

EXPANDING THE PROHIBITED "RED LIGHT" SUBSIDY CATEGORY

Paper from the United States

The following communication, dated 13 January 2006, is being circulated at the request of the Delegation of the United States.

The submitting delegation has requested that this paper, which was submitted to the Rules Negotiating Group as an informal document (JOB(06)/3), also be circulated as a formal document.

ISSUE

As the United States noted in its *Basic Concepts and Principles* paper¹, and subsequently in its *Subsidies Disciplines* paper², Members over the course of successive negotiating rounds have focused on improving subsidies disciplines by prioritizing the elimination of the most distortive categories of subsidies, while steadily strengthening the disciplines for countering the adverse trade effects that other subsidies can cause. Accordingly, in its *Subsidies Disciplines* paper, the United States stated that an obvious next step in the progressive deepening of subsidy disciplines is the expansion of the existing category of prohibited subsidies under Article 3 of the Subsidies Agreement to include those instances of government intervention that have a similarly distortive impact on competitiveness and trade as do export and import substitution subsidies.³ Accompanying this suggestion, the United States also raised the possibility of further transparency requirements related to certain types of government intervention. With this paper, the United States seeks to initiate a discussion in the Rules Negotiating Group (the "Group") on what additional types of subsidies should be prohibited, how these subsidies should be defined according to clear and objective criteria, and what added transparency obligations should be considered.

DISCUSSION

It has long been accepted that subsidies contingent on export performance or on the use of domestic over imported goods are particularly egregious because they have a direct and immediate impact on international trade. Accordingly, they are prohibited under the Subsidies Agreement. However, serious market and trade distortions can result from other forms of subsidization as well. These subsidies distort normal market mechanisms and provide recipient firms with a considerable competitive advantage in their export markets as well as their home markets. While most subsidies

¹ TN/RL/W/27 (22 October 2002)

² TN/RL/W/78 (19 March 2003)

³ All subsidies in an expanded category of prohibited subsidies under Article 3 of the Subsidies Agreement would be subject to the remedies in Article 4.

have the potential for distorting trade, the Group should discuss the appropriate criteria that should be used for determining the types of subsidies that should be included in an expanded category of prohibited subsidies. In the view of the United States, the Group should focus its discussions on those additional types of actionable subsidies that represent the most intrusive government interference in the marketplace. It is these subsidies that have the potential to create the most significant trade distortions.⁴

Any newly prohibited subsidies should be defined and identified according to clear and objective criteria.⁵ Certain types of subsidies have a greater potential to have distortive effects. For example, the Group's discussion should address subsidies to cover a company's losses, which represent an extreme intervention in the market. Moreover, the Group should consider whether – from a policy perspective – certain subsidy "forms" may be less transparent and monitorable than others and, therefore, in the long-term, should be discouraged in favour of more transparent subsidies. The important point here is that there is a broad array of possible normative criteria that potentially can be used in combination with quantitative criteria.

In evaluating possible normative criteria, the Group should consider, at the very least, those subsidies that most typically and directly have forestalled or impeded industry restructuring and rationalization, often resulting in inefficient excess capacity. As has been evident in, for example, the steel sector, so-called "creation and maintenance subsidies" (*i.e.*, those which facilitate new capacity that would not otherwise be viable, or keep existing capacity online that competitive forces would otherwise force to close) can be especially disruptive and can become a chronic source of trade friction. Because these types of subsidies can directly supplant or frustrate market forces and distort trade patterns, the Group should consider whether these types of subsidies should be subject to stricter disciplines.

With the above considerations in mind, in our *Subsidies Disciplines* paper, the United States suggested that practices similar to those 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. In addition to the obvious candidates noted above, there are other subsidy categories which this Group could consider for discussion. These could possibly include other forms of egregious government intervention such as equity investment in, or lending to, companies with poor financial prospects unable to attract commercial financing or other funding of companies or projects that would not otherwise receive conventional commercial financing.^{6, 7}

⁴ This proposal is made without prejudice to any new subsidies rules developed in the agriculture negotiations. In light of the ongoing agriculture negotiations, some of the proposed new disciplines discussed in this paper may not be applicable in the agricultural sector. For example, in the agriculture negotiations, Members continue to discuss the level of allowable government support and agricultural export credit financing and the disciplines that will be applicable. Any such new subsidies rules developed in the agriculture negotiations should prevail over the general subsidy rules as established, or as may be established, in the Subsidies Agreement.

⁵ The United States is prepared to consider specificity as one of the criteria for any newly prohibited categories. However, any such specificity requirements should not disturb the existing specificity provisions, including the deeming provision under Article 2.3 with respect to the prohibited subsidies currently listed in Article 3.1(a) and 3.1(b).

⁶ To the extent that a subsidy, as defined by the Subsidies Agreement, is provided, special consideration could be given to: (1) government support for small business; (2) government financing of public utilities, given the role such utilities normally play in market economies; and, (3) passive investments and other government investment not driven by government industrial development policies. The consistency of any new rules with the export credit rules might also need to be considered. As noted above, the Group could consider whether specificity should be one of the criteria for any newly prohibited category.

⁷ We also note that other Members have called for the reinstatement of the "dark amber" category of subsidies under the lapsed provisions of Article 6.1.

This Group could also consider measures complementary to the disciplines noted above. For example, with regard to government equity infusions, as stated in its *Subsidies Disciplines* paper, the United States questions the justification for government investment *at all* in the private sector in countries with well-developed capital markets. Government investment decisions that run counter to the private sector's assessment that a company is not likely to generate a market return should be transparent, closely scrutinized and, as appropriate, curtailed. Accordingly, the United States suggested that there be a requirement that Members notify the Subsidies Committee of any intended provision of equity capital, including debt-to-equity conversions. Such notifications should describe: (1) the terms of the transaction; (2) how such an investment is consistent with the usual practice of private investors; and, (3) potential adverse trade effects.

The United States believes that such additional notification requirements are appropriate in the case of equity infusions given their unique character. In particular, unlike other types of financial contributions, equity infusions entail the government taking a direct ownership stake in and, in many cases, control over the recipient company. In such circumstances, the government is positioned to ignore the normal private sector profit-maximization imperative and to manipulate the decision-making of the company to pursue the government's own priorities irrespective of market signals and incentives. Additional transparency measures should be considered for all government-controlled companies as well, such that Members can be assured of a consistently commercial, arm's-length relationship between the government-owner and the state-owned enterprise.

CONCLUSION

The United States believes that past negotiations on subsidies have led to genuine and important improvements in international trade. However, it is necessary to build on those past successes with stronger and more comprehensive rules that address the issues, concerns, and areas of dispute with which WTO Members are faced today and can anticipate in the future. Prohibition clearly can be a more effective and timely discipline for addressing unfair subsidization than other post-hoc, remedial approaches which, though useful, have their limitations. It is hoped that this paper will initiate a productive conversation as to how the rules can be improved such that the most blatant and distortive government interventions in the market can be effectively disciplined and that the market is the primary determinant of resource allocation and international trade flows.
