WORLD TRADE ORGANIZATION

TN/RL/W/78
19 March 2003

(03-1611)

Negotiating Group on Rules Original: English

SUBSIDIES DISCIPLINES REQUIRING CLARIFICATION AND IMPROVEMENT

Communication from the United States

The following communication, dated 19 March 2003, has been received from the Permanent Mission of the United States.

Introduction & Background

At the Fourth Ministerial Conference in Doha, Ministers agreed to negotiations aimed at clarifying and improving disciplines under the subsidies and antidumping agreements, while preserving the agreements' basic concepts, principles and effectiveness, and taking into account the needs of developing and least-developed countries.[1] In this initial phase of the negotiations, participants are to indicate the provisions, including disciplines on trade distorting practices, that they seek to clarify and improve in the subsequent phase. Identification of enhanced disciplines on trade distorting practices, including subsidies – broadly defined – is particularly important because it is these practices that are often one of the root causes of trade friction.

As the United States noted in its *Basic Concepts and Principles* paper[2], there is widespread and longstanding agreement that government subsidies distort the efficient allocation and utilization of resources, thereby undermining the best foundation of economic growth and development. The subsidy-induced production distortions that occur domestically frequently spill-over internationally, distorting the efficient flow of trade and diminishing the economic development and growth potential of all participants in the world economy. One of the fundamental economic principles upon which the trading system is based is that trade flows should be determined by comparative advantage and market forces, not government intervention. In recognition of this principle, Members have over time committed to increasingly stringent and mutually beneficial rules on the provision of subsidies.

Historically, a pragmatic approach has been taken by Members over the course of successive negotiating rounds to improving subsidies disciplines by prioritizing the elimination of the most explicit and egregious categories of subsidies, such as export subsidies and import-substitution subsidies, while further clarifying and strengthening the disciplines for countering the adverse trade effects that other subsidies can cause. Consistent with the Doha Mandate and the progressive deepening of subsidy disciplines witnessed over the last fifty years, this paper identifies existing provisions of the Subsidies Agreement which are ripe for further clarification, development and improvement. Of particular importance, it suggests greater disciplines on those types of subsidies

[1] WT/MIN(01)/DEC/W/1 (paragraph 28)
[2] TN/RL/W/27 (22 October 2002)

which most directly and substantially contravene market-determined economic growth and international trade patterns.

This contribution identifies a range of issues that the Rules Group needs to address and will likely be supplemented with other contributions. The United States reserves its rights to identify additional areas for clarification and improvement in the future.

Prohibited Subsidies

An obvious next step in the progressive deepening of subsidy disciplines is the expansion of the existing category of prohibited subsidies to include those instances of government intervention that have a similarly distortive impact on competitiveness or trade as do export and import substitution subsidies. These newly prohibited subsidies should be defined and identified according to clear and objective criteria. Some of the practices listed in the now-lapsed "dark amber" provisions of Article 6.1 of the Subsidies Agreement should be the first candidates for inclusion in an expanded prohibited category of subsidies. These include: large domestic subsidies, subsidies to cover operating losses by a company and direct forgiveness of debt. Recipients of these types of subsidies have benefited from extraordinary government intervention typically designed to save them from bankruptcy and to allow them to maintain production and sales in spite of the dictates of the market. Large subsidies can also substitute for commercial investment to prompt and ensure the establishment of a company or product that would not have been created by the market.

The existing remedies for prohibited subsidies should also be discussed. The current dispute settlement rules for prohibited subsidies do not require any showing of adverse effects (*i.e.*, injury to a domestic industry, serious prejudice, or nullification and impairment). This demonstrates the very clear consensus among Members that these types of subsidies should not be provided. However, injury to a Member's domestic industry from these subsidies must still be shown in the context of a national countervailing duty proceeding. The United States believes it may be appropriate to explore strengthening the remedies for prohibited subsidies.

Serious Prejudice

The Subsidies Agreement provides for dispute settlement proceedings to be initiated against non-prohibited subsidies (also referred to as "actionable" or "yellow light" subsidies) once a Member affirmatively establishes that its industry has suffered "adverse effects" from a particular subsidy practice. One type of adverse effect is "serious prejudice". which applies with equal force and effect regardless of the market affected by the actionable subsidy (*i.e.*, the market of the importing country, subsidizing country or a third-country market). One of the major subsidy discipline advancements of the Uruguay Round was that it defined "serious prejudice". The lack of criteria regarding serious prejudice in the Tokyo Round had been one of the major causes of the ineffectiveness of dispute settlement.

Despite the progress made in the Uruguay Round, the serious prejudice provisions of the Subsidies Agreement have rarely been used. Thus, as other Members have noted[3], the serious prejudice remedy needs to be strengthened and made more effective. The causation provisions, in particular, should be reviewed. Moreover, the remedy after the finding of serious prejudice (and the other two types of adverse effects) allowing a Member "to remove the adverse effects" is too vague and impractical to implement in a straightforward and meaningful manner. Therefore, consideration should be given to clarifying this particular remedy or eliminating it entirely and establishing the withdrawal of the subsidy as the exclusive remedy.

[3] TN/RL/W/1 (15 April 2002)

Indirect Subsidies[4]

In our *Basic Concepts and Principles* paper, we discuss the importance of addressing those national government distortive subsidies "that are so entrenched or disguised within countries' political and economic systems that it will take some time to identify and implement the appropriate multilateral disciplines necessary to root all of them out". Many of these distortive practices take the form of indirect subsidies to specific companies or industries in which governments act through government-owned, government-controlled or government-directed private entities to provide financial support to companies, which would either not be available from the private sector or would not be available on the same terms.

Where a government-owned or controlled entity provides a subsidy to a specific firm or industry, an actionable subsidy exists. However, while ownership by the government of a majority of an entity's stock is sufficient to establish government ownership, the determination of government control is a standard worthy of further development. It would also be productive to discuss and clarify the definition of "public body" as that term is used in Article 1 of the Subsidies Agreement. Similarly, the "entrusts or directs" provision of Article 1.1(a)(1)(iv) needs to be examined to clarify the rules in cases where government action, though very much influencing the course of events, may not be clear or explicitly documented.

The United States has encountered these types of issues in the context of US countervailing duty proceedings, for example, in situations involving direct government intervention in bankruptcy or near bankruptcy proceedings, and industry restructuring. Perhaps one approach to determining whether there has been inappropriate government intervention in these types of situations is to clarify, improve and further develop the specific terms of Article 14(b) regarding the provision of government loans. Clarification and improvement in this regard could also include certain notification/transparency requirements in those instances in which a government, government-owned or -controlled entity, or "public body", becomes involved in assisting a financially troubled company. Members should also consider whether stronger and more expeditious disciplines are warranted in these circumstances.

Natural Resource and Energy Pricing

Government measures and practices affecting natural resources and energy touch on issues of state sovereignty and normally involve difficult questions of fair market value prices, and thus, have been sensitive and controversial topics. While the principle that trade flows should be determined by comparative advantage is broadly accepted, it must also be accepted that preferential natural resource pricing has been and, if not addressed, will continue to be a source of considerable trade distortion and friction. Simply put, there is no difference between the government provision of a natural resource at less than fair market value and the government provision of a cash grant allowing the purchase of a natural resource at less than fair market value.

Government intervention in the natural resource and energy sectors can take a variety of forms. One such practice is dual pricing: one price for exports, and another controlled price for domestic consumption, benefiting domestic producers and exporters, especially those who use the resources intensively in their own manufacturing processes. The advantage provided to domestic producers in this situation unfairly magnifies the comparative advantage that would otherwise be determined by market forces and production efficiencies. While Members made progress in addressing these issues during the Uruguay Round, further clarification and improvement of the rules and remedies in this area are warranted.

[4] Activities of the international financial institutions, such as multilateral development bank lending, or international development institutions, would not be subject to the disciplines discussed in this section.

Provision of Equity Capital

Under the existing terms of the Subsidies Agreement, the government provision of equity capital to a specific company or industry does not confer a benefit unless the investment decision can be regarded as inconsistent with the usual investment practice of private investors. While this standard needs clarification, the more fundamental issue is: should governments be investing in private sector companies and if so, under what circumstances? While it could be argued that the nature of capital markets in certain lesser developed countries may lead to government investment in the private sector, what is the justification in countries with well-developed capital markets? In such countries, there is no basis to argue that companies with reasonable prospects of generating a market return are not able to attract commercial investment.

If the equity markets determine that a company will not generate a market return, the actions of any government which determines otherwise should be subject to strengthened disciplines.[5] A first step in this direction could be to require that a government provide prior notification to the Subsidies Committee of any intended provision of equity capital. A mandatory part of this notification might also require that a Member explain how the government investment was consistent with the usual investment practice of private investors. Additional disciplines should also be considered. Because of the nature of their capital markets, consideration should be given to certain lesser developed countries with respect to these requirements, except perhaps, in those sectors which have been shown to be export competitive.

The specific provisions of Article 14(a) regarding the provision of equity capital also need to be clarified and improved. The standard "inconsistent with the usual investment practice (including for the provision of risk capital) of private investors . . ." is open to a variety of very different interpretations, and it may not be clear how to apply this standard in a reasonable way to the facts of a particular equity infusion. Specifically, there are several important practical issues that can arise in analyzing equity infusions – such as the role of independent studies, the specific factors that should be considered when examining the financial health and prospects of a company, and the use of initial and secondary stock prices – which should be addressed.

Taxation

The Subsidies Agreement disciplines direct and indirect taxes differently. Under the existing Agreement, it is more likely that direct tax concessions related to export activity will be found to be export subsidies, and therefore inconsistent with the Agreement, than would export-related concessions on the payment of indirect taxes. The United States recognizes that this distinction has existed in the GATT/WTO subsidy rules for some time. Nonetheless, the United States believes that an essential part of the work of the Rules Group should be to work toward greater equalization in the treatment of various tax systems that, at least with regard to their subsidy-like effects, have only superficial differences. The current distinction risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors operating under a direct taxation system.[6]

[5] Activities of the international financial institutions, such as multilateral development banks and international development institutions, would not be subject to the disciplines discussed in this section.

[6] Regardless of the discussion in this section, the United States intends to comply fully with its WTO obligations.

Royalty-Based Financing

As to the definition of subsidy, more explicit rules are needed as to royalty-based financing schemes. These programmes provide government funds with a repayment obligation based on future sales. Similar to the granting of government loans or the government purchase of equity, these schemes need to be judged against a market or commercial standard. Obviously, if royalty-based financing is provided by a government to a company and repayment is based on assumptions and sales projections that would be rejected by the market, a benefit has been bestowed.

Codification of Analytical and Quantification Methodologies

The Uruguay Round was successful in defining broad methodological concepts in the Subsidies Agreement regarding the benefit measurement of various types of subsidies. However, as other Members have pointed out[7], the lack of clarity and detail in certain areas has led to questions concerning the precise nature of Members' obligations under the Subsidies Agreement.

Greater clarity is needed on a host of measurement-related concepts, such as when and how to allocate subsidy benefits over time, the determination of market-based interest rate benchmarks, and the attribution of subsidy benefits to specific categories of a company's sales and among related companies. We note that extensive work was done several years ago by an Informal Group of Experts in the Subsidies Committee on some of these topics, which may serve as a useful starting point for further discussions.

Procedural Issues

One of the common procedural complexities that occurs in both anti-dumping and countervailing duty investigations is how to deal reasonably with large, fragmented industries. Very often these types of cases involve agricultural products, where there may be hundreds, if not thousands, of producers. When producers in such an industry are interested in filing an antidumping or countervailing duty case, difficulties arise in establishing whether sufficient domestic industry support exists. Similarly, when such an industry is the subject of an investigation, selection of the producers to be examined is an exceedingly difficult and controversial exercise.

This problem is compounded in the course of the first administrative review during which producers not examined in the investigation are entitled to an expedited review. These problems were anticipated to some degree by provisions in both the Subsidies and Anti-Dumping Agreements allowing for statistically valid sampling techniques. However, clarification is needed as to the precise manner by which a statistically valid sample can be developed. For example, what are the relevant characteristics of the underlying population, and what is the relationship between the available sampling units and the parameter value to be estimated? As noted above, regardless of how such sampling issues may be clarified, the issue will remain as to how to deal realistically, practically and fairly with the hundreds or thousands of producers that are not selected for detailed examination in the investigation, but which under the current provisions are entitled to an expedited administrative review.

As noted by other Members in the context of antidumping reviews[8], all Members would benefit from the development of "model" questionnaire and verification outlines to be used in countervailing duty investigations. The development of such models would be beneficial for two reasons. First, by agreeing upon the "normal" information to be sought in the course of an investigation, a convergence of the underlying analytical methodologies of Members would be

[7] TN/RL/W/19 (7 October 2002)
[8] TN/RL/W/30 (21 November 2002)

encouraged. Second, lesser developed countries facing resource constraints would be aided by the existence of such models for application or adoption within their own countervailing duty regimes. Of course, Members would not be required to use such models unchanged, but would instead be encouraged to use the models as a starting point for the development of suitable documents for the particular needs of the investigation.

Subsidy Notification

Other Members have raised the need to improve compliance with the subsidy notification obligations of the Subsidies Agreement. We agree. As Members know, the Subsidies Committee has been looking at this issue and has developed a particular approach to implementing Members' notification obligations. The formal reflection of this approach in the Subsidies Agreement should be considered. Moreover, some of the information required under the current notification provisions could be eliminated or consolidated without detracting from transparency goals. The requirement that the "trade effects" of the notified subsidy be described, for example, is difficult if not impossible to answer accurately and, thus, is normally left unanswered by most Members.

Lesser developed countries, especially those in Annex VII of the Subsidies Agreement, appear to have the most difficulties in satisfying the notification obligations of the Subsidies Agreement. To ease this burden, the efforts of the Subsidies Committee to provide technical assistance should continue and consideration should be given to other ways to lessen the burden on these Members.

Conclusion

The issues identified in this paper represent some of the current problems or deficiencies we generally see with respect to the provisions of the Subsidies Agreement that would benefit from clarification and improvement, as envisioned in the Ministerial Declaration. Furthermore, in our view, addressing these issues would be consistent with the progressive deepening of subsidy disciplines that has been historically characteristic of the international trading system. We intend to provide additional detail on these points and raise other issues in future submissions.