POLICY BRIEFING 31

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Subsidies as an Instrument of Industrial Policy: Are they WTO Compliant?

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RECOMMENDATIONS

- Subsidies do not necessarily violate WTO rules, but 'bail-outs' do. Therefore, South Africa should carefully tailor any assistance to strategic industries so that maximum benefits are achieved without legal implications.
- South Africa should work towards long-term solutions within the multilateral trading system, which would include the promotion of policy space for developing countries to invest in emerging industries, such as green technology.
- As measures to free-up trade will generate long-term results, South Africa should create policies aimed at investment in trade-related infrastructure and trade facilitation.

EXECUTIVE SUMMARY

Global responses to economic recession revealed a trend towards trade protectionism, specifically through 'bail-out' measures in the form of large sums of government revenue handed out to specific industries. South Africa similarly responded to the economic crisis by offering rescue packages to affected industries. While they may generate some short-term benefits, these measures erode the efforts of the multilateral trading system to reverse the injurious effects of unilateral trade measures. It may be more advantageous to South Africa and the multilateral trade system to focus on long-term measures, such as increased trade-facilitation that would free up trade and help reverse the contraction of global trade.

INTRODUCTION

The economic recession revealed a global trend towards trade protectionism, replicating the fortification of domestic labour and commercial interests that occurred during previous periods of recession. Although countries employ a wide range of trade protective measures, the ones that have caught everyone's attention are the 'bail-out' measures in the form of large sums of government revenue handed out to specific industries.

In the wake of the recession, South Africa adopted similar measures. While not likely to lead to widespread trade restriction and retaliation, these measures place a stranglehold on multilateralism and have the potential to hurt economies, including ironically the economies being parachuted to safety. Furthermore, some of these measures, including those adopted by South Africa, may have the potential to violate multilateral trade rules that were adopted to prevent protectionist measures by members of the World Trade Organization (WTO).

RESPONSES TO THE GLOBAL ECONOMIC CRISIS

In the wake of the Great Recession,[2] which caused the global economy to plummet

to the worst financial and economic crisis since the Great Depression of the 1930s,[3] all G20 countries have adopted trade restrictive measures aimed at protecting their domestic markets. Over the last two years, the response of most G20 countries was to implement new fiscal programmes and provide support for severely impacted sectors. However, countries also responded to the crisis by introducing trade-restrictive measures such as additional tariffs, subsidies or outright import bans.

The trade restrictive measures of choice tend to be trade remedies, such as safeguards, anti-dumping duties or countervailing measures. However, some countries have implemented new subsidies in a range of sectors, which include fruit and vegetables, sugar, dairy, textiles, construction, green products and renewable energy and the aviation and automotive industries. Certain sectors are favoured by way of bail-outs, such as the automobile industry, which received subsidies amounting to $48 billion.[4] The US provided a direct subsidy of $17.4 billion to its three national companies, while Canada, France, Germany, UK, China, Argentina, Brazil, Sweden and Italy also provided direct or indirect subsidies to their industry. What appears to be the trend for automotive bail-outs is that once a government implements a new subsidy, its trading partners quickly follow suit in an attempt to remedy any competitiveness effects. For example, policymakers in several industrialised nations rushed to redress the harm done to their car manufacturers by the US government bailout of automotive giants.[5]

The Peterson Institute found that developing countries have or considered implementing a larger number of protectionist measures than developed countries. These have tended to be non-financial measures because richer developed countries have the fiscal power to deploy costly subsidies. However, South Africa, a developing country, has followed the example of its developed-nation trading partners and adopted rescue measures aimed at supporting its local industries.

SOUTH AFRICAN RESPONSE MEASURES

In December 2008, the social partners that comprise the Presidential Economic Joint Working Group, namely organised labour, business and government, met to consider South Africa's collective response to the global economic recession. The result was the 'Framework for South Africa's Response to the International Economic Crisis', which inter alia suggests sector-specific strategies for vulnerable sectors, such as clothing, textiles and footwear, mining and the auto and capital equipment sectors. Combining trade, industrial and social policy measures, these strategies aim to prevent job losses, regain jobs and productive capacity lost in recent years and promote employment creation through 'rescue packages' for affected industries.

The newly formed Economic Development Department was tasked with co-ordinating the framework's implementation. The department created a ZAR[6] 6.1 billion fund, administered by the Industrial Development Corporation (IDC), to assist companies in distress and introduced a ZAR 2.9 billion training layoff scheme to serve as an alternative to retrenchment. IDC has also approved funding to several South African companies, in sectors such as metals, chemicals, mining, clothing and textiles, tourism, catering, agriculture, forestry, sawmilling, automotive and auto parts and accessories. In addition, support packages were developed to meet the needs of specific sectors. These include preferential financing schemes, trade measures such as increased tariffs and rebate permits, while additional measures, such as the promotion of local procurement preferences, are in progress.

Although, in size, the South African bail-out measures are no way near those of countries such as the US ($700 billion), the wisdom of cherry picking specific sectors and companies can be questioned. Companies, which already benefit from massive tax incentives, protective tariffs and indirect subsidies such as cheap electricity and water, should not be turned into subsidy junkies. Their reliance on state assistance will not only spell doom for South Africa's long-term competitiveness, but also, as illustrated below, potentially violates multilateral trade rules. To make matters worse, the Industrial Policy Action Plan (IPAP) will give more long-term effect to some of the protectionist actions, as measures, such as preferential procurement and the leveraging of industrial financing through IDC's concessional credit, will become the mainstays of South Africa's industrial policy. However, on the

positive side, IPAP also includes examples of trade policies that could help reverse the contraction of global trade, such as trade facilitation measures to address customs fraud and to support the development, accreditation and enforcement of technical standards to meet export demands. These are examples of trade policies that could contribute positively to help reverse the contraction of global trade. Nevertheless, it would be prudent to consider the implications of these measures for the multilateral trade framework and whether they potentially violate the rules of the WTO.

IMPLICATION FOR WTO DISCIPLINES

The subsidies employed by governments to respond to the global economic crisis include a broad array of measures, some of which fit neatly under the definition of subsidies as found in the Agreement on Subsidies and Countervailing Measures (ASCM)[7]. Most economists agree that, although these subsidies may generally distort markets by under pricing goods, they do not necessarily violate WTO rules. In essence, the international trading system recognises that subsidies remain an important tool of national governments for promoting legitimate government policies in areas such as education, poverty alleviation, national security etc. In fact, subsidies can play an important role in securing public goods for the benefit of a country's citizens.

However, the international trading system also recognises that the way in which subsidies are implemented could cause distress to the industries of its trading partners, for example, in the case of subsidies specifically aimed at maximising exports, or subsidies aimed at import substitution. Furthermore, even no export or import substitution may cause harm or injury to the industry of trading partners. As such, it creates conflicting policy goals between trading partners, i.e. the legitimate policy goal of providing support to its industries versus legitimate concerns about the harm that subsidised goods may cause own industries. The ASCM thus provides a balancing mechanism, which aims to determine whether the economic bail-out measure is trade distorting and, more specifically, whether it harms the industry and export of another country, has the effect of nullification or impairment of benefits, or cause serious prejudice. These so-called actionable subsidies can lead to countervailing duties under the domestic laws of the country where the injury is alleged to occur or at the Dispute Settlement Body of the WTO.

The measures employed by the South African government, specifically the IDC-administered preferential financial schemes to distressed sectors, are arguably subsidies as defined by the ASCM. First, article 1 of the ASCM defines a subsidy as 'a financial contribution by a government or public body'. Since the loans are made by the IDC and not the government itself, it begs the question whether it could still be a subsidy given that the IDC is not a public body. However, article 1.1(a)(1)(iv) of the ASCM provides for such a scenario by defining 'financial contribution' as one where 'a government makes payments to a funding mechanism, or entrusts or directs a private body' to grant the loan. Considering that IDC is primarily funded by the South African government, these loans would therefore still fit within the definition of a subsidy.

Second, the ASCM specifies that the financial contribution must confer a benefit, but what exactly constitutes a 'benefit'? In *Canada – Measures Affecting Exports of Civilian Aircraft*,[8] the Appellate Body states that the financial contribution should make the recipient 'better off' than it would otherwise have been, absent that contribution. Article 14 of the ASCM clarifies further what is considered a benefit and establishes 'guidelines' for calculating benefits conferred with respect to equity investments, loans, loan guarantees, the provision of goods or services by a government, and the purchase of goods by a government. Specifically, the guidelines assess whether a company that is granted a government loan at below commercial rates receives a benefit, confirming that a benefit arises if the recipient has received a financial contribution on terms more favourable than those available in the market. The terms on which loans have been granted to a South African company are not publicly available. However, as South Africa's response measures specifically provide for loans on 'preferential terms', it is fair to assume that a benefit as outlined by article 14 has indeed been conferred.

The South African response measures also include 'preferential procurement', although what

this entail is not clear. Nonetheless, preferential procurement could also potentially be termed as a subsidy, as article 14 states that 'the provision of goods/services or purchase of goods by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration'. In such a situation, the benefit is 'the adequacy of remuneration … determined in relation to prevailing market conditions for the good or service in question in the country of provision or purchase (including price, quality, availability, marketability, transportation and other conditions of purchase or sale)'.

Finally, to qualify as a subsidy, 'specificity' is required. In other words, the subsidy must be conferred on an identifiable enterprise or group of enterprises. The ASCM provides for elucidating principles with regards to specificity, and article 2.1(a) makes it clear that 'where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific'. The IDC has approved funding to specific companies in specific sectors and in doing so has thus limited access to the subsidy to certain enterprises as set out in article 2.1(a).

It is therefore clear that some South African response measures could potentially be an actionable subsidy, as set out by the ASCM. However, in the final instance, any action against South Africa would have to be premised on the fact that such a subsidy is trade distorting and that it causes harm to the industry and export of another country.

CONCLUSION

Like many of its trading partners, South Africa has chosen the short-term benefits of pursuing unilateral trade policy, which potentially violates multilateral trade rules. This behaviour is in line with the traditional philosophy underlying international trade, that governments impose unilateral trade restrictions in order to maximise national welfare. However, in some ways the WTO has facilitated such a long-term approach by creating the scope for governments to co-ordinate trade measures through trade agreements, which prevents protectionism. Stimulating the economy through subsidising production will ultimately erode the multilateral trading rules built up over the last 60 years to reverse the effects of unilateral trade measures, which were in response to the last Great Depression.

ENDNOTES

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2 Peterson Institute for International Economics, *G20 Protection in the Wake of the Great Recession*, report commissioned by the International Chamber of Commerce's Research Foundation, June 2010, http://www.piie.com/publications/papers/hufbauer20100622.pdf. Its findings reveal that by September 2009, the G20 were responsible for implementing 172 trade protective measures, with hundreds more 'in the pipeline'.

3 Peterson, *op. cit*.

4 Gamberoni E & R Newfarmer, 'Trade protection: incipient but worrisome trends', *Tradenotes,* March 2009, p. 37.

5 Evenett, SJ & F Jenny, 'Bailouts: how to discourage a subsidies war', in Baldwin R & S Evenett, *The Collapse of Global Trade, Murky Protectionism and the Crisis: Recommendations for the G20*. VoxEU.org publication, 2009.

6 ZAR: South African rands.

7 WTO, *The Legal Texts – The Results of the Uruguay Round of Multilateral Trade Negotiations*. New York: Cambridge University Press, 2007, http://www.wto.org/english/res_e/booksp_e/analytic_index_e/subsidies_01_e.htm. This reference is valid for all subsequent quotations from the report.

8 WTO, *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R, Report of Appellate Body, August 1999, http://www.wto.org/english/tratop_e/dispu_e/repertory_e/s4_e.htm.

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