General introduction

The basic set of existing multilateral disciplines on governments' use of subsidies and countervailing measures has been in place since the birth of the World Trade Organization (WTO) in 1995. The Uruguay Round negotiations (1986–94) resulted in the Agreement on Subsidies and Countervailing Measures (SCM Agreement), disciplining subsidization affecting trade in goods, as well as in the Agreement on Agriculture, elaborating specific disciplines on agricultural subsidies.

The strengthening of subsidy disciplines elicited a lively discussion on whether the SCM Agreement overly confines developing countries' policy space to use subsidies as a development tool. For instance, the UNCTAD has openly regretted these countries' loss of policy space resulting from the Uruguay Round trade agreements. The 2006 UNCTAD Trade and Development Report referred to the SCM Agreement as one of the agreements that 'impinges directly on national rulemaking authority'.[1] The former WTO Director-General, Pascal Lamy, firmly responded to what he called an accusation:

> The alternative, it seems, would be to have no subsidy disciplines, which raises an intriguing question. Do we want to argue that the best contribution the WTO can make to development is to ensure that developing countries have no obligations in this area? Or that export subsidies should be allowed?[2]

However, this 'intriguing question' is not confined to the situation of developing countries. Indeed, it is equally disputed whether the current WTO subsidy disciplines leave sufficient policy space for developed countries. Some scholars have reached the conclusion that the

[1] UNCTAD, *Trade and Development Report, 2006: Global Partnership and National Policies for Development* (New York: United Nations Publications, 2006), at 169.

[2] WTO, Lamy Calls for Debate on 'Flexibility' and What Makes Good 'Policy Space', 27 September 2006, available at www.wto.org/english/news_e/sppl_e/sppl40_e.htm.

SCM Agreement is one of the 'least economics-informed agreements in the WTO'.[3] Others have even pointed to a 'basic dilemma' in the restrictions on export subsidies, as these restrictions run 'counter to the essential purpose of international trade agreements' to expand trade beyond unilateral levels.[4] This debate on the balance struck under the WTO subsidy regime has further intensified since the outbreak of the global financial and economic crisis in 2007/8. While some have questioned whether the SCM Agreement leaves sufficient policy space to respond adequately to the challenges of the crisis, others have, rather, pointed to the current system's weaknesses in preventing detrimental subsidy competition among WTO members. The same debate can be observed with regard to environmental subsidies: do WTO disciplines inhibit a 'green revolution' or, rather, guard insufficiently against 'green protectionism'? Finally, the reach of agricultural subsidy disciplines remains debated. Here, it is mainly alleged that the existing regime still offers too much policy flexibility.

This book aims at addressing these 'intriguing' questions from the perspective of both developing and developed countries. Does the set of multilateral disciplines, elaborated in the SCM Agreement and the Agreement on Agriculture, find an adequate balance between policy space left to WTO members and legal constraints imposed upon them? To answer this overarching research question, a threefold analysis is endorsed. First of all, an economic analysis should help understand why governments have an incentive to offer different forms of subsidies and what the welfare impact of such interventions is. Next, a legal analysis should address the existing constraints on both types of intervention under the WTO. Confronting the economic and legal analysis, a normative analysis should finally evaluate whether an appropriate balance is reached under existing multilateral disciplines.

This book embraces this threefold analysis not only in a general way but also with regard to the disciplines on export credit support in particular. To this end, four general parts are distinguished.

[3] P. C. Mavroidis, P. A. Messerlin, and J. M. Wauters, *The Law and Economics of Contingent Protection in the WTO* (Cheltenham: Edward Elgar, 2008), at 462.

[4] M. E. Janow and R. W. Staiger, 'Canada – Dairy, Canada – Measures Affecting the Importation of Dairy Products and the Exportation of Milk (WT/DS113; WT/DS103; DSR 1999:V, 2057, DSR 1999:VI, 2097; DSR 2001:XIII, 6829; DSR 2001:XIII, 6865; DSR 2003:I, 213; DSR 2003:I, 255)', in H. Horn and P. C. Mavroidis (eds.), *The American Law Institute Reporters' Studies on WTO Case Law: Legal and Economic Analysis* (Cambridge University Press, 2007), 906pp., 249–92, at 264.

First, Chapter 1 sheds light on governments' rationales in offering subsidies. This short opening chapter introduces a positive and normative question. Why *do* governments in reality offer subsidies (positive question) and why *should* governments have an interest in preserving policy space to offer subsidies (normative question)? The basic assumption in the latter normative analysis is that governments should strive at maximizing welfare or at fostering sustainable development more generally. The chapter starts by explaining how a welfare-maximizing country would not be interested in offering subsidies if markets are complete and perfectly competitive. Four broad rationales explaining why governments, nonetheless, offer subsidies are further distinguished for the purpose of this study: the market failure, profit-shifting, redistributive, and political-economy rationales. Although this list does not capture the large variety of reasons why governments subsidize their producers, many of these reasons could be traced back to one or more of these four rationales.

Part I conducts the core legal analysis and turns to the framework elaborated under the SCM Agreement and the Agreement on Agriculture.[5] Tracing the origins of existing disciplines, this legal analysis will first provide some insights into why countries have agreed to confine their policy space on subsidization and the imposition of countervailing measures.[6] Next, the current disciplines imposed on both developed and developing countries are systematically discussed. Finally, the extent to which the Agreement on Agriculture still delineates more flexibility on agricultural subsidies is examined. The vast amount of case law is integrated into this legal analysis and is critically evaluated. Likewise, proposals touching on these disciplines that have been tabled in the Doha Round negotiations are introduced.

Part II illustrates the threefold analysis in a case study on export credit support. Here, the analysis focuses on the policy space left to WTO members to offer export credit support for industrial and agricultural products as well as for services. The complexity and particularity of the legal framework as well as the specificity of the rationales for government intervention explain why a separate case study is devoted to this topic. Grasping and evaluating the balance struck under the WTO regime on

[5] The relevant jurisprudence adopted until May 2013 is integrated.
[6] Unless otherwise specified, all GATT documents (pre 1995) cited in this book can be found at Stanford's GATT Digital Library: 1947–1994 (http://gatt.stanford.edu/bin/search/advanced) and all WTO documents (post 1995) can be found at the WTO website (http://docs.wto.org).

export credit support seem far from evident. Observe, for instance, that the former WTO Director-General urged increased export credit support to fill the gap in private trade financing resulting from the financial and economic crisis. However, by analysing existing disciplines in the light of the case law, it will be demonstrated that members simply were prohibited from responding to this call. Disciplines on export credit support for industrial and agricultural products will be explored in parallel so as to elucidate the differences between both regulatory regimes. Next, this part will turn to export credit support affecting trade in services. This is meant to illustrate the limited reach of substantive disciplines on subsidies under the General Agreement on Trade in Services (GATS). After discussion of the proposals circulating in the Doha Round, a normative assessment of the disciplines on export credit support for industrial and agricultural products is conducted.

Part III finally arrives at the overarching normative analysis of the appropriateness of the balance between 'policy space' and 'policy constraints' under WTO disciplines on subsidies and countervailing measures, based on the premise that trade agreements should foster global welfare. The policy space under the SCM Agreement and Agreement on Agriculture, elaborated in Part I and further explained in Part II, is assessed in the light of the rationales for government interventions on subsidies as introduced in Chapter 1 and further developed in this closing analysis. After evaluating the scope of the SCM Agreement, the policy space left for members on domestic as well as on export subsidies will be assessed. This exercise is conducted for developed and developing countries, respectively. Next, members' flexibility over using unilateral countervailing action is critically evaluated. Finally, the analysis reflects on whether the existing disciplines should be reconsidered in the light of government interventions in response to the financial and economic crisis.

1

Rationales for offering subsidies

This opening chapter briefly introduces governments' incentives to offer subsidies. The question on governments' rationales to subsidize is approached from both a positive and normative perspective.[1] First, why *does* a government de facto offer subsidies (positive theory)? Second, why *should* a government offer subsidies (normative theory)?[2]

Some important terminological specifications could be helpful in setting the stage. In general terms, the concept of 'subsidy' in the SCM Agreement 'captures situations in which something of economic value is transferred by a government to the advantage of a recipient'.[3] In this introductory chapter, the thorny issue of which situations exactly are covered by the term 'subsidy' is left aside. A subsidy is considered an antonym to a tax, and thus connotes a transfer of money from the government to a private actor.[4] Taxation and subsidization are hereby considered as two alternative fiscal instruments by which a government could intervene in the market and are on this basis distinguished from non-fiscal or 'regulatory' government interventions (e.g., technical regulations). Puzzling observations that a tax or regulatory burden on some private actors might very well be considered as a subsidy to other private actors or that a subsidy might simply compensate for another tax or regulatory burden are thus neglected in this introduction. Depending on the direct recipient, 'consumer subsidies' are primarily distinguished

[1] The rationales for imposing CVDs is integrated into the normative analysis (see below Chapter 18).

[2] Such a distinction between a 'positive' and 'normative' theory of trade policy is made, for example, by A. K. Dixit, 'Trade Policy: An Agenda for Research', in P. Krugman (ed.), *Strategic Trade Policy and the New International Economics* (Cambridge, MA: MIT Press, 1986), 283–304, at 296.

[3] Appellate Body Report, *US – Softwood Lumber IV*, para. 51.

[4] WTO Secretariat, *World Trade Report 2006: Exploring the Links between Subsidies, Trade and the WTO* (Geneva: WTO Publications, 2006), at 47.

from 'producer subsidies' in the literature. Depending on the conditions for receiving producer subsidies, different types are further distinguished. First of all, a fundamental distinction is drawn between 'export subsidies' and all other types of subsidy, often labelled 'domestic subsidies'. In the economic literature, an export subsidy is only paid on production that is exported and, as it thus directly stimulates exportation, is often categorized as a 'trade instrument'. In contrast, 'a production or output subsidy' is a form of domestic subsidy that is granted on all production or output, regardless of whether it is exported or not. Other types of domestic subsidy are those offered to specific inputs or activities in the production process, such as subsidies for research and development (R&D subsidies) or labour subsidies. 'Import substitution subsidies', also named 'local content subsidies', are a specific sort of domestic subsidy as they are offered on condition of the use of domestic over imported inputs. Whereas production subsidies are mostly recurring, governments sometimes offer non-recurring, one-off subsidies, for instance for the acquisition of fixed assets (e.g., equipment, plant). In short, producer subsidies are distinguished on the basis of the conditions attached thereto and thus on the specific activity (e.g., exports, production, R&D, acquisition of fixed assets) they directly or indirectly aim at stimulating. Accordingly, the concept of 'subsidies' is occasionally distinguished from so-called 'transfers', as the latter are not conditioned on any specific use and are therefore considered to leave the allocation of resources unaffected. With these broad descriptions in mind, the rationales for subsidization, or the absence thereof, are introduced.

1.1 The absence of a rationale for subsidization

In a world of complete and perfectly competitive markets, mere interaction between supply and demand results in an efficient allocation of resources and a level of output produced at the lowest possible price, which equals the marginal cost of production and the socially optimal price.[5] Welfare is maximized under market forces (Pareto optimum[6]) and government

[5] In a perfectly competitive market, firms are price takers and can enter or exit freely, and products are homogeneous. As a result, price will equal marginal costs of production. Complete markets are characterized by full information and the absence of externalities, resulting in a price which also equals the socially optimal price.

[6] Marginal costs to producers equal marginal benefits to consumers, implying that no one can be made better off without someone else being made worse off.

interventions only distort efficient resource allocation by creating a wedge between the marginal cost price and the socially optimal price.[7]

In those markets, there is no reason why a static welfare-maximizing government would offer a specific subsidy to an industry. In the case where this subsidy is provided by a so-called 'small' country (i.e., a country which cannot affect the world price and thus its terms of trade[8]), a welfare loss arises to this country because the increase in producer welfare does not cover the cost to the government, although the welfare of other countries is, by definition, not affected.[9] A subsidy offered by a so-called 'large' country lowers the world price and, therefore, can affect the welfare of third countries. As a consequence, because it negatively affects its terms of trade, welfare in the subsidizing country deteriorates even more when a subsidy is given by a 'large' country to its export-competing industry.[10] Overall, the rest of the world is better off in welfare terms as a result of the depressed world price, but net exporting countries (and all foreign producers) are adversely impacted,[11] whereas net-importing countries (and all foreign consumers) are benefiting from the lower price. From the perspective of the subsidizing country, production and export subsidies both benefit domestic producers as they increase their sales, but they have a very different welfare effect on domestic consumers: these benefit from the lower price induced by domestic subsidies (if given by a large country), whereas they are hurt by export subsidies, as such subsidies give an incentive to domestic producers to export rather than to produce for the domestic market, thereby creating a wedge between the world price and the higher domestic price. Thus export subsidies are seen as more distortive than domestic subsidies, both from the perspective of the subsidizing country (as they also negatively affect domestic consumers) as well as

[7] Welfare is commonly defined as the sum of consumer surplus (i.e., the difference between the price consumers have to pay and are willing to pay or their 'marginal benefit'), producer surplus (i.e., the difference between the price at which producers sell and are willing to sell or their 'marginal cost') and government revenue.

[8] Terms of trade is defined as the ratio of export prices to import prices.

[9] Any displacement of foreign producers in volume terms is also considered too marginal to be noticeable.

[10] This is illustrated below in figure 5.2 (Chapter 5, section 5.1.3.2.2), which illustrates the welfare effects of the US production subsidies for cotton that were challenged in the *US – Upland Cotton* case. A welfare maximizing large country is rather advised to *tax* exports. A production subsidy to its import-competing industry could, in theory, be welfare-improving for the subsidizing country, but an optimal tariff would be a more direct, and thus efficient, instrument to exploit its terms of trade to maximize its welfare. Y.-H. Yeh, 'On Subsidies vs. Tariffs', 38 *Southern Economic Journal* (1971), 89–92.

[11] The are displaced by subsidized exports and have to accept the depressed world price for their remaining sales.

from the perspective of net exporting countries (as they have a more direct effect on the terms of trade).[12]

Hence, to understand why countries offer subsidies, the complete and perfectly competitive markets assumption has to be relaxed *or* subsidization has to be explained by reasons other than maximizing welfare. For the purpose of the present study, four explanations for subsidization are distinguished in which these assumptions are relaxed.

1.2 The market failure rationale for subsidization

The presence of subsidization can be explained if the perfect and complete market assumption does not hold. Even if the market price equals the marginal cost of production, this market price may not reflect all benefits or costs to society and thus deviate from the 'socially optimal price'. Positive or negative externalities (also called 'spillovers') are, respectively, benefits or costs resulting from consumer or producer actions that are not reflected in the market price and, thus, external to the market. Such marginal external benefits or costs can be internalized by government intervention in a way that the new market price equals the socially optimal price.

Hence, in the presence of market failures, the Pareto-efficient outcome does not result from market forces but requires government intervention. Of course, government intervention does not guarantee that a Pareto optimal outcome will be reached. Governments should intervene in an effective way and tackle the market failure as directly as possible and choose the appropriate instrument (e.g., some type of subsidy, tax, regulation) therefor (targeting principle).[13] In the case where the optimal instrument directly targeting the market failure is unavailable for political or other reasons, the theory of the second-best applies: governments have to have recourse to a second-best option to solve the market failure by intervening in other segments of the economy, but only insofar as the benefits of correcting the market failure still outweigh the costs that result from the creation of new distortions in those other segments (cost–benefit analysis).[14]

[12] One reason why these subsidies are usually criticized by third countries could be found in the fact that the adversely affected producers are better organized than benefiting consumers.
[13] J. N. Bhagwati, 'The Generalized Theory of Distortions and Welfare', in J. N. Bhagwati (ed.), *International Trade: Selected Readings*, 2nd edn (Cambridge, MA: MIT Press, 1987), 265–86.
[14] For an overview of papers dealing with second best interventions, see P. Krishna and A. Panagariya, 'A Unification of Second Best Results in International Trade', 52 *Journal of International Economics* (2000), 235–57.

If a domestic market failure occurs, a trade policy response is, at most, a second-best option, because a new distortion is created. Domestic distortions should in principle be corrected by domestic instruments (e.g., taxes or subsidies on domestic consumption, production, or input factors) and not by trade instruments (e.g., tariffs, export taxes, or export subsidies).[15] In general, if domestic production is too low because of a domestic market failure, a production subsidy is superior to an import barrier (or export subsidy), as the latter also negatively affects consumers in the domestic market.[16,17] Equally, a production or output subsidy is warranted only where the externality is directly linked (or fixed) to the level of production.[18] Even in that case, a *consumer* subsidy might be more efficient than a production subsidy, because a consumer subsidy boosts production without discriminating between different producers. A consumer subsidy does not discriminate against foreign producers. If the market failure is not directly linked to production, but rather to an activity (e.g., R&D), so-called *functional* or *horizontal* subsidies inducing these activities are more targeted than selective subsidies to particular sectors (e.g., high-tech industry).

From a national and world welfare perspective, all countries in which distortions are present are advised to adopt corrective measures (e.g., corrective subsidies). Conversely, countries in which such distortions are not displayed should not intervene, even though they might be confronted with corrective measures (e.g., subsidies) abroad and might thus claim that the playing field is not level.[19]

[15] J. N. Bhagwati and V. K. Ramaswami, 'Domestic Distortions, Tariffs and the Theory of Optimum Subsidy', 71:1 *Journal of Political Economy* (1963), 44–50; H. G. Johnson, 'Optimal Trade Intervention in the presence of Domestic Distortions', in J. N. Bhagwati (ed.), *International Trade: Selected Readings*, 2nd edn (Cambridge, MA: MIT Press, 1987), 235–63.

[16] See also J. J. Barceló, 'Subsidies and Countervailing Duties – Analysis and Proposal', in R. Howse (ed.), *The World Trading System: Critical Perspective on the World Economy*, vol. 3, *Administered Protection* (London: Routledge, 1997), 252–314, at 259; K. Bagwell, 'Remedies in the WTO: An Economic Perspective', working paper, 9 January 2007, at 25.

[17] This statement has to be nuanced where taxes required to finance subsidies are themselves distortionary. In that case, a combination of tariffs and subsidies may be optimal to correct the domestic distortion. See D. Brou and M. Ruta, 'A Commitment Theory of Subsidy Agreements', WTO Staff Working Paper ERSD-2012–15 (25 September 2012), 33 pp.

[18] See also G. M. Grossman, 'Promoting New Industrial Activities: A Survey of Recent Arguments and Evidence', 14 *OECD Economic Studies* (Spring 1990), 87–125, at 118.

[19] See also A. V. Deardoff, 'Economic Effects of "Levelling the Playing Field" in International Trade', RSIE Discussion Paper No. 289, July 2009, at 20.

1.3 The profit-shifting rationale for subsidization

In some markets, barriers to entry (e.g., large fixed costs) result in only a limited number of firms present because a high level of production is required to recover initial costs. In such oligopolistic markets, individual firms are not price takers as under perfect competition, but set output (Cournot model) or price levels (Bertrand model) taking into account output and price decisions by competitors. Hence profits of one firm are directly affected by strategic decisions of its competitors. The central insight of strategic trade theory, which has developed since the 1980s, is that governments' trade policy can alter this strategic interaction between firms in such a way as national welfare is optimized. Here, governments do not intervene to correct market failures, but rather to shift profit strategically from foreign competitors to domestic firms.

In the market equilibrium, firms are making true profit (price is higher than average costs) and total output is less than under perfect competition (oligopolistic distortion). Brander and Spencer have shown that this feature of oligopolistic markets has important consequences for the design of trade policy.[20] A country could shift a larger share of profitable output from foreign competitors to domestic firms by subsidizing domestic exports. The export subsidy commits domestic firms to a higher level of exports, resulting in a reaction by foreign competitors to contract their output. Given that the profit gain to domestic firms (expanded output and market share at a price above average costs) is larger than the subsidy amount (and the negative terms of trade effect), net welfare of the subsidizing country increases.[21] In addition, total output also increases, resulting in lower world prices to the benefit of importing countries. On the other hand, exporting countries are hurt as profitable output is shifted away from their firms. Accordingly, such strategic trade policy has a beggar-thy-neighbour element: the subsidizing country's welfare increases, but at the expense of other exporting countries' welfare. The change in total world welfare as a result of this profit-shifting subsidy is nonetheless positive because the

[20] J. A. Brander and B. J. Spencer, 'Export Subsidies and International Market Share Rivalry', 18 *Journal of International Economics* (1985), 83–100.

[21] The contribution of the subsidy to the profit of the domestic firm is offset by the subsidy cost to the government (transfer). Yet the subsidy has an additional indirect positive effect on domestic firms' profit by lowering the output level of foreign firms. The subsidy's strategic effect on foreign firms' behaviour precisely explains the positive welfare effect in the subsidizing country. See also P. Krugman, 'The US Response to Foreign Industrial Targeting', 1984:1 *Brookings Papers on Economic Activity* (1984), 77–131, at 98–9.