



NOTE TO CORRESPONDENTS N°48

TAD/INF/NC48
23 January 2003

Export processing zones at risk? The WTO rules on subsidies: what options for the future?

Developing countries have to give up a common policy for attracting export-oriented foreign direct investment (FDI): the granting of export subsidies. Usually linked to export processing zones (EPZs), export subsidies have played a significant role in the development strategies of many developing countries. However, developing country members of WTO agreed during the Uruguay Round to eliminate their export subsidies by 1 January 2003. (The prohibition has applied to developed countries since the 1960s.¹) At the Doha Ministerial Conference, it was decided to allow developing countries to request, by 31 December 2001, an extension of the transitional period, and a number of countries have been granted extensions pursuant to these requests.² But even these countries will have to consider what to do once the extended period is over.³

This was the theme of the special segment of UNCTAD's Commission on Investment, Technology and Related Financial Issues, which took place yesterday in Geneva. The Commission is meeting concurrently this week with the Eighth Annual Conference of the World Association of Investment Promotion Agencies (WAIPA). In alerting developing countries governments to the challenges ahead, Patricia Francis (Jamaica), Chairperson of the WAIPA conference, noted that "the modernization and transformation of developing countries' bureaucracies and legal frameworks is a long and difficult process, and it has been simpler and quicker for most governments to create discrete measures supporting export-oriented production while allowing time for domestic companies to become globally competitive. The timetable for transformation into WTO compliance is short. Governments must now focus on creating an efficient environment capable of attracting and retaining export-oriented FDI while providing technical assistance to introduce the necessary regulatory and administrative reforms. Multilateral and bilateral agencies that form part of WAIPA's Consultative Committee can play an important role in supporting governments and the private sector in meeting these challenges. We look forward to some interesting ideas coming out of the upcoming discussions which can point us toward solutions".

In brief, the Agreement on Subsidies and Countervailing Measures defines what is a "subsidy" and establishes disciplines on the granting of incentives falling within that definition. Provisions on prohibited subsidies (part II), actionable subsidies (part III) and countervailing measures (part V) apply only to subsidies that are "specific", i.e., granted to a particular company or companies; to a particular sector or sectors; or to a particular region or regions. The Agreement prohibits

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specific subsidies that are contingent upon export performance and those that are contingent upon the use of domestic goods over imports. The Subsidies Agreement covers only subsidies related to goods. Subsidies related to services are dealt with separately, in the General Agreement on Trade in Services (GATS). Under GATS, services subsidies are neither prohibited nor actionable – at least for now.

Prohibited subsidies

Annex I of the Subsidies Agreement contains an illustrative list of prohibited export subsidies ((see http://www.wto.org/English/docs_e/legal_e/24-scm_oi_e.htm). These include a number of incentives that are often offered to companies investing in EPZs. Examples of subsidies identified in the list are:

- Provision by governments of goods and services for use in the production of goods for exports on terms more favourable than those available for use in the production of goods for domestic consumption;
- Full and partial remission or deferral of direct taxes (e.g. income and property taxes) and social welfare charges, specifically related to exports;
- Government-mandated internal transport and freight charge for exports on terms more favourable than those available for domestic shipments; and
- Government-provided export credit guarantees or insurance pursuant to loss-making programmes.

While *bona fide* duty drawback programmes are not subsidies, programmes that do not base benefits on the actual duty incidence on imported inputs incorporated into the exported product (such as programmes based on a fixed percentage of the f.o.b. value of the exports) are prohibited.

Reduction of tariffs on imported goods which do not require the same or identical components to be re-exported (such as duty exemptions on imported machinery used to produce goods for export and duty exemptions on imports of one product where another product is exported) are also prohibited.

Non-prohibited subsidies

On the other hand, the exemption or remission of indirect taxes on an export product, such as value-added tax (VAT), is permitted. A WTO member may also provide remission or drawback of import charges on goods incorporated into an export product and on energy, fuels, oil and catalysts used to produce goods for export. Export credits may be provided if on terms consistent with the interest-rate provisions of the OECD Arrangement.

Actionable subsidies

Other specific subsidies are not prohibited. But their use is not without risk, since they can also be *actionable*, i.e., challenged by trading partners in WTO dispute settlement, or subject to countervailing measures, if they are demonstrated by another WTO member to cause adverse effects to their interests. (The Agreement defines in detail the meaning of adverse effects.)

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Actionable subsidies thus could include most "specific" subsidies, not least "production" incentives. These, and especially locational incentives, are still widely used in both developed and developing countries to promote export-oriented FDI. The implication here is that, if it is found that any such subsidy has resulted in adverse effects to the interests of another WTO member – and if the effects are not removed or the subsidy is not withdrawn – the affected member may be authorized by the WTO dispute settlement body to take countermeasures.

Options for developing countries

First of all, the attractiveness of EPZs to export-oriented foreign investors typically goes beyond the granting of export subsidies of the type that may be inconsistent with the WTO Subsidies Agreement. EPZs are often situated in an advantageous geographical location with an infrastructure appropriate for carrying out trade and industrial operations. Typically, customs services are streamlined and red tape is kept to a minimum. Moreover, WTO rules permit the use of border tax adjustments. Thus, EPZs can continue to exempt their companies' exports from indirect taxes (such as sales taxes), border taxes (e.g. consular fees) and import charges. Duty drawbacks and duty exemptions on inputs "consumed in the production process" (i.e., inputs that are physically incorporated into the exported product, and energy fuel and catalysts used in the production process) are thus permissible. However, special care would be needed to ensure that these measures are applied in a manner consistent with the WTO rules, by maintaining proper bookkeeping and accounting practices. In the case of developing countries, this may require special technical assistance efforts. In addition, while WTO members may not give special tariff exemptions on imported machinery to exporters, members could of course lower or eliminate import duties on machinery altogether, particularly in cases where there is no domestic production of machinery benefiting from the tariff protection.

If these advantages prove to be insufficient to entice foreign investors, there are various other options available to countries. For example:

- to maintain incentives for EPZ companies but eliminate the conditionality of restricting sales in the domestic market; and
- to establish a new system of incentives that is not contingent upon export performance in either law or fact.

There is still the risk that some of these subsidies may nevertheless be actionable, and hence subject to WTO dispute settlement and possible countermeasures. Countervailing measures may also be applied. This means that maintaining actionable subsidies can introduce an element of uncertainty and risk into investor locational decisions – and possibly deter them from a particular location.

Longer-term approaches include the transformation of traditional EPZs into industrial parks/clusters or similar formations, to be islands of efficiency. The idea behind the creation of industrial clusters is that, to benefit fully from export-oriented FDI, and facilitate and upgrade export-oriented FDI activity, host countries need to encourage linkages between foreign affiliates and local suppliers. These linkages may be facilitated if buyers and suppliers operate in the same spatial and industrial area. As the development of infrastructure, business services

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and specialized skills often involves significant levels of investment, governments in many countries have encouraged the formation of such clusters. These efforts seek to create conditions that will promote dynamic interaction, learning and competition among the relevant actors. Indeed, the increasingly interdependent nature of policies on investment, trade, technology and enterprise development call for a more integrated approach to fostering export-oriented FDI and economic development.

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<http://www.unctad.org/press>

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¹ WTO members listed in Annex VII of the Agreement on Subsidies and Countervailing Measures (namely, (a) LDCs designated as such by the United Nations which are members of the WTO, and (b) Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe, until their per capita GNP reaches \$1,000 per annum) are exempted from this requirement. A decision taken by ministers at Doha provides that a member loses its Annex VII protection only once its per capita GNP reaches \$1,000 in constant 1990 dollars for three consecutive years.

² The WTO members that received extensions of the transition period in respect of one or more export subsidy programmes under SCM Article 27.4 are Antigua & Barbuda, Barbados, Belize, Colombia, Costa Rica, Dominica, Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Jordan, Mauritius, Panama, Papua New Guinea, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, Thailand and Uruguay. Not all these extensions were pursuant to the Doha decision. The actual decisions, which were taken on a programme-by-programme basis, may be found in WTO documents G/SCM/50 through G/SCM/102.

³ The Doha Declaration also includes a negotiating mandate on subsidies (paragraph 28) aimed at clarifying and improving existing disciplines, while preserving the basic concepts, principles and effectiveness of the Agreement and its objectives, and taking into account the needs of developing countries and LDCs.
