindered by the custom-made nature of many services; such problems are augmented by the fact that there are frequently important quality differences among similar services. While issues of this nature arise in the goods context, they are likely to be more prevalent for services. Further, given the scope for product and therefore price differentiation, individual service providers can in many instances be expected to price according to how much individual consumers are willing to pay in specific markets. Any subsidization will tend to augment such price differentials.

4. Comprehensive, detailed and comparable trade and production data do not exist for services. This is true with respect to trade statistics in particular. Currently, the primary source of comprehensive data on trade in services are balance-of-payments statistics where the level of aggregation is very high.² Information is usually only reported for expenditures by travellers (travel), receipts and payments for the transport of freight (shipment) and people (passenger services), and flows associated with port services. All other services transactions are frequently lumped together in one residual category called "other goods, services, and income." Additionally, comparable nomenclatures are often not used across countries for production statistics. One implication is that even if detailed data exist on domestic production of a specific service, these cannot be matched with trade statistics for the same service. One reason for the lack of trade statistics is that unlike goods, customs agents generally do not record service products passing the frontier. In addition, if customs agents do not have the opportunity to

¹If the government of the service exporter restricts participation of foreign providers of comparable services, this is likely to reduce the elasticity of demand facing the service provider in its home market. In general, fewer substitutes implies a lower elasticity of demand, and thus higher prices. However, the larger the market in question and the smaller the optimal size firm in the services industry concerned, the greater will be competition among domestic suppliers and therefore the smaller will be the price raising effect of limiting market access for foreign suppliers.

²For a discussion of data limitations on statistics relating to trade and production of services, see MTN.GNS/W/58 and MTN.GNS/W/94, as well as Volume I of International Trade 1988-89.

levy tariffs on imported services (either sold across the border or via a domestic presence), government measures to increase prices of imported services may have to focus on either producers or consumers of services rather than on the service itself.

5. As a result of the possibility of multiple modes of delivery for certain services, the government wishing to increase the price of an imported service may have to tax the service itself (assuming this is technically feasible), the producer of the service or the consumer of the service. For example, if foreign suppliers provide a service via a local presence (be it temporary or long-term) to tax the service as such, would involve taxing services products of domestic suppliers. In such cases, a tax on the foreign provider may be more effective and easier to implement. Alternatively, if both cross-border trade and sales via a local presence occur for a given service, measures may have to be designed that affect both products that cross the frontier and sales by foreign providers that have a local presence. A further consideration is the case of direct support to a domestic supplier of services as against a foreign supplier providing a service through a local presence. This could, of course, be both a subsidy and a national treatment issue. These issues will be discussed at greater length below.

III. Applicability of Articles VI and XVI to services

6. Although the term subsidy is not defined in the GATT, Article XVI requires notification by a country to the CONTRACTING PARTIES of the extent and nature of any subsidies which operate directly or indirectly to increase exports from, or reduce imports of any product into, its territory. Those contracting parties that have accepted the obligations of paragraph four of Article XVI are required to refrain from granting any form of subsidy to the export of any product other than a primary product if such a subsidy results in sales in export markets at prices below what is charged for comparable products in the home market.³ This requirement was converted into an outright ban on export subsidies for non-primary products for signatories of the Tokyo Round Agreement on Interpretation and Application of Articles VI, XVI, and XXIII (the Subsidies Code).

7. Use of subsidies other than export subsidies is not prohibited under the rules of GATT. However, if such subsidies have an adverse impact on trade - in particular, result in material injury of domestic firms in importing countries - Article VI permits the imposition of a countervailing duty that offsets the effect of the subsidy. Among other things, Articles 1-6 of the Subsidies Code establish procedural requirements that need to be met by signatories, before imposing countervailing duties as well as further defining terms such as "material injury."

³Note the similarity with the definition of dumping.

8. Despite the differences in the trade and production of goods and services, at the most fundamental level, many of the difficulties that arise in disciplining the use of subsidies and countervailing measures in the services area bear a clear similarity to those that arise in the goods context. Issues for both goods and services involve agreeing on how to define a subsidy and measure its size and trade impact. These topics have been discussed at length in the Uruguay Round negotiating group on subsidies and countervailing measures and have proved difficult to resolve. One issue on which there is a divergence of views is whether there should be a charge on the public account (that is, a financial contribution by a government) for a subsidy to be countervailable or actionable. Many participants consider that this should be the case; others, however, take the position that implicit forms of subsidization where there may be no financial contribution by government, but where government action results in benefits for the domestic producers should in principle also be countervailable. Participants proposing the latter view also take the position that the valuation of the subsidy conferred should be measured by the benefit to the recipient(s). See, for example, MTN.GNG/NG10/W/32 and MTN.GNG/NG10/W/29.

Subsidies in services industries

9. The types of subsidies used to support service sector activities are frequently similar to those used to support goods-producing industries. Examples include direct payments or grants, tax concessions, "soft" loans and government guarantees and equity participation. Furthermore, they may be industry or sector-specific, region-specific, activity-specific (such as the promotion of R&D), or focused on firms of a particular size. A recent OECD study provides some information on the relative importance of various types of subsidies in OECD countries⁴. The study indicates that on average between two-fifths and three-fifths of total industrial subsidies are sector-specific, and that much of the support⁵ goes to non-service industries such as steel, shipbuilding, and mining. Of the service sectors, available statistics show that rail transport is often highly subsidized, with rates of support varying between 15% and 180% of total value added produced in this sector. Support for rail transport in Belgium, France, West Germany, and Italy is close to or over 40% of

⁴Robert Ford and Wim Suyker, Industrial Subsidies in the OECD Economies, Department of Economics and Statistics Working Paper No. 74, Paris: OECD, January 1990.

⁵Subsidies are defined to include direct grants, tax expenditures, equity participation by governments, soft loans and loan guarantees. The OECD paper draws on research undertaken by the Commission of the European Communities and the EFTA Secretariat. Methodologies used by these two institutions differ, which is one source of the variation in average sector-specific aid.

sectoral value added.⁶ Ocean freight frequently benefits from subsidies on labour inputs as well as subsidies for the shipbuilding industry, while publicly-owned PTTs may be required to employ telecommunication revenues to cross-subsidize postal services.

10. As is the case for goods, governments may take a variety of actions that could confer a benefit to specific service firms or industries, actions that do not necessarily imply a financial contribution on its part. Such actions may be more prevalent in the services context, both because regulatory intervention at times has a wider scope, as does the restriction of market access possibilities. One implication is that difficulties similar to those encountered in the area of goods may arise in reaching agreement on what constitutes a countervailable subsidy.

11. Many service industries are often highly regulated. For example, there may be licensing requirements for service providers to meet the stated objective of ensuring quality standards. Alternatively, governments might offer insurance to consumers of specific services; such insurance may be explicit (e.g. deposit insurance by the government). In principle, unless self-financing, such intervention could be considered to act as a subsidy.

12. In principle, the distinction between export and domestic subsidies is as relevant for services trade as it is for merchandise. Indeed, in some service sectors it is relatively straightforward to identify policies that promote exports of services (e.g. guarantees for foreign construction contracts). As in the goods context, however, problems may arise in determining what are export subsidies and what are not. The possibility that services are provided via different modes of delivery may complicate matters somewhat further. Articles VI and XVI of the GATT focus on the trade impact of foreign subsidies on domestic industries. It is conceivable that a service provider that sells its service via a local presence benefits from subsidies granted to the parent company in the home country. Should sales by the affiliate then be considered to have benefited from an export subsidy? While such issues may also arise in the goods context, the fact that sales of services may or may not require a local presence of providers may complicate matters more than in the case of goods. This issue is explored further below.

⁶Very detailed data on the sectoral distribution of subsidies are available for the Federal Republic of Germany and are illustrative. Nine sectors had support rates greater than 10% of sectoral value added (in declining order of importance): railways, agriculture, coal mining, shipbuilding, health and veterinary services, navigation, insurance, aircraft and aerospace, and other transport.

⁷Lawrence White has estimated that total subsidies granted to United States shipping in the last fifty years have exceeded \$35 billion (in 1985 dollars). (International Trade in Ocean Shipping Services: The United States and the World. Cambridge, MA: Ballinger Press, 1988).

13. In conclusion, while subsidies used to support service sector activities will frequently be similar to those applied to goods-related sectors, an approach focusing on benefits to recipients without necessarily requiring a financial contribution by the government may be more far-reaching than in the goods context. Such policies are often less binding in the goods context due to the possibility of arbitration across markets via cross-border trade in the products concerned.

Countervailing measures

14. A number of issues would arise if current countervailing duty procedures were applied to services. Abstracting from the problem of how to define a subsidy, the question arises whether existing interpretations of terms such as "products imported into the territory of a contracting party", "established domestic industry", "amount of estimated bounty or subsidy", and "material injury" might be applied in the services context if this was considered to be appropriate. While many of these are similar to issues arising in the area of goods, a major example being whether the amount of subsidy to be offset in countervailing actions should be the cost to a government or the financial benefit to the recipient, a number of services-specific considerations may be identified.

Exports and domestic industry

15. In the case of goods, foreign-owned firms established abroad will usually be considered domestic firms for the purposes of countervailing investigations; the focus of material injury is on cross-border trade of the goods concerned. An approach that is limited to cross-border trade of products may not be feasible for service industries; a foreign provider may opt for- or indeed be required to- establish a local presence in order to sell a particular service.⁸ One possible way to proceed could be to focus on foreign producers, irrespective of location, rather than on imported services products. However, presumably both domestic and foreign firms with a commercial presence will be subject to domestic competition and other laws. The question may then be posed as to why foreign-owned firms should face the possibility of countervailing duty action as well being subjected to local competition laws. One possible justification is that the local presence is temporary (e.g. to provide a construction and engineering service) and of insufficient duration to apply domestic legislation. A practical consideration is then: what constitutes temporary presence? A further practical problem that is likely to arise if there is discrimination among producers, is that it will often be difficult to determine the nationality of the producer, especially in those cases where there are joint ventures, local equity participation, or ownership distributed across a number of nationalities.

⁸ This requirement may be technologically determined or may be the result of a regulatory requirement.

16. Countervailing duty investigations as currently pursued are product-specific, where the product is usually defined very narrowly as one or a subset of a tariff-line item of the national trade nomenclature. However, as noted earlier, such detail is not available in the context of services production and trade, as the only source of comparable data is national balance-of-payments statistics. The dearth of detailed statistics and the absence of common nomenclatures are additional constraints on accurate and objective application of countervailing duty action.

Material injury

17. As noted above, services may be tailored to the needs of the customer and many services require the producer and the consumer/receiver to interact if the provision/sale is to occur. Given that many services will be unique, it may be difficult to determine the extent to which, if any, subsidization affects prices of the exported product and sales of similar products by domestic producers. One problem that may arise results from the difficulty in determining the unit of output of the service, and therefore in establishing unit costs or prices.

18. Such difficulties are augmented to the extent that the service is part of a bundle of activities or products; a bundle that may be unique. The problem here is similar to that of identifying like products for purposes of anti-dumping investigations. Further, in the case of services, it will frequently be difficult to objectively determine the quality of a service; services of equivalent quality will need to be compared in order to establish the effect of a subsidy on domestic producers. This problem of comparability applies both if cross-border trade occurs and if sales take place via a local presence, assuming that in both instances like products are sold in the home market by the firms concerned. Thus, it may be difficult to calculate not only the size, but also the effect of the subsidy, and thus whether material injury has occurred as a result of the subsidy. In practice, considerable discretion may then be involved in investigations, creating the risk of inconsistency with respect to decisions concerning the existence and effect of subsidization.

Offsetting injurious subsidization

19. The intangibility of services imposes constraints on possible instruments that can be used to offset the price differentials caused by subsidization. In the context of trade in goods, countervailing measures generally involve the use of either border instruments such as tariffs, or (price) undertakings by the foreign suppliers. As noted earlier, because of the distinguishing characteristics of most services - which may involve factor or consumer mobility - border measures frequently cannot be employed. The feasibility (effectiveness) of alternative instruments will depend in part on the type of service involved, particularly the alternative modes of delivery that may exist. Even where observable cross-border trade occurs, and thus may be reduced by a border measure such as a tax, a quantitative restriction, or a prohibition, such

intervention may not be effective if there are acceptable alternative modes of delivery. If multiple modes of delivery exist, one implication may be that it is necessary to tax both cross-border flows and foreign producers that have a local presence. It would then be necessary to ascertain the ad valorem equivalent of taxes on cross-border flows and locally-produced services.

20. For a number of service sectors it may be difficult to impose restrictions on foreign supplied products or sales by foreign owned firms. If trade cannot be observed, intervention will have to focus on sales of the service product (i.e., a tax on consumption) or the activity of producing the service (i.e., a tax on production). However, it may not be feasible to distinguish sales or production of domestic firms from sales or production of foreign-owned firms. As mentioned previously, a general problem relates to distinguishing firms according to nationality of ownership, as many firms may be joint ventures or be partly owned by domestic residents. If it were to be accepted that sales by firms with a local presence constitute "imports," and it could be shown that such sales have benefited from subsidies to parent firms in their home markets and that these subsidies have injured "domestic" firms, countervailing measures could not be taken at the border. Instead, selective sales taxes or similar instruments may have to be imposed.

21. As in the case of goods, countervailing measures can only have an effect to the extent that the subsidized goods are imported. Subsidies to import-competing industries and subsidies to firms that export to third markets cannot be dealt with in this manner. Furthermore, similar conceptual issues arise with respect to determining the amount of subsidy to be offset if countervailing action is undertaken. Thus, whether this should be equal to the financial benefit accorded to the recipients of the subsidy or equal to the cost of the subsidy is not an issue on which the peculiarities of services has an impact. Finally, it can be pointed out that imposition of countervailing measures will generally lower the welfare of the country in question. Discussion might therefore focus on alternative responses to harmful subsidization. Examples of possible alternative approaches are discussed below.

Classifying subsidies

22. The Uruguay Round negotiating group on subsidies has been focusing on a three-fold breakdown of subsidies as a framework of discussion. These three categories are: (1) prohibited subsidies; (2) non-prohibited but countervailable subsidies; and (3) non-actionable subsidies. Two criteria that can be helpful in classifying subsidies are first, to determine whether the subsidy in question is an export subsidy (and if so, it could be prohibited), and second, to determine whether the subsidy is generally available or is specific. If generally available, it could be non-actionable. Examples of such subsidies are measures aimed at assisting adjustment of industries, protection of the environment, promotion of R&D, regional development and cultural objectives. The GNS may wish to consider whether such an approach could be applicable to services.

23. Three issues can be identified that may be relevant in this respect. First, many types of intervention in service sectors are intended to meet broader social objectives. Examples include health, education, transportation, communications and R&D. Public assistance may be sector-specific, even though the objective is economy-wide. It may then be more difficult to classify subsidies depending on whether they are specific or general. Second, public assistance may frequently be off-budget. As is well known, many service sectors are highly regulated; they may be state-run or private monopolies. Furthermore, certain standards may be applied in order to control quality or accountability. While this is the case both in the services and goods context, it will be much more prevalent in the case of services. As discussed above, the extent to which such regulations and intervention could be considered to be subsidies is an issue that evolves largely around the fundamental question of what the conditions should be for countervailability or actionability, and what is to be offset. Third, as mentioned earlier, issues relating to the mode of delivery and the definition of "domestic industry" and "imports" may be a consideration in the context of services.

IV. General considerations: criteria and offsetting actions

24. Subsidization, however defined, may lead to cost advantages for domestic producers and thus to differences in prices charged for similar products in the subsidizing country, or to differences in prices charged by a firm on different markets. However, differences in prices charged for similar products on a single market or on different markets may occur for a variety of reasons. For example, transportation and distribution costs will generally drive a wedge between prices charged on the home market and those charged in export markets. All other things equal, the prices charged for a similar product will tend to be higher in the export market than at home. However, various situations exist where the home market price may nevertheless be above the export market price. For example, variations in tastes across countries may imply that markets are to some extent segmented or isolated, so that producers may be able to charge different prices for similar products. There are two situations where international price differentials in excess of transportation costs may arise. The first is when this is due solely to market forces. An example pertains to trade in differentiated products. The second is when markets are "artificially" segmented, due to public assistance to firms in the exporting country. Two issues arise. The first pertains to possible criteria for responding to price differentials caused by public assistance, whether these occur on a single market (due to production subsidies, for example) or across markets (due to export subsidization, for example); and the second pertains to methods of offsetting such differences if the required criteria have been met.

Criteria

25. Procedures for dealing with price differences that result from subsidization require material injury due to subsidization as a necessary precondition for undertaking offsetting action. As noted in MTN.GNS/W/70, many services play an important support and infrastructural role in the

functioning of an economy. Transportation, storage, telecommunications, and distribution services are frequently crucial in linking producers to each other and to consumers. An implication of this is that actions limiting imports of services are likely to have a greater impact on the economy as a whole than actions that pertain to imports of goods. The important linkage and support role of many services also suggests that a wider conception of injury may be relevant when considering whether to offset price differentials. That is, participants in the GNS might consider the question of whether an "injury to the economy" criterion could be employed instead of an "injury to producers" criterion. Alternatively, a producer focus might be augmented by a need to determine that offsetting action is in the interest of the economy/community as a whole.

Offsetting measures

26. There are two types of procedures authorized by the GATT in cases where subsidization is deemed to adversely affect the interests of a country. The first is the general GATT dispute settlement procedure - Articles XXII and XXIII dealing with acts that are alleged to nullify or impair benefits accruing to a country as a result of participation in the General Agreement. The second is to impose a countervailing duty on the "harmful" imports subsequent to an investigation that has established both the existence of a subsidy, material injury and causality between the subsidy and material injury. Participants might consider whether a general dispute settlement procedure may be preferable in dealing with instances of injury due to subsidization.

27. Unilateral responses to public assistance such as countervailing duties tend to be rather inefficient and costly methods of offsetting injury. This is because they can only have an effect to the extent that the country concerned imports the relevant products. Even if this is the case, countervailing duty measures are inefficient because they will rarely improve the welfare of the country concerned. Policies to eliminate the source of the problem or to obtain compensation may be preferable. It can also be noted that although unilateral measures may be the optimal approach in cases where the foreign firm has established a local presence, there is the alternative option of applying national laws to these firms, implying that no trade policy is required to offset any injurious effects subsequent to the establishment.

28. In general, participants might consider whether a "nullification and impairment" approach could suffice in dealing with problems associated with subsidization. That is, instead of authorizing a unilateral response subject to satisfaction of certain criteria, a dispute settlement procedure could be invoked if a country felt its benefits under a services agreement were being nullified or impaired by actions of governments leading to price differentials across and within markets.

V. Possible questions for discussion

1. Should there be a mechanism to offset the effect of certain types of subsidy/public assistance to specific service sectors? If so, what types of subsidy/public assistance?
2. If a foreign subsidy is deemed to harm domestic interests, what remedial measure could be used?
3. What criteria should be satisfied before measures to counteract the subsidy can be taken? Should "material injury" to domestic firms be maintained? If so, how should "domestic industry" be defined?
4. Should there be a prohibition on specific types of governmental assistance?
5. Given that foreign firms that have established a local presence will be subject to national laws and regulations, should such firms also be faced with the additional possibility of a "trade" action? How could such an approach be reconciled with a "national treatment" provision?