

Export Subsidies and the World Trade Organization

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EXECUTIVE SUMMARY
(for Estey Centre Research Papers, No. 1)

Estey Centre for Law and Economics
in International Trade

March 2001
(Electronic Version)

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Introduction

The mere utterance of the word “subsidies” sounds alarm bells in the minds of some international trade policy pundits and politicians. Yet, worldwide, governments closely guard the right to subsidize. One of the primary functions of modern governments is to redistribute income. Taxation and subsidization are major instruments governments use to achieve this redistribution. At the same time, because governments believe international trade is beneficial, they enter into agreements with other countries to regulate international commerce, and these agreements place limits on the use of subsidies.

The World Trade Organization (WTO) is the major multilateral institution where countries can make commitments that limit their own ability to interfere in markets in ways that inhibit or distort trade. Member countries of the World Trade Organization have agreed to a number of commitments regarding how they use subsidies. One of these commitments is to prohibit the use of export subsidies. There are, however, a number of exceptions. Until the Uruguay Round Agreement created the WTO in 1994, agricultural subsidies were governed by a different set of commitments under the General Agreement on Tariffs and Trade (GATT), which, in effect, allowed for widespread use of export subsidies. By the 1980s, the absence of effective commitments to reduce export subsidies in agriculture had led to a *beggar thy neighbour* subsidy war which significantly distorted agricultural trade and put heavy demands on some countries’ treasuries. At the Uruguay Round, members agreed to bring export subsidies for agricultural commodities under the general World Trade Organization commitments, but with a period of transition. The *Uruguay Round Agreement on Agriculture* set out the members’ commitments to reduce export subsidies for agricultural goods.

Because reducing subsidies is often difficult for governments, they are only likely to comply up to the letter of their WTO commitments. Subsidies run contrary to the spirit of free trade embodied in the WTO, but their use remains rampant and pervasive worldwide, particularly in some sectors, one of which is agriculture.

Given the high degree of subsidization that exists in agriculture, a great deal is at stake both for governments and for the recipients of existing subsidies. These high stakes make the exact meaning of the agreements extremely important both for those countries faced with reducing export subsidies and for those expecting the trade benefits arising from the reduction of subsidies. As with any legal agreement, the parties can have disagreements about the meaning of the commitments. In the WTO these disagreements are settled by the new Dispute Settlement Body (DSB) that was put in place when the WTO came into being in the wake of the Uruguay Round Agreement. As both the DSB and the commitments to reduce export subsidies have only been in place for half a decade, insights into how the wording of the agreements is being interpreted are only coming to light as cases work their way through the dispute settlement system. The rules embodied in the *Agreement on Subsidies and Countervailing Measures (SCM Agreement)* and the *Agreement on Agriculture (AOA)* have received close scrutiny by states and have been the frequent topic of disputes in the DSB. The results of this scrutiny are extremely important and politically charged, particularly in agriculture where the degree of subsidization and other market interference remains high.

This paper provides a framework that can be used to analyze domestic policy initiatives to decide whether they comply with the WTO agreements. The study details the evolving definition of the term “export subsidies” in the WTO. Until now, the literature has provided little detailed examination of the meaning of the term. The texts of the relevant agreements and the decisions made by the DSB regarding export subsidies furnish evidence of how the term “export subsidies” is intended and interpreted. Five years of jurisprudence from the DSB demonstrate that the wording of the agreements relevant to export of agricultural commodities will be interpreted quite literally and legalistically. From these judicial pronouncements, the paper develops proposed legal tests that can be used to determine whether an export subsidy exists under the terms of the agreements. The paper goes on to explore questions about the soundness of the economic analysis on which the DSB bases its decisions.

Outline of the Study

The study has four main sections. The first section supplies background and reviews the last ten years of legal literature on WTO rules that affect export subsidies. The second part of the paper explores the interpretive approach the DSB has taken in addressing disputes. The third part provides a detailed interpretation of the meaning of the term “export subsidies” under the *SCM Agreement*. The fourth section delves into the treatment of export subsidies in the *AOA*. Each of these latter two sections examines the jurisprudence of the WTO’s Dispute Settlement Body, and both end with proposed legal tests for export subsidies under their respective agreements. The final section of the paper provides an economic perspective on the export subsidy tests.

Legal Literature

The legal literature follows four major streams. The first provides general analysis of WTO provisions on subsidies. This stream provides only a broad analysis of subsidy rules without a detailed examination of the language involved. There is no detailed analysis of how the *SCM Agreement* and the *AOA* relate to each other with respect to the treatment of agricultural export subsidies.

The second area of legal literature looks at the effects the two agreements have on the design of legislation and subsidy programs in member countries and on the administration of countervailing duty law. The WTO has replaced the flexibility of GATT’s consensus-based approach with a strict and rigid legalistic approach. The loss of the pragmatic approach to problem solving results in an increasingly complex and difficult legal approach to dealing with export subsidies.

A third literature stream analyzes DSB decisions that have focused on countervail measures or specific subsidies. The common conclusion is that the WTO rules are having a significant, limiting impact on domestic policy options in the area of subsidies. The DSB case record appears to show that the WTO is getting tough on trade-distorting subsidization.

The fourth area of legal literature focuses on the impact of WTO subsidies law on specific sectors, particularly agriculture. This literature does not provide detailed analysis of the ambit of WTO disciplines on export subsidies. There is a need for further work in this area.

DSB Interpretive Approach

A brief chronology of subsidy cases that have come before the DSB shows that there has been a rapid application of a consistent definition of “subsidy” in the WTO jurisprudence, both for agricultural and non-agricultural products. The standard interpretive approach developed by the DSB includes:

1. an examination of the ordinary meaning of words by their dictionary definitions;
2. a textual approach, considering the immediate text of the agreement involved;
3. a contextual approach, considering all parts of any relevant WTO documents; and
4. an “objects and purpose” approach which examines the objects and purpose of the various agreements.

The SCM Definition of Export Subsidies

The definition of an export subsidy under the *SCM Agreement* contains three elements: a financial contribution is made by a government; a benefit is conferred on the recipient of the financial contribution; and the financial contribution must be contingent upon export performance. The meaning of each of these elements is examined below.

A financial contribution

What might amount to a financial contribution is not exhaustively defined by the *SCM Agreement*. Three types of financial contribution are explicitly mentioned. These three appear to be straightforward and have not been the subject of definitional disputes in the DSB. They are:

1. a direct transfer of funds;

2. a provision of goods or services or the purchase of goods or services by a government;
and
3. a government payment to a funding mechanism.

The written decisions in the *Canada–Aircraft* and *Canada–Milk* cases have defined a legal test for a financial contribution. The test is to determine if there has been a transfer of economic resources by the grantor. This is now the general test for determining if a financial contribution has been made.

A fourth type of financial contribution is more ambiguous than the three types mentioned above and has been the subject of dispute in the cases of *Canada–Automobiles* and *US–Foreign Sales Corporations*. This fourth type of financial contribution occurs when government revenue that is otherwise due is foregone or not collected. The foregoing of revenue by government is considered a transfer of economic resources from the government, and would fall within the general test for a financial contribution. The key issue in this type of contribution is to consider when government revenue should be considered “otherwise due”. The DSB decisions have established a legal test for this element. The legal test is to look for what revenue would be due to the government in other circumstances, not including the program being challenged. The “other circumstances” referred to are the general domestic legislative framework or benchmark that would exist apart from the program. Any variation from the domestic legislative benchmark would result in the loss of revenue otherwise due to the government. This test was applied in the *Canada–Automobiles* case, and the resulting finding was that revenue was foregone from an import duty remission. It was also applied in the *US–Foreign Sales Corporations* case, and the finding was that revenue was foregone from a special tax exemption for export income.

A benefit

The second element of the subsidy definition under the *SCM Agreement* is that a benefit is conferred. The legal test for this has been expanded by the DSB to include a consideration of whether the transfer of economic resources involves a benefit to the recipients as a result of transfer for less than full

consideration. Determination of whether a transfer has been for less than full consideration requires an examination of what is otherwise available to the recipient in the domestic marketplace. The domestic marketplace includes all of the existing domestic market framework, including the existing government programs other than the challenged provision.

Contingent upon export performance

A subsidy that meets the definition of “export subsidy” under the *SCM Agreement* will be contingent upon export performance. This contingency can be either in *law* or in *fact*. The first is demonstrated on the basis of the law or other relevant legal instrument, without reference to external factual elements. Contingency “in law” can either be stated expressly or implicitly in the law. The DSB has confirmed that a subsidy is contingent in law if it is conditional or dependent for its existence upon export performance. The DSB has also confirmed that it is not necessary to prove actual distortion of trade in order to prove export contingency. The only legal test remains whether the subsidy is conditional or dependent for its existence upon export performance.

The DSB has determined that a subsidy is contingent “in fact” upon export performance if there is a relationship of conditionality or dependence between the grant of the subsidy and the anticipated exportation or export earnings. The legal test is further defined as including three elements: (1) In providing the subsidy, did the granting authority impose a condition based on export performance? (2) Was the subsidy tied to export performance through limiting or restricting conditions? and (3) Is there objective evidence that the subsidy was tied to actual or anticipated exportation or to export earnings? Thus a detailed factual examination is required in order to prove export contingency in fact.

To summarize, the wording of the *SCM Agreement*, together with its application by DSB panels, leads to the following parameters:

1. A subsidy occurs when a grantor makes a financial contribution which confers a benefit on the recipient, above any benefits that would have been otherwise available to the recipient in the marketplace, where:
 - (a) a financial contribution is a transfer of economic resources, including a payment-in-kind which denotes a transfer of economic resources other than money, from the grantor to the recipient, and
 - (b) a benefit occurs through a transfer of economic resources from the grantor to the recipient for less than full consideration. This analysis requires the following:
 - an examination of the economic value of what has been transferred.
 - a determination if something has been transferred for less than full consideration.
 - determination of economic value and full consideration according to the marketplace.
2. Subsidies which are contingent upon export performance are prohibited by the *SCM Agreement*.

The AOA Definition of Export Subsidies

Product classification

The legal regime of the WTO for export subsidies is different for a scheduled agricultural product than it is for other goods. This means it is important to determine if the product at issue is an agricultural product based on the explicit definition in the *Agreement on Agriculture*. If it is, then the provisions of the *AOA* must be examined first, as that agreement has priority over the *SCM Agreement* with respect to agricultural products.

Some agricultural products are scheduled products in the Member Country Schedule to the *AOA*. If a product is unscheduled, then any export subsidy, as defined in the *SCM Agreement*, is prohibited. If a

product is a scheduled product, the next step is to determine if the alleged subsidy program falls within the types of programs defined in Article 9.1 of the *AOA*. If the program is not within any of the programs defined in Article 9.1, then it must be still examined using the subsidy definition from the *SCM Agreement*. If such a program satisfies the *SCM* subsidy definition, then the export subsidy program will be illegal, and must be withdrawn or subject to the reduction commitments in the *AOA*. If the program does fall within Article 9.1 of the *AOA* then it will be considered a subsidy, subject to the reduction commitments contained in the *AOA*.

Article 9.1

The application of Article 9.1 of the *AOA* has been considered in detail by the DSB. The following parameters have now been established by the decisions of the DSB:

1. Does the program at issue for a scheduled product fall within the definitions in Article 9.1?
Consider the exact wording of the Article 9.1 provision involved.
 - (a) Where the term “subsidy” is used in 9.1(a), (d) and (f), use the *SCM Agreement* definition of “subsidy”.
 - (b) If the term “subsidy” is *not* used, then consider the exact words of Article 9.1(b), (c) and (e) to see if the program fits the meaning of the words.
2. The general definition of “subsidy” in the *SCM Agreement* is applicable to the term “subsidy” in the *AOA*.
3. In Article 9.1 (a) programs:
 - (a) Is the program offered by a government or a government agency? A government agency is an entity which exercises powers vested in it by a government for the purpose of performing functions of a governmental character, that is, to regulate, restrain, supervise or control the conduct of private citizens. The source of the agency’s powers must be a government. The

functions the agency performs must be governmental in the sense that those functions are enforceable in courts of law.

- (b) Does the program offer a direct subsidy?
 - i) Is there a subsidy within the meaning of the SCM Agreement?
 - ii) Within the meaning of “subsidy” is the transfer of economic resources done by a payment-in-kind (as a transfer of economic resources in a form other than money)?
 - iii) Is the subsidy direct from the government or its agency to the recipient, with no intermediary?

4. In Article 9.1(c) programs:

- (a) Is there a payment in the nature of a transfer of economic resources for a consideration less than the full market price?
- (b) The payment can be in money or a form other than money.
- (c) Is the payment financed by virtue of government action, considering the activities of the government or agency, taken as a whole?

5. In Article 9.1(d) programs:

- (a) Does the program offer a subsidy within the meaning of the SCM Agreement?
- (b) Does the program reduce the costs of marketing exports of agricultural products, which are costs that are incurred as part of and during the process of selling the product?

DSB rulings under the terms of Article 9.1 can be applied to questions about the status of pooling schemes. The conclusion from the *Canada–Milk* case is that Canada might have saved its Special Milk Class Scheme from WTO ineligibility if it had allowed exporters to access milk from other markets at competitive prices. This would have established a benchmark price for export milk that would have resulted in no “payment” in the Special Milk Class Scheme. The question of pooled returns would then have been irrelevant. This analysis also points to a path to the future for other pooled returns in

agriculture, such as those administered by the Canadian Wheat Board, for example. Pooling schemes themselves are *not* WTO incompatible. It is the price-setting mechanism which must pass WTO scrutiny.

Contingent upon export performance

The test for contingency upon export performance for an alleged export subsidy of an agricultural product is the same as the legal test under the *SCM Agreement*.

Economic Questions

The economic analysis of export subsidy law deals with two major questions. The first relates to the question of what constitutes a transfer of economic resources. The second major question is whether the WTO legal test has set an economically defensible framework for establishing a benchmark price. These questions must be considered in light of the reality of existing WTO rules, which are not always consistent with economic theory. Instead, they represent what countries, collectively, can “live with” as part of a system of compromises. Therefore, the economic analysis in this paper does not test WTO export subsidy reduction commitments against standard economic criteria such as welfare maximization. Further, the WTO rules do not require an examination of whether a particular export subsidy actually distorts trade. Export subsidies are assumed to be trade distorting, as the members have agreed to ban their use.

The WTO commonly conducts its economic analysis within a *partial equilibrium-comparative statics* framework. The test the DSB uses to determine whether a transfer of resources has taken place must be carried out within this framework. This means that the appropriate starting point in the analysis is the observed state of the market prior to the export subsidy program. This analysis is appropriate for answering the question of whether those who are engaged in exporting have more resources than they did before the policy was introduced. The DSB is precluded from asking whether those extra resources lead to an increase in exports. This results in a divergence between economic questions relating to export subsidies and the legal questions that are now involved.

The legal test regarding the transfer of economic resources also leaves unanswered a further economic question: Does the transfer of economic resources necessarily reduce the economic resources available to other activities? This is not part of the legal test, but it would be relevant to assessing whether this type of transfer resources should be prohibited.

With respect to the reference price or legislative framework, the economic analysis concludes that the DSB has properly applied partial equilibrium–comparative statics analysis. The proper reference price or benchmark price is the market price that would otherwise exist. This would not likely be the theoretical price that would be found in a theoretical, “first best world”, since any market is necessarily distorted. The domestic benchmark is the accepted economic starting point for an export subsidy analysis.

The analysis concludes that a market pooling system is not synonymous with a transfer of resources. A detailed analysis of the mechanics of each pooling system would have to be conducted to determine if there was a transfer of resources from one group to another.

The key economic questions to be answered in any export subsidy case are:

1. Do those involved in export activities end up with more resources than they would in the absence of the policy?
2. Has there been a transfer of resources from other activities?
3. Has the increase in the resources to those engaged in export activities led to an increase in exports?

At present, the DSB need only examine the first two questions. Failure to consider trade-distorting effects while only looking for transfers may lead to error regarding the true effect of a policy.

Conclusion

This study shows that new international law delineating illegal from legal export subsidies has rapidly developed in the WTO. A review of the cases that have come before the WTO’s Dispute Settlement Body demonstrates that the DSB will interpret the words of the *Agreement on Subsidies and Countervailing*

Measures and the *Agreement on Agriculture* quite literally and legalistically. The DSB has developed a very broad definition of the term “export subsidy”. The requirement of a financial contribution is now defined as any transfer of economic resources. The requirement of a benefit is defined as a transfer of resources for less than full consideration, using the marketplace to provide a benchmark for comparison of the value and consideration. Finally, export contingency can be defined as being conditional, in law or in fact, upon objectively anticipated exportation.

Furthermore, the DSB has extended its broad definition of “export subsidy” from the *SCM Agreement* into the *AOA* context. But the DSB has not stopped there. In addition, certain additional measures are defined in the *AOA* to be export subsidies even though the same measures may not satisfy the *SCM* test.

We argue that the application of the legal tests developed in this study to existing government policies and programs will give a rough idea as to their WTO-compatibility.

While the work of the DSB on the difficult job of defining “export subsidy” is laudable, its approach is not without shortcomings. By legalistically and sometimes rigidly following the literal interpretation, the DSB has, to this point, failed to fully explore appropriate economic principles upon which to base its decisions. Ultimately, the question that remains to be answered is whether the DSB’s literal definitions, without appropriate reference to solid economics, will ultimately help to eliminate trade-distorting export subsidies. Are the legalistic decisions apt to create more confusion about what practices are allowed because those decisions are out of sync with the economic realities of international trade?

Many questions remain about export subsidies, particularly relating to agricultural products. Did WTO member states really intend that any type of co-operative action by exporters that has the benefit of a legislative framework be caught in the illegal export subsidy net? Regardless of member intentions, will members now accept that their national marketing schemes may be illegal based on this new international legal standard? It will take a few more years to answer these questions.

In spite of the questions and uncertainty remaining, the DSB's broad legal tests will give the DSB the flexibility to deal with all types of potentially trade-distorting measures under both the *SCM Agreement* and the *AOA*. The uncertainty resulting from some of the language in the reports is a growing pain in a newly developing legal system. This is only short-term pain for the long-term gain of a sound world trading system.

The examination of export subsidies provided in this study points to the type of work which will be important as the WTO moves towards a rule-based legal system. This type of legal and economic analysis will ultimately encourage members to accept the limitations placed on their domestic policy making by the new international trade law regime.