

CHAPTER 8

Rules governing subsidies on industrial products

Summary

The GATT rules on subsidies stipulated in Article XVI have been clarified and elaborated by the Agreement on Subsidies and Countervailing Measures (SCM) and the Agreement on Agriculture. Broadly speaking, the provisions of the Agreement on SCM apply to industrial products; those of the Agreement on Agriculture cover agricultural products.

The SCM Agreement recognizes that governments utilize subsidies to attain various policy objectives. However, it restrains the right of governments to grant subsidies that have significant trade-distorting effects. Its rules are complex.

The Agreement divides subsidies into prohibited and permissible subsidies. Prohibited subsidies include export subsidies. In the past, the rule against the use of export subsidies on industrial products applied only to developed countries; the Agreement extends this rule to developing countries. The latter countries have a transitional period of eight years within which to bring their subsidy practices into conformity with the rule. During this period, they cannot increase the level of their export subsidies. The rule against the use of export subsidies does not apply to least developed countries and to developing countries with per capita GNPs of less than US\$ 1,000.

All subsidies that are not prohibited are permissible. The permissible subsidies are divided into two categories: subsidies that are actionable and those that are not actionable.

The Agreement provides two types of remedies where the subsidies granted by governments cause "adverse effects" to the trade interests of other countries.

Where such adverse effects take the form of material injury to a domestic industry in the importing country, the Agreement authorizes that country to levy countervailing duties to offset the subsidy. Such duties can be levied only if, after duly conducted investigations, the investigating authorities are satisfied that there is a causal link between subsidized imports and material injury to the industry concerned. Furthermore, such investigations can normally be initiated only on the basis of a petition from the affected industry alleging that such imports are causing it damage.

Alternatively, both in the case of serious prejudice to a domestic industry and in the case of other adverse effects, the importing country can bring the matter before the Dispute Settlement Body (DSB) to secure withdrawal or modification by the subsidizing country of the subsidies that are causing adverse effects.

Governments grant subsidies to attain various policy objectives. Thus, subsidies may be made available to promote the development of new industries; to encourage investment and the establishment of industries in a country's backward regions; to assist industries in export development; to improve the infrastructure for agricultural production and to ensure a reasonable income level for farmers.

The GATT rules governing the use of subsidies are complex, and they differ for industrial and for agricultural products. The main GATT provisions on subsidies are elaborated in the Agreement on Subsidies and Countervailing Measures (SCM), and in the Agreement on Agriculture. The provisions of the Agreement on SCM apply, with a few exceptions, to industrial products; those of the Agreement on Agriculture relate to agricultural products. The rules of the SCM Agreement are described in this chapter, those applicable to agriculture are discussed in chapter 15.

Definition of subsidies; aim of the Agreement on SCM

Agreement on SCM,
Article 1

Under the SCM Agreement, an industry is deemed to have received a subsidy where a *benefit* is conferred on the industry as a result of:

- Direct transfer from the government of funds (e.g. grants, loans or equity infusion) or government guarantees of payment of loans;
- The government foregoing the revenue that should otherwise have been collected;
- The government providing goods or services, or purchasing goods.

The concept of *benefit* is essential to determining whether a measure represents a subsidy. Although the Agreement provides only limited guidance on this point, as a general rule it may be said that a government action that is not consistent with commercial considerations confers a benefit. Thus, a government infusion of equity on terms a private investor would not accept, a loan on terms more favourable than those offered by commercial banks, or the provision by a government of goods or services for less than the prevailing market price, is likely to confer a benefit and may therefore be a subsidy.

The aim of the Agreement is not to restrain unduly the right of governments to grant subsidies but to prohibit or discourage them from using subsidies that have adverse effects on the trade of other countries. Towards this end, it categorizes subsidies into those that are prohibited and those that are permissible.

Prohibited subsidies (red subsidies)

The following subsidies are prohibited:

Agreement on SCM,
Article 3

- Export subsidies, i.e. subsidies that are contingent on export performance (see box 22 for an illustrative list),
- Subsidies that are contingent on the use of domestic over imported goods.

In the past the rule prohibiting the use of export subsidies on industrial products applied only to developed countries. The Agreement extends the application of the rule to developing countries. These countries (with some exceptions) may, however, gradually abolish the use of such subsidies over a transitional period of eight years expiring on 1 January 2003. They also have a transitional period of five years to eliminate subsidies that are contingent on the

Box 22**Illustrative list of prohibited export subsidies**

The Agreement on SCM's illustrative list of prohibited export subsidies includes the following:

- Direct subsidies based on export performance;
- Currency retention schemes involving a bonus on exports;
- Provision of subsidized inputs for use in the production of exported goods;
- Exemption from direct taxes (e.g. tax on profits related to exports);
- Exemption from, or remission of, indirect taxes (e.g. VAT) on exported products in excess of those borne by these products when sold for domestic consumption;
- Remission or drawback of import charges (e.g. tariffs and other duties) in excess of those levied on inputs consumed in the production of exported goods;
- Export guarantee programmes at premium rates inadequate to cover the long-term costs of the programme;
- Export credits at rates below the government's cost of borrowing, where they are used to secure a material advantage in export credit terms.

use of domestic over imported products. This period expires on 1 January 2000. Box 23 describes the provisions of the Agreement which extend special and differential treatment to developing countries in regard to the use of prohibited and permissible subsidies.

Permissible subsidies

Under the Agreement's rules, governments are in principle permitted to grant subsidies other than those described above, which are prohibited. However, the Agreement groups permissible subsidies into two categories: those that are actionable and those that are non-actionable. It has become common practice to compare the Agreement's categorization of subsidies to the traffic light. Prohibited subsidies are called red subsidies; those that are actionable, amber; and those that are non-actionable, green.

Permissible subsidies that are actionable (amber subsidies)

Broadly speaking the Agreement uses the concept of *specificity* to categorize subsidies that are actionable and those that are non-actionable. A subsidy is specific if it is limited to:

- An enterprise or group of enterprises;
- An industrial sector or group of industries; or
- A designated geographic region within the jurisdiction of the granting authority.

All specific subsidies (other than those identified in the section that follows) are actionable if they cause what the Agreement calls "adverse effects to the interests of other Members". Such adverse effects take the form of:

- Serious prejudice to the domestic industry;
- Injury to the domestic industry in the importing country;
- Nullification and impairment of the benefits of bound tariff rates.

Box 23**Flexibility available to developing countries in the use of subsidies***(Agreement on SCM, Article 27)*

The Agreement on SCM recognizes that “subsidies may play an important role in economic development programmes of developing country Members.” Because of this, it further acknowledges that these countries may not be able to abide immediately by the full discipline of the rules which it lays down. To allow for flexibility in the application of the rules, the Agreement provides for special and differential treatment of developing countries.

Export subsidies

As noted earlier, the rule prohibiting export subsidies will apply to developing countries only after a transitional period of eight years, i.e. by 1 January 2003. These countries are, however, urged to phase out such subsidies progressively within the eight-year period and are not allowed to increase the level of their export subsidization. The transitional period may, if requested by a developing country, be extended by another two years.

These countries are further required to phase out within a period of two years export subsidies for any product in which they have become export competitive. A country is considered to have reached export competitiveness in a product if it has attained a share in the world market of 3.25% for two consecutive years. A product for this purpose is defined as a section heading of the Harmonized System Nomenclature, developed by the World Customs Organization for the classification of tariffs and trade statistics.

The least developed and low-income developing countries, with per capita GNPs of less than US\$ 1,000, are totally exempt from the rule prohibiting export subsidies. If, however, they are found to have developed export competitiveness in any product, they are under an obligation to phase out the export subsidies granted to that product within eight years (compared with the two-year period given to other developing countries).*

Export subsidies by developing country members remain actionable, however, both multilaterally and through countervailing duties.

Subsidies to promote the use of domestic goods

The rule prohibiting subsidies to promote the use of domestic over imported goods will be applicable to developing countries after a transitional period of five years (by 1 January 2000) and to least developed countries after eight years (by 1 January 2003).

Subsidies to encourage privatization

To encourage privatization, the Agreement provides that “direct forgiveness of debts, subsidies to cover social costs, in whatever form, including relinquishment of government revenue ...” by the government of a developing country shall be treated as non-actionable multilaterally, provided such subsidies are granted for a limited period and are in accordance with a privatization programme. They remain subject to countervailing measures, however.

** The low-income countries whose per capita GNPs are currently less than US\$ 1,000 per annum are: Bolivia, Cameroon, Côte d’Ivoire, the Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, the Philippines, Senegal, Sri Lanka and Zimbabwe. These countries will, however, be required to accept the obligation to prohibit the use of export subsidies when their per capita GNPs reach US\$ 1,000.*

One basis for actionability is the existence of *serious prejudice* to the interests of other countries. This course of action is likely to be invoked when the subsidized product is displacing the complainant’s exports from the market of the subsidizing country or of a third country. Box 24 describes the criteria which the Agreement lays down for determining whether a subsidy granted by a country is causing serious prejudice to the interests of other Members.

Box 24**Criteria for determining serious prejudice to the interest of another country***(SCM, Article 6)**The Agreement clarifies that serious prejudice to the interest of another country shall be presumed to have occurred, inter alia, where:*

- Total ad valorem subsidization of a product exceeds 5%;
- Subsidies cover operating losses sustained by an industry;
- Subsidies other than one-time measures cover operating losses sustained by an enterprise; or
- There is direct forgiveness of debt by the government.

In all other cases, in order to establish that serious prejudice has actually occurred, the complainant must demonstrate that the effect of the subsidy is:

- To displace or impede imports from another member country into the subsidizing country;
- To displace exports to a third country market;
- Significantly to undercut or suppress prices in the subsidizing market;
- An increase in the world market share of the subsidizing country over its average share in the previous three years for the product or commodity benefiting from subsidy.

Material injury is another basis for actionability. In particular it is the basis under which an importing country can levy countervailing duties on subsidized imports that are causing injury to its domestic industry.

Subsidies that cause *nullification and impairment* of the benefits which the GATT system provides are also actionable. Such nullification and impairment of benefits could be deemed to have occurred when an exporting country finds that the value of the concession in the form of tariff binding it has obtained in trade negotiations by making a reciprocal concession has been greatly reduced because a domestic industry has lost market share to an industry in the importing country benefiting from subsidy.

Permissible subsidies that are non-actionable (green subsidies)

With a few exceptions, all permissible subsidies that are specific are actionable. Those which are not specific are non-actionable. Subsidy programmes providing subsidies on the basis of objective economic criteria and which are horizontal character and “do not favour certain enterprises over others” are not specific. They are therefore non-actionable. Thus the subsidies given by governments to small and medium-sized enterprises, identified on the basis of their size or number of employees, would ordinarily be non-actionable.

In addition, certain subsidies that are specific are non-actionable, provided the specific conditions governing their grant comply with the rules of the Agreement. These include subsidies:

- For research activities conducted by firms, provided certain conditions are met;
- To adapt existing production facilities to new environmental requirements, provided that the subsidy is a one-time non-recurring measure and is limited to 20% of the cost of adaptation; and

- To assist in the development of industries in disadvantaged regions, provided certain conditions are met.

Importing countries cannot levy countervailing duties on products benefiting from non-actionable subsidies.

Remedies available to affected industries and to their governments

What are the remedies available to industries and to governments of countries which consider that their interests are being damaged by subsidized imports?

Agreement on SCM,
Articles 4, 7, 9

The Agreement provides for two types of remedies. First, a country which considers that either a prohibited subsidy is being used or that it is being adversely affected by the grant of a permissible subsidy, may raise the matter before the WTO Dispute Settlement Body (DSB) for redress. Where the adverse effects take the form of “material injury” to its domestic industry, the importing country may, instead of invoking dispute settlement procedures, levy countervailing duties on the imported subsidized products (see box 25). Such duties can however be levied only when investigations carried out at the national level and on the basis of a petition from the affected industry have established that the subsidized imports are causing injury to the domestic industry. Countervailing duties cannot be levied on products benefiting from non-actionable subsidies.

Box 25

Remedies available to importing countries under the Agreement on SCM

(Articles 4, 7 and 9)

Two types of remedies are available to an importing country which considers that the use of subsidies by other member countries is affecting its interests adversely. It may levy countervailing duties if, after investigations carried out in pursuance of a petition made by the affected industry, it is established that subsidized imports are causing the industry material injury. It may also bring the matter for redress before the Dispute Settlement Body (DSB).

Prohibited subsidies. *Any country which considers that another country is using a prohibited subsidy may, if bilateral consultations with that subsidizing country do not lead to its withdrawal, bring the matter before DSB.*

Actionable subsidies. *A country which finds that an actionable subsidy granted by another country has adversely affected its interests may refer the matter to DSB for settlement, if bilateral consultations fail to bring about a mutually agreed solution.*

Non-actionable subsidies. *Countervailing duties cannot be levied on products that have benefited from non-actionable subsidies. However, where a country “has reasons to believe” that the subsidy programmes have had “serious adverse effects” on its domestic industry as to cause damage which would be difficult to repair, it may request consultations with the country granting subsidies. If the consultations fail, it may request the Committee on Subsidies and Countervailing Measures (SC), which has been established under the Agreement, to determine whether such effects exist.*

In all the three cases mentioned above, if the subsidizing country fails to take appropriate steps to implement the recommendations made, the DSB/Committee on SC could authorize the affected country to take countermeasures that would affect the trade of the subsidizing country.

The Agreement on SCM lays down detailed rules and procedures for investigating authorities to follow in carrying out investigations and calculating the amount of countervailing duties that can be levied. Since the rules applicable to the levy of countervailing duties and to the use of anti-dumping measures are similar, and since in most countries the investigations for the levy of both these duties are carried out by the same investigating authorities, these rules are explained together in chapter 11.

Business implications

The rule against the use of export subsidies for industrial products, which in the past applied only to developed countries, is now also valid for developing countries. (The exceptions are least developed and developing countries with per capita GNPs of less than US\$ 1,000.) These countries have a transitional period of eight years (to 1 January 2003) within which to withdraw their existing subsidy systems. During this period, they may not increase the level of their subsidies or grant subsidies to products not previously covered. Enterprises currently benefiting from export subsidies will therefore have to prepare themselves for the withdrawal of these subsidies by their governments by the end of the transitional period, if not earlier.

It should be noted that while the SCM Agreement permits developing countries to use export subsidies during the transitional period, these subsidies can be countervailed by importing countries even during that period if they cause injury to their domestic industries. This also applies to the developing countries that are exempt from the rule prohibiting the use of export subsidies. The maintenance of export subsidies on products that are considered import sensitive by importing countries (e.g. textiles, leather and leather products, etc.), albeit permitted under the Agreement, is therefore fraught with danger. It is thus important for governments to adopt trade and foreign exchange policies that will remove the bias against their countries' exports and reduce the need for export subsidies. It is also necessary for them to examine, in consultation and in cooperation with their exporting enterprises and their associations, whether assistance, where needed, can be provided in the form of permissible subsidies and preferably those that are not actionable by importing countries. In this context it is important to note that subsidies that are not specific to particular industries but are of general application are not countervailable by importing countries.