

Section I

Issues in the WTO

1. Export Processing Zones and the WTO Agreement on Subsidies and Countervailing Measures

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Introduction

Many of the Commonwealth's developing countries have established export processing zones (EPZs) as trade policy instruments designed to promote non-traditional exports. Typically, these programs provide that if a company locates a manufacturing facility within a geographically delimited zone, and exports all or most of its products, it will be provided with a number of incentives. These incentives range from exemption from various direct and indirect taxes and customs duties to provision of a number of free or low-cost services. EPZs located in developing countries typically provide the greatest number of incentives.

The WTO's Agreement on Subsidies and Countervailing Measures (SCM) contains specific definitions, restrictions and implementation deadlines in relation to the use of export subsidies. These rules may affect incentives granted to EPZ companies in Commonwealth developing countries that are currently WTO Members or are contemplating accession.

This paper aims to highlight some of the potential conflicts between the SCM Agreement and EPZ incentives. It should be borne in mind, however, that each EPZ will have particular regulatory characteristics and that each Commonwealth WTO Member may have differing bilateral or regional obligations. The comments made in this paper can, therefore, only be general in nature and should not substitute a case-by-case review of EPZ incentives.

Agreement on Subsidies and Countervailing Measures

The SCM Agreement came into effect on 1 January 1995 and builds on Article XVI of the General Agreement on Tariffs and Trade 1947 (GATT) and the earlier Agreement on Interpretation of and Application of Articles VI, XVI and XXIII. The SCM Agreement provides a more or less complete code in relation to the use of subsidies that reference back to GATT 1947 and the earlier Agreement on Interpretation is not necessary in most instances.

Definition of Subsidy

The rules contained in the SCM Agreement apply only to subsidies as defined within the Agreement. A subsidy is defined in Article 1 as a financial

contribution by a government or any public body, including a direct transfer of funds (e.g. grants, loans and equity infusion), government revenue that is forgone (e.g. tax credits), provision of goods or services by a government, other than infrastructure, and income or price support.

This very broad definition is qualified by two provisos. First, to become subject to the rules in the SCM Agreement, a subsidy must confer a *benefit* on the recipient, and secondly, it must be *specific*, namely, available only to an enterprise or industry or group of enterprises or industries within the jurisdiction of the authority granting the subsidy. Article 2.2 specifically provides that “*a subsidy which is limited to certain enterprises located within a designated geographical region. ...shall be specific.*” Subsidies extended on the basis of administrative delineation would also be specific.

The general definition of subsidy is further refined by specifying two categories of subsidies: *prohibited export subsidies and actionable subsidies*. These two categories are also referred to as “*red light*” and “*yellow light*” subsidies. Until 2000 there was a third category of *non-actionable subsidy*, which has been discontinued.

Prohibited Export Subsidies

Prohibited export subsidies are those “... *contingent, in law or fact ... upon export performance ... and those contingent. ...upon the use of domestic over imported goods*”. *Prohibited export subsidies* are described further by reference to Annex I of the SCM Agreement, which provides an illustrative list of *Prohibited Export Subsidies*. Annex 1 includes as *prohibited export subsidies* a number of the incentives that might be offered to EPZ companies including:

- transport or freight charge subsidies on export shipment provided or mandated by the government;
- the provision by governments of export credit guarantees or insurance programs at premiums that are adequate to cover the long-term operating costs and losses of the programs; and,
- the full or partial exemption remission, or deferral in relation to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises. (Direct Taxes are defined as taxes on wages, profits, interests, rents, ‘royalties, and all other forms of income, and taxes on ownership of real property).

Developed WTO Members are prohibited from granting or maintaining prohibited export subsidies. However, the SCM Agreement recognises that subsidies may play an important role in the economic development of developing countries. Accordingly, least-developing countries (as designated by the United Nations), and developing countries with a GNP per capita of less than \$1,000,

are exempted, from the prohibition on *prohibited export subsidies* indefinitely, or at least for so long as their GNP remains below the specified level.

Developing countries, other than least developed and those with a GNP below \$1,000 per capita, are exempted from this prohibition until the end of 2002. However, they are required to phase out *prohibited export subsidies* within the eight-year implementation period, preferably in a progressive manner, and they may not increase their level of export subsidies.

If a developing country requires an extension of the period of exemption in relation to *prohibited export subsidies* Article 27.4 of the SCM Agreement provides that it may enter into consultation with the Committee on Subsidies and Countervailing Measures (the Committee) to determine whether an extension of the period is justified. These consultations must be initiated at least one year before the end of the exemption period, i.e. by the end of 2001. If, having taken into account all relevant economic, financial and development needs, the Committee is of the view that the extension is justified then the subsidy will be subject to annual reviews from then on.

It is worth noting that developing countries may be reluctant to apply for extensions on the grounds that to do so could create unease amongst existing or prospective EPZ companies. The alternative is develop a strategy for bringing the incentive packages within the SCM Agreement rules.

A further exemption is provided in relation to the prohibition against subsidies in the form of domestic content requirements or preferential treatment for domestic over imported inputs. Developing countries were exempted from this prohibition until 2000, Least developed countries are exempt until the end of 2002.

Some Further Examples of Measures Likely to Constitute Prohibited Export Subsidies

Each of the following measures may, subject to the particular circumstances of the EPZ concerned, constitute a *prohibited export subsidy*:

- exemption from taxes on real estate;
- exemption from taxes on profits as well as of any other tax determined on the basis of gross or net income, dividends paid to shareholders or income or sales;
- income tax exemptions based on locating plant in areas of “lesser development”;
- income tax exemptions based on reinvestment in the host country;
- exemption from taxes on remittances abroad;
- provision of non-chargeable customs processing services; and,
- the provision of public administrative services to EPZ manufacturers on a non-chargeable basis, such as assistance in selection of personnel,

advice regarding government regulatory requirements and assistance with housing and educational needs of personnel.

Actionable Subsidies

The second category of subsidies are actionable subsidies. These subsidies are defined by reference to the effect they have on another WTO Member. Therefore, if a subsidy falls within the Article 1 definition of *subsidy*, confers a *benefit* on the recipient and is *specific*, but is not a *prohibited export subsidy*, then the following test will be applied to determine whether it is an *actionable subsidy*:

Article 5:

“No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e.

- (a) injury to the domestic industry of another Member;*
- (b) nullification or impairment of benefits accruing directly or indirectly to other Members;*
- (c) serious prejudice to the interests of another Member.”*

Serious prejudice is deemed in certain circumstances, namely where the total *ad valorem* subsidisation of a product exceeds 5% of its value or where subsidies are paid to cover operating losses sustained by an industry. Where *serious prejudice* is deemed to exist, the burden of proof is on the subsidising Member to show that the subsidies in question do not cause serious prejudice to the complaining Member. This presumption of *serious prejudice*, however, only applies in relation to developed countries. For developing countries *serious prejudice* must be demonstrated by positive evidence.

Further, where a developing country maintains an actionable subsidy, i.e. one which causes adverse effects to the interests of other Members as per Article 5, a remedy will only be granted where the subsidy in question also displaces or impedes imports of like products into that country, or injures a domestic market in another country. In other words, the threshold to be reached before a remedy will be granted in response to an actionable subsidy is raised for developing countries.

Some Examples of Measures Likely to Constitute Prohibited Export Subsidies

The measures listed below may, depending on the particular circumstances of the EPZ concerned, constitute *actionable subsidies*:

- exemption from import charges on the importation of raw materials, machinery and any other components necessary for EPZ company manufacturing (where the same exemptions are granted to imports for the manufacture of like products for domestic consumption);
- exemption from municipal taxes;

- exemption from stamp duty or transaction taxes; and
- exemption of sales and consumption taxes on purchases of goods and services.

Non-actionable Subsidies

The final category of subsidy recognised by the SCM Agreement was *non-actionable*. Article 8 provides that subsidies which are not specific and certain other specific subsidies, e.g. industrial research subsidies, assistance to disadvantaged regions and subsidies to implement environmental requirements, are non-actionable. Members relying on the exemptions in Article 8 had to notify the Committee. However, Article 31 of the SCM Agreement provides that Article 8, amongst others, would apply only for a provisional period of five years. The Committee was then faced with the task of deciding whether to extend Article 8's application. The Committee failed to reach a consensus on an extension before 31 December 1999. Accordingly, this exemption no longer applies and previously non-actionable subsidies will now be treated in the same way as other subsidies.

This raises the question of whether subsidies previously notified under Article 8 continue to enjoy their exempt status, and if so for how long.

Notifications

The SCM Agreement builds on the obligation contained in Article XVI of GATT 1947 that Members must notify any subsidy that they maintain. Article 25 of the SCM Agreement requires Members to notify any specific subsidy within the broad definition of Article 1, i.e. prohibited export subsidies, and actionable subsidies as well as any non-actionable subsidies. Notifications are to be submitted by 30 June each year and Members may bring to the attention of the Committee any Members' failure to notify.

Remedies

Where a WTO Member maintains a *prohibited subsidy* the aggrieved WTO Member may initiate the SCM Agreement dispute settlement process, which includes an expedited timetable for action by the Dispute Settlement Body. If it is found that the subsidy is indeed prohibited, it must be immediately withdrawn. If this is not done within the specified time period, the complaining member may be authorised to take countermeasures.

It is worth noting that in the *Australia - Subsidies Provided to Producers and Exporters of Automotive Leather Case*, a dispute between the United States and Australian Governments resulted in a WTO Panel ordering that the exporter concerned repay A\$30 million of export assistance to the Australian Government. A sanction of this type passed through to a corporation clearly

demonstrates the risks that EPZ companies will be evaluating in relation to the incentives they receive.

An alternative course of action open to the aggrieved WTO Member, once a *prohibited export subsidy* is established, is to initiate a countervailing duty investigation with a view to imposing an additional import duty on the product or products concerned from the subsidising country. Before an aggrieved Member may impose a countervailing duty, it must comply with the detailed obligations contained in the SCM Agreement regarding the conduct of a countervailing duty investigation and the findings of a subsidy, injury, and a causal link between the two.

Affected Members can take action against a Member maintaining an actionable subsidy in the same way as for prohibited subsidies. In the event that it is determined that *adverse effects*, as defined in the SCM Agreement, exist the subsidising Member must withdraw the subsidy or remove the *adverse effects*.

Alternatively, a countervailing duty investigation may be commenced once the existence of an *actionable subsidy* has been established.

The SCM Agreement provides that a countervailing duty investigation of a product originating from a developing country is to be terminated if it is determined that the level of the subsidies does not exceed 2% (3% for some developing Members) of the value of the product, or if the subsidised imports from the developing country concerned amount to less than 4% of the total imports of the *like product* into the aggrieved country.

Finally, a countervailing duty investigation will also be terminated in circumstances where the amount of the subsidy is *de minimus* or where the volume of exports or the injury is negligible.

What are the main issues for Commonwealth Governments with EPZS?

1. Illegal prohibited export subsidies

Several of the preferential incentives typically provided to companies in EPZs fall squarely within the definition of *prohibited export subsidy* as described in Article 3 and the illustrative list in Annex I. For example:

- the exemption or partial remission of direct taxes such as wage taxes, profit taxes, rents royalties and property taxes;
- transport or freight charge subsidies on export shipment provided or mandated by the government; and,
- the provision of export credit guarantees or discounted insurance program.

It is important to note that the SCM Agreement is not targeting duty-free imports and exports. Rather, the Agreement targets the set of fiscal incentives, such as tax breaks and utility subsidies, which are offered on a preferential

basis to exporters. If these measures were applied nation-wide and to companies other than exporters, they would not be considered discriminatory and therefore would probably not be subject to WTO regulation. However, where these fiscal incentives are provided to EPZ firms on a preferential basis they become *prohibited export subsidies* (as described above) and are viewed as being an export subsidy for the EPZ companies' exported goods.

Therefore, developing Commonwealth countries with active EPZs and a per capita GNP of US\$1000, technically have until the year 2003 to remove the prohibited subsidies or realign ERZ incentive schemes with national norms. Where this is not done these countries disciplinary actions and countervailing measures from trade partners.

As discussed above, the least developed Commonwealth countries and those with a GNP per capita of less than US\$1000 are exempt from this restriction on prohibited subsidies.

2. *Illegal local content requirements*

Prohibited export subsidies include both subsidies contingent on export performance and those contingent on the use of domestic over imported goods (Article 3.1(b)). The phase out period for these local content subsidies is slightly different to that for export performance subsidies. Developing countries were required to remove all such subsidies by the end of 2000. Least developed countries have until the end of 2002 to remove local content subsidies. Local content requirements may also conflict with a country's obligations under the WTO Agreement on Trade Related Investment Measures.

3. *Introduced prohibited export subsidies*

It should be remembered that the eight year period before developing countries are prohibited from maintaining *prohibited export subsidies*, i.e. until 2003, is intended to be a phase-out period. Article 27.4 of the SCM Agreement provides that a developing country "*shall not increase the level of its export subsidies*". Accordingly, where Commonwealth developing countries have, or are proposing to increase the level of subsidies or introduce new subsidies, a careful assessment should be made as to whether the subsidy falls within the definition of *prohibited export subsidy*. Where such subsidies have already been introduced there is of course the possibility of retaliation from a trade partner.

4. *Extended time-limits for specific prohibited export subsidies*

For all developing Commonwealth countries there is room in the SCM Agreement for a one year extension of the exemption in relation to particular *prohibited export subsidies*, with annual consultation regarding further yearly extensions. These consultations must be initiated by the end of 2001.

5. *Illegal actionable subsidies*

Where a Commonwealth country maintains an actionable subsidy, i.e. one which causes *adverse effects* to the interests of another Member and exceeds the de minimus thresholds, that country may become the focus of a direct challenge to the subsidy or a countervailing duty investigation, potentially resulting in the country being forced to withdraw the subsidy or remove the adverse effects or the country's exporters facing a higher duty on exports to certain foreign markets.

It should be noted, that while least developed countries or those with a GNP per capita below \$1000 are exempt from the restrictions on *prohibited export subsidies* there is no exemption in relation to actionable subsidies. Therefore, if such a country were to export sufficient levels of subsidised product to pass the de minimus thresholds, an aggrieved country could take action against it.

6. *Failure to notify subsidies*

Article 25 of the SCM Agreement requires Members to notify any subsidies being maintained by 30 June each year. This includes an obligation to notify that no subsidies at all are maintained.

7. *New Round of negotiations*

The issues raised above all presume that the SCM Agreement remains unamended. However, developing countries, including Commonwealth developing countries, may decide that the export subsidy exemptions for developing and least developed countries should be extended as part of any future negotiating round.