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Rethinking Subsidy Disciplines For the Future

Policy Options Paper



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Rethinking Subsidy Disciplines For the Future

Gary Horlick and Peggy A. Clarke

on behalf of the E15 Task Force on Rethinking International Subsidies Disciplines

January 2016

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Note

The policy options paper is the result of a collective process involving all members of the E15 Task Force on Rethinking International Subsidies Disciplines. It draws on the active engagement of these eminent experts in discussions over multiple meetings as well as an overview paper and think pieces commissioned by the E15Initiative and authored by group members. Gary Horlick and Peggy Clarke were the authors of the report. While a serious attempt has been made on the part of the authors to take the perspectives of all group members into account, it has not been possible to do justice to the variety of views. The policy recommendations should therefore not be considered to represent full consensus and remain the responsibility of the authors. The list of group members and E15 papers are referenced.

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Abstract

Subsidies are a critical instrument in the toolbox that governments use to achieve a variety of policy goals. In an increasingly interdependent world, addressing the negative externalities of subsidies while maintaining their market-correcting function and the policy space for development is an imperative from a sustainable development perspective. In light of the changes in the global economy and emerging social and environmental concerns, the present paper seeks to assess the adequacy of existing international subsidy disciplines and suggest possible areas for improvement and reform. Three groups of policy options are identified. First, revisit international disciplines by creating, under the WTO Agreement on Subsidies and Countervailing Measures, a narrowly

defined category of non-actionable subsidies with clear boundaries, as well as a category of subsidies subject to absolute prohibition or a presumption of prohibition. Second, the procedures for establishing, monitoring and resolving disputes for the various types of subsidies should be adjusted by strengthening the role of a neutral decision-maker while restricting the option for unilateral action. Finally, a key consideration in the field of subsidies is that of obtaining better data and measuring impacts. The establishment of an independent platform for data collection using common standards and definitions is recommended. Where appropriate, the paper seeks to identify gaps in priorities and concerns over subsidy disciplines between advanced and developing economies.

Contents

6	Executive Summary
8	1. Introduction
9	2. Should Something Be Done About the Use of Subsidies?
9	2.1 Arguments for Disciplining Subsidies
10	2.2 Arguments against Subsidy Disciplines
10	2.3 Evaluating the Cross-Border Impact of Subsidies
11	3. Policy Options: Revisiting International Disciplines
11	3.1 Non-Actionable Subsidies
12	3.2 Subsidies to be Phased-Out or Prohibited
15	3.3 Are Services Different?
16	3.4 Everything Else
18	4. Process: Monitoring and Next Steps
18	4.1 Who Decides?
19	4.2 Questions of Proof
19	4.3 Remedies
19	4.4 Definitions of Subsidies
20	4.5 How to Get There
20	4.6 Data Collection
20	4.7 Concluding Note
22	References and E15 Papers
23	Annex 1: Summary Table of Main Policy Options
27	Annex 2: Members of the E15 Task Force

List of Boxes

16	Box 1: Revisiting the Concept of Specificity
20	Box 2: Big and Rich vs. Small and Poor Country Issues

Abbreviations	
ASCM	Agreement on Subsidies and Countervailing Measures
CVD	countervailing duty
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GHG	greenhouse gas
GVC	global value chain
LCR	local content requirement
OECD	Organisation for Economic Co-operation and Development
PGE	Permanent Group of Experts
R&D	research and development
SPS	sanitary and phytosanitary
TBT	technical barriers to trade
TiSA	Trade in Services Agreement
TTIP	Transatlantic Trade and Investment Partnership
WTO	World Trade Organization

Executive Summary

In an increasingly interdependent world, addressing the negative externalities and beggar-thy-neighbour effects of subsidies, while maintaining their market correcting function, the policy space for development, and their role in delivering essential public goods, is an imperative from a sustainable development perspective. The international community has long attempted to address the concept of subsidies discipline, currently through the WTO Agreement on Subsidies and Countervailing Measures (ASCM). However, a fresh look at the issue is necessary. To this end, ICTSD, in partnership with the World Economic Forum, convened a task force of leading experts, as part of the E15 Initiative, to analyse the role of subsidies and the adequacy of international disciplines. Based on this analysis, the paper puts forward new directions for discussion and future policy implementation.

Should Subsidies Be Disciplined?

For the purpose of this study, the concept of subsidies is broadly defined as a subset of government intervention (or inaction) in the marketplace. Industry-specific protective tariffs, safeguards, export taxes, input quotas and trade remedy tariffs are not addressed. More broadly, the discipline of regulatory action with subsidy-like effects is not treated.

While the ASCM provides some discipline on the use of subsidies to goods, there are almost no multilateral disciplines in services and the agricultural sector receives different treatment. This paper takes the view that subsidies for agriculture and services should be subject to the same (or similar) discipline as goods, even if remedies for services may need to be different.

The proposals in this paper stem from an assessment that the arguments for some disciplines on the use of subsidies are, on balance, stronger than the counterarguments. The arguments in favour derive from the following impacts amongst others: subsidies can distort trade and resource allocation, and lead to unfair competition; they can encourage behaviours proven to be destructive of the environment; and they may increase the development gap between rich and poor. The economic arguments against the implementation of disciplines on subsidies, widely viewed by governments as effective instruments to achieve a variety of policy goals, must nevertheless carefully be considered. Subsidies “may represent sensible policy responses to a range of market failures [...] and] the task of distinguishing the good from the bad is extremely complex as a practical matter. Existing subsidies disciplines do a poor job in this regard, and simple fixes are not apparent” (Sykes 2010).”

The paper thus considers some form of discipline as desirable, even though the type and extent of that discipline may vary depending on the type or purpose of the subsidy—e.g. measures that target subsidies that have a negative impact on the global commons as against subsidies that are distortive of trade. The underlying issue is how to evaluate (and measure) the impact of subsidies outside the border of the subsidizing government and on global public goods. Any discipline must recognize the positive as well as the negative. If one starts with the proposition that governments should have the policy space to provide subsidies as long as it does not cause adverse impact outside their territory or on the commons, then the question becomes how to determine whether there is impact and to what extent.

Revisiting International Disciplines

In recommending reform and improvements in subsidies disciplines, a three-tiered approach such as that found in the existing ASCM is considered appropriate. A key concern in framing this categorization is that of establishing clear definitions and strict criteria for inclusion.

Non-Actionable Subsidies

The first category would be composed of narrowly defined non-actionable subsidies (i.e. not subject to discipline, as envisaged in ASCM, Article 8, which expired) with clear boundaries. This would include safe harbours for subsidies that usefully address market failures or other externalities: subsidies to address climate change adaptation and mitigation as well as other environmental concerns (as long as the purpose of the subsidy is not to gain a commercial advantage); regional development subsidies for disadvantaged regions within a country; certain subsidies that target R&D activities beneficial to society at large in which private commercial incentives may be insufficient; and subsidies aimed at recovery from natural disasters and conflict.

Prohibited Subsidies

The second category would consist of subsidies that could be subject to absolute prohibition or a presumption of prohibition (such as in the now defunct ASCM, Article 6.1). This would include subsidies that generate such negative externalities that they should be phased-out and prohibited. The ASCM already reflects a consensus that there exist certain forms of subsidies, the results of which are so harmful to external parties or economically undesirable that they should be banned (i.e. export-contingent and domestic content subsidies). There are other subsidies that have the potential to create significant harm to global

welfare. The following areas should thus be considered for additional prohibition purposes: locational subsidies designed to attract investment which may encourage a race to the bottom (both at a subnational and international level); subsidies that encourage the exploration, production or use of fossil fuels (while taking into account the impact of consumption subsidies on the poor); and other resource-depleting subsidies of the most egregious types that impact on the global commons (for example capacity-enhancing subsidies in fisheries).

Actionable Subsidies

The third category would include all subsidies that do not fall neither into the non-actionable nor prohibited boxes and that consensus indicates may be permissible yet actionable. If it is demonstrated that others (or the sustainability of shared natural resources) are harmed by their use, recourse to remedy should be possible. The most likely type of process to be acceptable in this instance is one similar to that currently provided for in the ASCM, with adjustments to make multilateral disciplines more effective and unilateral disciplines (i.e. countervailing duties) less prone to protectionist leanings.

Subsidies Not Currently Covered by the ASCM: Are Services Different?

Some disciplines on services subsidies should be established; especially in light of the increasingly prominent role of services in international trade. To date, negotiations under the General Agreement on Trade in Services (GATS) have failed to reach a consensus on this issue. In exploring the scope for disciplines, the definition of subsidy and potential remedy would have to be adjusted to account for the different nature of services trade and the diverse modes of delivery. The first step in this examination is the need for far better data allowing for a more informed mapping of the nature and sectoral incidence of subsidy practices and their use across country groupings.

Monitoring and Next Steps

The procedures for establishing, monitoring and resolving disputes for the different types of subsidies categorized above would not necessarily be identical although there would be certain commonalities.

Who Decides?

The ASCM takes a mixed approach. The multilateral dispute resolution process provided for in the WTO reflects the goal of having a neutral decision-maker determine whether members' interests have been harmed through the use of subsidies. The ASCM also allows for national decision-makers in the form of countervailing duty actions. Empirical evidence suggests that when the unilateral approach is taken there is an inherent tendency towards a protectionist bent. The following two options should thus be considered.

First, strengthen the role of a neutral decision-maker in the resolution of subsidies disputes. The advantage of a neutral decision-maker is that one can apply a broader definition of subsidy (coupled with high standards of proof). One possibility would be to establish a multinational

group of experts (e.g. the role originally envisaged for the independent Permanent Group of Experts as established under ASCM, Article 24). Another option would be to use expedited arbitration procedures using existing practices with some disputes subject to binding arbitration (on prohibited subsidies for example).

Second, eliminate or at least restrict the option for unilateral action. The ASCM provides for unilateral subsidy discipline actions and outlines rules for how they should be undertaken. The current system should at a minimum be adjusted to apply to only the narrowest definition of a subsidy. Countervailing duties should be limited to offsetting only the effect of subsidies in excess of the support received by competitors in the importing country. National decisions must be subject to a binding dispute resolution that is faster than the current system and more effective in reaching compliance.

How To Get There?

Despite the general stagnation in WTO rules negotiations and the relative lack of interest in making major amendments to the ASCM in the ongoing Doha Round, the issue of changes in current international subsidy disciplines deserves renewed attention and effort.

Interpretation of the ASCM by the Appellate Body would appear unlikely to bring about major change. At first sight, no other organization covering most countries seems likely to tackle the issue. But this is misleading: it is probable that changes will be made in subsidy disciplines in the course of negotiations over climate change for example. Greater transparency would help. However, even widely publicized lists of subsidies have at best a mixed record in obtaining reform.

Data Collection

A key consideration in the overall subsidies discipline debate is that of obtaining better data. The formal intergovernmental notification process has not produced the necessary breadth and depth of information about subsidies for a consistent set of reliable data that would permit more informed policy discussions and decisions. A recommendation is thus to establish an international consortium of universities and independent think tanks, supported by funding, that could develop a platform for data collection using common standards and definitions.

1. Introduction

The analysis and recommendations presented in this paper draw on a collective examination by a group of experts on the role of subsidies and the desirability of international disciplines. While we acknowledge that the international community has for a long time attempted to address the concept of subsidies discipline, currently through the WTO Agreement on Subsidies and Countervailing Measures (ASCM), a fresh look at subsidies is necessary, unconstrained by the ASCM or other systems that have developed. The examination is nevertheless informed by previous experiences.

This paper is the authors' conclusions drawn from that examination. We are aware that this is a much-ploughed field and that different conclusions can be reached. We hope that the think pieces commissioned for this project (listed in reference) and the authors' attempt to draw conclusions are of use as issues about subsidies are debated—and possibly agreed upon—at discussions and negotiations around the globe. Each of the issues discussed in this paper already has a full bookshelf (or its digital equivalent) with far more nuance than is possible here. Yet our intention is to suggest new angles and possible directions for future discussion and policy implementation.

Subsidies are a critical instrument in the toolbox that governments use to achieve a variety of policy goals. These include promoting certain sectors, attracting investment, fostering economic transformation, developing disadvantaged regions and facilitating socio-economic adjustments, to list a few. The way in which subsidies are allocated contributes to shaping global consumption and production patterns, as well as income distribution and the use of natural and other resources. Critics often point to the inefficiencies and economic distortions they create, their perverse distributive consequences, and the negative impact they can have on the environment by lowering prices and exacerbating their effect (or lack thereof) on externalities. At the same time, subsidies can play a key role in addressing market failures—with regards research and development for example—and advancing public policy objectives, such as providing access to energy for the poor, supporting the livelihood of small farmers or delivering essential public goods.¹

In an increasingly integrated and interdependent world, addressing the negative externalities and beggar-thy-neighbour effects of subsidies, while maintaining their market-correcting function, the policy space for development, and their role in delivering essential public goods, is a clear imperative from a sustainable development perspective.

¹ Although those objectives can be a “smoke screen” for, inter alia, subsidizing large farmers.

2. Should Something Be Done About The Use of Subsidies?

Why start over, with blank sheets of paper? The world has changed since the early 1990s, with new public and private actors, new structures, especially global value chains, and new or renewed challenges (e.g. climate change, declining fish stocks, the revival of industrial policy). For the purpose of this examination, we start with a concept of subsidies broadly defined as a subset of government intervention (or inaction) in the marketplace. While we acknowledge that there may be instances of private subsidies, in considering international disciplines we concentrate on government intervention in the flow of the market (which may include government inaction in certain instances). So far, governments have not defined grants of monopoly rights (e.g. single-desk marketing boards, intellectual property protection, road and other concessions) as possible subsidies, although the large cash payments to monarchs for monopolies in the past hint they have monetary value. Similarly, industry-specific protective tariffs, safeguards, export taxes, input quotas and trade remedy tariffs are not considered subsidies, despite the large political investment in obtaining some of them.² Both would seem quantifiable, but we do not plan to address them here, as it would make the scope of this project overwhelming.

More generally, the subsidy-like effects of regulatory action (or inaction) have not been treated as a subsidy; at least since the 1982 US steel countervailing cases (possibly because the US Administration had granted the US steel industry special tax treatment, special environmental rules and a special import control regime as part of the 1980 presidential election). Attempting to discipline government regulatory action (or inaction) is thus best left to another study, as the current WTO regime of GATT plus technical barriers to trade (TBT) plus sanitary and phytosanitary (SPS) measures seems to be overtaken (at least for the moment) by the talks about regulatory convergence in the Transatlantic Trade and Investment Partnership (TTIP).³ That leaves open the question of where to put such intervention as maintaining input prices at home lower than their export prices.

While currently the ASCM and a few other agreements provide some discipline on the use of subsidies to goods, there are almost no multilateral disciplines on the use

of subsidies for services. Agricultural subsidies receive different treatment from subsidies to the manufacturing sector; however, the reason for different treatment lies more in historic political concerns than in current economic reasoning.⁴ We think that subsidies for agriculture (Josling 2015) and services (Sauvé and Soprana 2015, 10-11) should be subject to the same (or similar) discipline, even if the remedy may need to be somewhat different for service subsidies.⁵

2.1. Arguments for Disciplining Subsidies

On balance, while we acknowledge that there are good arguments against disciplining the use of subsidies (see section 2.2), we believe the arguments for some disciplines are stronger. Subsidies can potentially or actually distort trade, competition and investment decisions. Some subsidies have encouraged behaviours that have proven to be highly destructive of the environment (e.g. leading to over-fishing of ocean-going fish stocks, or leading to increasing emissions of greenhouse gases). Subsidies can also lead to massive waste, inefficient use of scarce resources and, possibly, even subsidy wars in certain industries or specific situations, while the benefits of the subsidies are captured by a few at the expense of the many. The use of subsidies can increase the development gap between rich nations (those that can afford to subsidize) and poor nations (those that cannot). The race to attract investment can lead to negative effects, including non-trade effects (such as unemployment or the destruction of non-renewable natural resources). Moreover, there are already a variety of subsidy disciplines in place, which implies an international consensus that some subsidy disciplines are beneficial. Therefore, we conclude that some form of subsidy discipline is desirable (or at least likely), even though the type and extent of that discipline may vary depending on the type or purpose of the subsidy. For example, if the reason for disciplining a certain type of subsidy is because it has a negative impact on the global commons, the form of discipline might be different than when a subsidy is distortive of trade (or harmful to competitors).

² The US in 1984 stated that industry-specific GATT-legal tariffs are not countervailable subsidies (Certain Steel Products from Australia, 49 Fed. Reg. 8,657 (Mar. 8, (1984)), then disagreed with itself in 1986 in order to countervail Canadian softwood lumber exports, (Softwood Lumber from Canada, 51 Fed. Reg. 37,453 (Oct. 22, 1986))—which eventually led to the pre-emptive WTO panel ruling seeming to hold that regulatory action is not countervailable (United States – Measures Treating Export Restraints and Subsidies, Panel Report, WT-DS194/R (adopted 25 Apr. 2001)).

³ See the policy options paper produced by the E15 Task Force on Regulatory Systems Coherence.

⁴ A set of recommendations specifically addressing agricultural subsidies can be found in the policy options paper produced by the E15 Expert Group on Agriculture, Trade and Food Security.

⁵ For example, tariffs such as countervailing duties which are applied when goods cross a border do not apply to services, but one could imagine an offsetting tax being applied if a neutral procedure and measurement methodology were to be devised.

2.2. Arguments against Subsidy Disciplines

There are economic and policy arguments against the implementation of subsidy disciplines. Subsidies are widely viewed by governments as effective policy tools and may be less trade destructive or distortive than the likely alternatives, such as higher tariffs.⁶ The essence of the economic case against subsidies discipline has been succinctly described by Sykes (2010):

Subsidies *may* create negative international externalities and distort global resource allocation. But they may also represent sensible policy responses to a range of market failures or play a useful role in addressing income inequality. The task of distinguishing the good from the bad is extremely complex as a practical matter. Existing subsidies disciplines do a poor job in this regard, and simple fixes are not apparent. Subsidies disciplines also invariably ignore the other side of the ledger (taxation and regulation), so that the *net* impact of government on competitiveness is unobserved and likely unobservable in practice.

He further argues that:

The rules that purport to distinguish permissible from impermissible subsidies are just incoherent. They rely on arbitrary criteria, distinctions that elevate form over substance, and on the wrong analysis of government measures that inevitably masks the full effects of government activity on business enterprises.

Finally, there is a concern that disciplines are (or would be) applied disproportionately to developing countries because the cost of implementing such disciplines is more easily borne by the developed countries that can bring greater resources.

2.3. Evaluating the Cross-Border Impact of Subsidies

Despite the arguments against discipline, some subsidies disciplines have worked reasonably well. An example includes the WTO prohibition against export-contingent subsidies (with limited exceptions for developing countries and a major exception with respect to export credits for mainly developed countries). In addition, the massive waste of public resources on often ineffective subsidies during the recent financial crises, and the use of “factory stealing” subsidies to influence investment decisions, suggests that at least some degree of discipline is necessary and that improvements to existing disciplines can be made. This would extend to subsidies that help deplete scarce and non-renewable natural resources and other global commons, even if the economic impact stays within the country. Therefore, on balance, we think that certain forms of subsidies discipline are desirable, even if perfect disciplines cannot be developed.

Nevertheless, the “no-discipline” arguments raise good points and we need to be very careful regarding the nature of the disciplines and how they are applied. This is particularly true with respect to the big vs. small economy disparities, discussed below (see Box 2). Even if subsidies should be disciplined, the discipline only applies to subsidies that have adverse effects outside the territory of the government giving them. Moreover, subsidies can have many positive effects, both domestically and across the border, and any discipline must recognize these positive effects as well as the negative.

The underlying question is how to evaluate, and perhaps measure, the impact of subsidies outside the borders of the subsidizing government. If one starts with the proposition that governments should have policy space within their own territory to give subsidies as long as it does not cause impact outside that territory, a concept already tried in the 1979 GATT Subsidies Code, Article 11.3, then the question becomes how to determine whether there is impact and by how much.⁷ Thinking in the late 1970s and early 1980s (when many of the current rules originated) reflected a concern with government assistance potentially reducing marginal costs within perfect competition. This has now been matched by a concern over whether governments are assisting companies to reduce their fixed costs. The work of Melitz, Levinsohn and others may provide a framework for analysing whether these effects are in fact occurring (Melitz 2003, Petrin et al. 2003, Levinsohn et al. 2004).

Much greater use of current methods of economic analysis for subsidies (as is increasingly the case in other WTO disputes) should be tried. If it were possible to obtain the necessary data, at least in large economies, it would be very interesting to go further than measuring impacts and try to identify if there are different impacts from different types and sizes of subsidies. In addition, at least in industries with imperfect competition, game theory could be explored as a tool for analysing subsidy impacts. Finally, if some priorities are considered particularly important (e.g. the need to tackle climate change), could harm be presumed, at least in a rebuttable manner, for some subsidies (along the lines of the current ASCM, Article 6.1)?

⁶ Subsidies may indeed target market failures and may, in some cases, represent the best policy instrument for addressing distortions. See, for example, Johnson (1965); and (Bagwell 2006). They may be especially important as a tool for economic development in developing countries, as argued for example by Dani Rodrik.

3. Policy Options: Revisiting International Disciplines

Arguments exist for and against treating subsidies intended for different purposes differently. Certain subsidies can usefully address market failures or other externalities, creating a public good. Economic logic suggests that subsidies that fall under these categories should be treated separately and addressed in a *sui generis* manner rather than being subject to a generic form of discipline. Using existing terminology on subsidies disciplines, these would be considered non-actionable (“permissible”) subsidies as long as certain criteria were met. The categories should be defined narrowly to avoid creating loopholes that eviscerate any subsidy disciplines that would otherwise exist.

In contrast, there are other forms of subsidies that create such negative externalities—e.g. distorting trade, harming the economic development of other countries, damaging the environment (including within the country)—that they should be banned. The difficulty lies in establishing clear definitions of these types of subsidies and strict criteria for determining when the negative externalities are sufficiently overwhelming. As can be seen in at least some of the categories proposed below, the externalities at stake may go beyond trade distortion; they may also reflect negative impact on the global commons.

In examining the overall issue, we find a three-tiered approach to subsidy discipline, such as in the ASCM, to be reasonable. Permissible subsidies—which would be narrowly defined—would not be subject to discipline as long as they fell within that narrow definition. The category of prohibited subsidies—i.e. those whose negative effects outweigh other considerations (such as subsidies that encourage fossil fuel production and consumption)—would be defined more broadly to include actions beyond the current ASCM subsidy definition that have similar economic impact. These would be subject to absolute prohibition or, perhaps, a presumption of prohibition such as in the now defunct ASCM, Article 6.1 (which defined where “serious prejudice” resulting from a subsidy was deemed to exist).

Finally, all other measures would fall within the category that the ASCM calls “actionable,” as long as an impact outside the country (or to a “global good,” perhaps even within the country) is demonstrated. These would be subject to disciplines, possibly similar to the existing ASCM approach with some adjustments, to make multilateral disciplines more effective and unilateral disciplines (countervailing duties) less prone to protectionist behaviours (or even abolished, as explained in section 4.1 below). In addition,

governments should be able to “club together,” either formally or informally, to limit their own subsidies, even those with no cross-border effects. The EU rules applicable to state aid and the OECD export financing arrangements can be viewed in this light.⁸

3.1. Non-Actionable Subsidies

Possible types of non-actionable subsidies are discussed in this section.⁹ We also address the difficulties and issues to consider in defining such subsidies and controlling their use.

3.1.1. Subsidies to address climate change and similar environmental issues

It is widely acknowledged that the Earth is experiencing a potentially profound period of climate change. This is leading to higher temperatures, rising seawaters, and more erratic and extreme weather events. The strong likelihood is that these changes will continue throughout the century. As a result, territories may need assistance to adapt to evolving climate patterns and rising sea levels. It may also be useful to support efforts that lessen the rate of increase of this change, such as a reduction in greenhouse gas emissions (both well described by Espa and Rolland (2015)). There is currently an initiative by a group of 17 WTO members to eliminate tariffs on a negotiated list of environmental goods—perhaps a first step would be the favourable treatment of subsidies targeted at the consumption of those goods as well.

Any safe harbour for climate change or other environmental subsidies, however, should not be used to enable one country to gain a commercial advantage over another. For example, many countries are currently racing to develop renewable energy capabilities. Subsidies that help industries use environmentally preferred energy sources might be good public policy (to lower the cost of green energy below that of fossil fuels). But subsidies directed at aiding one country’s industry manufacturing the technology (e.g. solar panels or wind turbines) over another country’s might be treated no differently than any other subsidy to the manufacture of goods. The inevitable “boundary issues” could be handled by a mix of “hard” and “soft” law, such as the discussions in relevant WTO committees or the role originally envisioned for the Permanent Group of Experts (PGE) in the ASCM—i.e. reviewing mandatorily pre-notified “permissible” subsidies under Article 8 as originally drafted.

⁸ The authors are unaware of any significant discipline on “domestic” subsidies to have occurred in regional trade agreements. For the limited disciplines on countervailing duties, see Table 1 in: Kasteng, Jonas, and Camilla Prawitz. 2013. Eliminating Anti-Dumping Measures in Regional Trade Agreements. National Board of Trade of Sweden.

⁹ The ASCM, when negotiated, recognized the idea that for some categories of subsidies the good outweighed the potential for trade distortion by including Article 8. However, this experiment in the “Identification of Non-Actionable Subsidies” ended in 1999 when the five-year term of Article 8 expired pursuant to the sunset clause in Article 31. Article 8 explicitly referred to three narrowly defined areas: R&D support; assistance to disadvantaged regions; and adaptation to new environmental requirements.

3.1.2. Regional development subsidies

Many countries, especially developing countries, experience very high domestic disparities in the cost of investment in different regions and extreme variations in income and employment opportunities in those same areas. A degree of financial redistribution may be rational, as well as politically inevitable. Some form of safe harbour for regional development subsidies should thus be considered (as well as a *de minimis* level). To prevent abuse, such subsidies should be limited to doing no more than offsetting the additional cost of investment in that region. Another possibility is to give preference to the poorest countries (using metrics such as the United Nations or World Bank indices of least developed countries). The safe harbour would also need to be limited to those regions of a country where the costs of investment and doing business were X percent above the norm for the country at issue (other metrics could be considered such as regional unemployment rates). The difficulty lies in how such costs are to be measured (and which measure of cost is relevant). An objective baseline would need to be established. Numerous metrics that measure the relative costs of investing and doing business within individual countries exist, which perhaps could be adapted to this purpose.

More broadly, the role of subsidies in economic development underlies nearly all the topics in this paper and is better discussed by experts in trade and development. Nonetheless, ASCM, Article 27, has an objective structure for inclusion and graduation that could be a more useful starting point than the subjective self-selection found elsewhere in the WTO.

3.1.3. Research and development subsidies

Research and development (R&D) is an area in which some incentive may be useful to overall development. With some R&D, a company cannot expect to capture more benefit than its cost plus profit. As a result, companies tend to invest less in R&D than is desirable for society as a whole. A safe harbour should thus be established for certain R&D subsidies. Any safe harbour, however, would need to be carefully crafted to avoid subsidizing R&D that would occur without the subsidies. Moreover, since the public would be funding such R&D (through the subsidies), the safe harbour could require that the results of the R&D be made publicly available to any agent who seeks to use it. While this requirement may act as a disincentive, there may still be an advantage to the firm conducting the research. Such a requirement would also serve as an incentive to companies to fund through commercial mechanisms some R&D they would otherwise fund with a subsidy, lest they be unable to retain the results of the R&D for their exclusive use. But it would run the risk of companies using government funding only for the least promising research. It may also favour richer countries over poorer ones due to their greater availability of resources to subsidize R&D. The answers to

the questions raised by Maskus (2015) about innovation suggest new ways of looking at the problem, especially through openness to competition. This may be a particularly good area for mandatory periodic review (without the draconian sunset in ASCM, Article 31, that eliminated Article 8).

3.1.4. Natural disasters

In recent years, the world has experienced natural disasters of such magnitude that recovery from them requires extraordinary investment. In these instances, perhaps there should be a safe harbour for subsidies provided to allow the industry or economy affected to return to its pre-disaster state.¹⁰ Any such safe harbour would need to be time restricted, with metrics established to determine when the recovery period has ended (perhaps using pre- and post-disaster employment and output levels as baselines). The safe-harbour would also need to be very specific on the magnitude of the natural disaster that would qualify for such treatment. The difficulty lies in narrowly crafting the safe harbour to permit subsidies to restore what was destroyed, without covering the cost of expanding or modernizing production. Metrics could possibly be developed by drawing on the experience and efforts of the UN Office for Disaster Reduction with respect to risk reduction in determining when the disaster is of sufficient magnitude to qualify for a safe harbour on recovery assistance.

3.1.5. Other disasters

If subsidies are necessary to recover from natural disasters such as earthquakes and tsunamis, what about man-made disasters such as war? The economic disruption caused by these disasters can induce further social and political instability. Therefore, a safe harbour (similar to that for natural disasters) should be recognized for the time-limited use of subsidies to allow an economy to recover after certain man-made disasters. The same concerns and considerations discussed above in the context of natural disasters would also apply to crafting this safe harbour, perhaps with a return to general subsidy rules over time.

3.2. Subsidies to be Phased-Out or Prohibited

The ASCM reflects a consensus (at least when it was drafted) that there exist certain forms of subsidies the results of which are so restrictive to trade, harmful to the economic development of third countries, anti-competitive, or otherwise economically undesirable, that they should be banned. This is reflected in the prohibition of subsidies that are contingent upon the exportation (or anticipated exportation) of the subject merchandise, and subsidies that are contingent upon the use of domestic over imported goods.

¹⁰ Under the ASCM, these subsidies could be considered regionally specific and thus actionable, although in practice this has not occurred. The Agreement on Agriculture, Annex 2(8), on non-actionable subsidies provides for payments for relief from natural disasters with criteria outlined for eligibility and compensation.

It can be argued that on an overall economic basis export subsidies have the opposite of the presumed effect—reducing the terms of trade for the subsidizing country and improving the terms of trade for the rest of the trading community as a whole (Sykes 1989). Subsidies that require the use of local content, on the other hand, can be argued to result in the deterioration of the terms of trade for the countries trading with the subsidized country. While local content requirements (LCRs) enable governments to increase the welfare of their local input suppliers (via increased production, sales or employment), they do so at the expense of competing suppliers in other countries (externalizing the harmful effects of trade). LCRs also harm industries, including in the jurisdiction imposing the LCR, that compete with the subsidized inputs. For these reasons, the ASCM prohibits the use of such subsidies.

There are other subsidies and government interventions in the marketplace that have the potential of creating similar negative externalized effects, or of creating such harm to global welfare, that they should be prohibited. Because the negative effects are externalized (or at least spread globally) rather than felt mostly among the relevant government's constituency, there is little internal political incentive for the government to act for the global good. Therefore, disciplines on such actions may need to come from multilateral processes.

Mindful of the economic counter-arguments, we thus suggest that the following areas be considered for subsidy prohibition purposes, and that the definition of subsidy in these instances be expanded from that found in the ASCM to include other forms of government intervention in the market that have similar economic effects as subsidies—for example waivers of regulations imposed for environmental, labour or safety reasons. At a minimum, such subsidies should be subject to soft law disciplines, such as codes of conduct, even if outright prohibition is not possible.

3.2.1. Locational subsidies

Locational subsidies cover a wide spectrum of actions designed to attract investment (in goods and services) from elsewhere to the territory of the authority providing the subsidy. Such locational subsidization can lead to wasted resources. They are pervasive in the United States, in particular at the state and local levels, with estimates ranging into the tens of billions of dollars a year.¹¹ In practice, virtually no significant investment is made in the US, either by foreign or local investors, without some form of locational subsidy (which the recipients often increase by starting false competitions between two or more sub-federal territories). The practice is widely recognized as a bad idea (waste of resources), and there have been sporadic attempts by subsets of states to stop the “arms race” (and similar anti-poaching clauses among Canadian provinces and Australian states, as well as EU enforcement against some member

state subsidies). Such agreements in the US rarely survive even the first tempting possibility.¹²

While theoretically US government policy-makers, particularly in the Treasury and the White House Council of Economic Advisors, should strongly support the concept of discipline, politically these practices are probably untouchable because they are seen as the main tool of economic development at the state and local levels. Local politicians would be reluctant to surrender this policy tool because doing so would deprive them of a politically popular practice. As many federally elected officials start their careers as local representatives, they are sympathetic to the local level desire to retain this policy space. Other countries, such as Canada and EU members, also face competition among their sub-federal jurisdictions that result in the use of locational subsidies, with effects similar to the US. These subsidies can be also used to “poach” investment across national boundaries.

Locational subsidies, particularly within a country, might originally have had some economic development reasoning (although, perversely, the poorest jurisdictions end up giving the most money to companies), but most of that has long since disappeared. Companies now use them in a purely cynical exercise to extract money from governments or, even worse, to eliminate regulatory requirements (e.g. environment, labour, safety). Because the most important subsidy offered by US states and municipalities are holidays from taxes that support local education, they may well be self-defeating. Nevertheless, the states and localities find it impossible to unilaterally disarm in the subsidy battle. An international prohibition of such subsidies would be beneficial to all, by providing political cover for an action that would appear to make economic sense. Failing that, they could be presumed to cause the adverse effect necessary for discipline, along the lines of the defunct ASCM, Article 6.1.

Locational subsidies cover a wide spectrum, ranging from explicitly described subsidies to attract outside investment to almost any government action or inaction (e.g. loosening regulatory controls) that will attract industry (since politicians will learn to avoid the explicit subsidies if they are banned). The difficulty thus arises in defining a locational subsidy with enough specificity to be identifiable, but also sufficient generalization to capture a range of locational investment incentives or permissible regional development subsidies. One possible definition would be: subsidies dependent on a specified company building a new or expanded facility; or, subsidies dependent on a target company staying in an existing facility for a period of time (or indefinitely).

In addition, because there are a number of practices that can have this effect yet fall outside of the ASCM's subsidy definition, it may be desirable to employ a broader definition of the term to include other government actions that

¹¹ The website Subsidy Tracker at www.goodjobsfirst.org offers numerous examples in the US.

¹² For example, a formal written compact signed by New York, New Jersey, and Connecticut fell apart when the three states competed for the headquarters of Mercedes Benz; which is now leaving the “winner,” New Jersey, for Atlanta, Georgia.

have a similar effect, such as regulatory waivers, to avoid detrimental competition to attract business. The definition would encompass subsidies otherwise permitted, such as environmentally desirable or regional development subsidies, when those subsidies are used for “factory stealing.” It would also include subsidies provided by all levels of government. Research is needed to see how these issues have been handled in federalized systems worldwide.

3.2.2. Fossil fuel subsidies

This category consists of subsidies that encourage the exploration, production or use of fossil fuels. One problem with such subsidies is that they encourage the depletion of a non-renewable natural resource for which unforeseen uses may be found in the future. At the same time, use of these resources leads to greater greenhouse gas (GHG) emissions. They therefore encourage the production and use of substances in a manner that can lead to lasting negative environmental (and potentially economic) consequences globally. The issues surrounding these subsidies are similar to the “commons” concerns discussed in Section 3.2.3 below.

An immediate stand-alone (phase out and) prohibition of fossil fuel production subsidies should be pursued, leading to an eventual ban on all fossil fuel subsidies while taking account of the impact of consumption subsidies on poor people (although much of the benefit often goes to wealthier consumers with more cars, larger homes, etc.). First steps could include better notification and peer review (within the OECD, for example, although it may be necessary to go beyond government-based notifications as discussed in section 4.6).

Climate change is a high priority global problem that cannot be solved solely at a national level. Fossil fuel subsidies can include government action or inaction, which makes investment in production, distribution or consumption more economically attractive than otherwise, with the adverse effect presumed. Enforcement can be through the “normal” mechanisms described in section 4 below, and with reverse notification by governments or private parties. Remedies should not allow countries to “buy their way out” with cash, tariffs or other compensation (as is possible in WTO disputes).

3.2.3. Other resource-depleting subsidies

At issue here is what has been called the tragedy of the commons. As identified by Garrett Hardin (1968), citizens acting independently and rationally according to their individual self-interest will behave contrary to the interests of the whole by depleting common resources. Examples of commons include fish stocks, forests, air, water and biological diversity. The effect of subsidies on over-fishing, for example, has been widely studied (OECD 2006; and UNEP 2011). Because subsidies for environmentally harmful

economic activity enhance the likelihood that individual countries will seek to externalize the costs of that depletion, this is an area that may need specific and strong disciplines. The fossil fuel subsidies addressed above also fall under this category.

Nevertheless, there are several considerations in taking such an approach. First, one must be careful not to define the category too broadly. Another difficulty is how to identify subsidies of this kind. There are many different forms these subsidies can take, with differing effects on the commons, local economies and development. For example, the Gordon-Schaefer model adapted by Sumaila et al. (Tipping 2015) shows that some fishing subsidies increase fishing effort and direct costs. Therefore, the requisite discipline for different categories of issues and impacts related to the commons will vary.¹³

Disciplines could include a prohibition of the most egregious subsidies—those that are most likely to expand the range of commons-harming production. For example, in the fisheries sector, subsidies to capital costs, variable costs and price supports (unaccompanied by production restrictions) are among those having the greatest negative impact (UNEP 2011). Under this approach such subsidies would be prohibited.

We would propose a combined approach to disciplining such subsidies: a hard law prohibition of specific types of subsidies that are most likely to increase over-production or otherwise encourage the expansion of resource-depleting activities, combined with a recognition that most other subsidies would be actionable (i.e. subject to discipline if harm to another country’s economic interests can be demonstrated). It may be that for particular activities there are subsidies that encourage desirable economic behaviour—such as the scrapping of fishing vessels under certain conditions (e.g. to prevent reuse or replacement for fishing). If such is the case, these subsidies could be placed in the permissible category.

These hard law approaches should also be accompanied by soft law approaches. For example, in industries where access to the resource is within an individual country’s control (e.g. fishing rights in territorial waters or the right to harvest lumber within the country’s borders), agreements to subject access to strict environmental controls could be established—this could include catch limits for fishing boats and sustainable forestry requirements for lumber.

If certain forms of subsidies are prohibited as suggested, then a process needs to be developed wherein challenges to a country’s provision of prohibited subsidies can be addressed. Perhaps the best approach is binding arbitration, with a requirement that all subsidies found to have been provided must be terminated and those already paid out be returned with interest.

¹³ For recommendations specifically tailored to fishing subsidies see the policy options paper produced by the E15 Expert Group on Oceans, Fisheries and the Trade System.

3.2.4. Export-contingent subsidies

There is a long history of identifying such subsidies as harmful. While on a macroeconomic basis such subsidies bring costs to the country of provision, theoretically by lowering the price of the exports and therefore the revenue earned from such exports, while benefitting the consumers of the exported goods abroad (Sykes 1989), on a microeconomic level they harm those industries that compete with the subsidized goods. As such, export subsidies are frequently viewed as the form of subsidy that has the most distortive effect on trade and they have consequently long been prohibited in one form or another. The ASCM has reduced, if not eliminated, the use of export subsidies by the larger trading countries. It is our view that such discipline should stand. On the whole, the procedures and remedies already in place appear to be adequate with respect to export subsidies.

3.2.5. Domestic content subsidies

The ASCM was the first agreement to prohibit the provision of subsidies, receipt of which would be contingent on the use of domestic over imported goods. “Domestic content” subsidies distort cross-border trade by restricting imports and they can reduce the efficient allocation of resources and stifle innovation. Therefore, there are good grounds for prohibiting these types of subsidies, yet there are problems with the existing approach.

First, WTO panels and the Appellate Body have interpreted this prohibition narrowly, finding that a domestic content requirement is acceptable if it could be satisfied through labour and services. But there is nothing inherently less trade distortive in requiring the use of domestic services than there is in requiring the use of domestic goods. With the increasing growth of trade in services globally, a prohibition limited to the cross-border trade in goods is out-dated. Second, it is fairly simple to have an implicit local content obligation without making it explicit. Such an implicit condition is difficult to discipline, as discussed in section 4.2 below.

3.2.6. The legacy of Article 6.1 and Annex IV of ASCM

Article 6.1 of ASCM created a presumption of prohibition for certain horizontal types of subsidies (e.g. thresholds above 5% of a product’s value, operating losses, debt forgiveness), with some details in Annex IV. That may be a useful negotiating tool for increasing discipline, although it may be too blunt an instrument for the different areas highlighted in this paper. As with Article 8 on non-actionable subsidies, Article 6.1 was rarely used and expired in 1999 via a sunset clause. For subsidies which are agreed to be undesirable, it represents a possible softer approach to prohibition and is perhaps more easily achievable as a first step.

3.3. Are Services Different?

While Article XV of the WTO General Agreement on Trade in Services (GATS) provides for negotiation on the appropriateness of subsidy discipline, to date these negotiations have been unable to reach consensus on whether disciplines should be in place or what form they should take. As with trade in goods, there are arguments for and against the use of subsidies in services. Many developing countries are concerned that the main providers of subsidies are developed countries with more resources to offer and that those subsidies hinder the ability of developing countries to enter service sectors. At the same time, many countries (developing and developed) wish to maintain “policy space” to “nurture” domestic service providers. Thus, subsidies discipline could act as a barrier to development. Another concern is that services subsidies potentially have a multiplier effect, given that the production, distribution and transportation of traded goods is dependent on services. Finally, subsidies in the service sector (as with subsidies to goods) can have negative environmental effects. For example, subsidies to the tourism industry could lead to the over-exploitation of natural resources (Benitah 2005). In contrast, there are also concerns that discipline might prevent the use of subsidies even where the effect is either trade neutral or used for goals other than to incur a trade advantage. These could include subsidies applied to correct market imperfections arising from high entry costs or difficulties in access.

In the course of negotiations in the 1990s in the Working Party on GATS Rules, various countries suggested that a definition of subsidy extending beyond the “financial contribution” requirement of the ASCM would be appropriate for any services discipline. Yet they also expressed concern with carefully delineating how “injury” or “harm” from another country’s services subsidies would be determined.¹⁴

The role of services in trade has been especially prominent since the expansion of global value chains (GVCs). As Hoekman (2015) explains, this suggests the need to look at goods and services together, perhaps initially under a plurilateral arrangement.¹⁵

In sum, the scope for some form of services subsidies discipline should be explored. This should comprise further discussion on whether the definition of a subsidy should be broadened beyond that of “financial contribution” to include: the provision of monopoly rights and other restrictive trade practices that can be shown to exert harmful effects on trade and investment in services; and, as Sauv e and Soprana (2015) propose, domestic regulatory actions with subsidy-like properties. However, given the likely controversial nature of the issue, any discipline that is imposed should be multilateral in nature with the question of harm or injury to be determined by a neutral panel that

¹⁴ See, for example, Communication from Chile: The Subsidies Issue, S/WPGR/W/10 (2 April 1996).

¹⁵ Article 1.1(a) of ASCM defines a subsidy to include the provision of goods or services at less than adequate remuneration.

includes at least one expert in the sector under review. A problem with developing effective disciplines for subsidies to services is the variation in methods for delivering services as reflected in the four modes established in the GATS for services commitments. Perhaps discipline could be established along the same lines, either as part of the initial commitments or through additional commitments under GATS, Article XVIII. The first step, as Sauv  and Soprana note, is the need for much better data allowing for a more informed mapping of the nature and sectoral incidence of subsidy practices and their differing use across country groupings. Absent further progress at the WTO, the Trade in Services Agreement (TiSA) process could be enlisted to gather this data as part of the negotiation or thereafter.

3.4. Everything Else

The subsidies that do not fall into either the non-actionable or prohibited boxes outlined in sections 3.2 and 3.3 are subsidies that consensus indicates may be permissible yet actionable. If it is demonstrated that others (or the public good) are harmed by their use, recourse to remedy should be possible. The most likely type of process to be acceptable in this instance is one similar to that currently provided for in the ASCM (as discussed in section 4 *infra*).

Box 1: Revisiting the Concept of Specificity

A. The Benefit Debate

It may be worth revisiting the debate in the early 1980s about whether the test of a subsidy should be if there is a “benefit” to a recipient or a “cost” to a government. It is questionable how serious the debate was (when the EU began advocating the “cost to the government” test in defence of countervailing duty (CVD) cases in the US, its own countervailing duty regulation used the “benefit to the recipient” test for soft loans for example).¹⁶ However, at a deeper level, this debate requires a consideration of what is the “effect” of the subsidy. This recalls the argument that government should be left policy space in general to subsidize as long as there is no underlying effect outside its own country.¹⁷ Is there a universe of government activities with no effect outside the border?

The concept of “specificity” (if not its current application by national authorities or the Appellate Body) tries to capture this thought: are there government activities that would not affect comparative advantage within its own territory? At the other end of the spectrum: are there “benefits” which enterprises receive that are not readily

captured or calculated? The alleged US government subsidy to Fannie Mae, from the (unwritten but expensive) implicit or assumed guarantee by the US Treasury was readily calculated (but not without controversy). Could subsidy disciplines be applied to designated “national champions” such as the President’s son’s automobile company in Indonesia beyond identified financial assistance because of the designation itself?¹⁸ Once again, specificity may be a useful tool. If the President has a lot of relatives running national champion companies, does that sufficiently dilute or eliminate the impact on comparative advantage within the country? If China’s catalogue lists more than 400 industries in almost every possible area, are they all national champions?¹⁹

B. Specificity – Is this Requirement Still Needed?

Specificity arose in the context of US countervailing duty law (Horlick 2004). It was viewed as necessary on at least two grounds. First, broadly distributed subsidies were thought not to favour a specific industry (i.e. to distort comparative advantage within a country).²⁰ Second, in practice, it was necessary to filter out subsidy allegations that would affect virtually all products, including normal government functions such as roads, schools, police protection and so on (especially since, at the time, no injury test was required under US countervailing duty law against most countries, which meant that one finding of subsidy could be replicated simply by copying the last decision and applying it to every other product from that country).

It is worth re-examining the issue as part of a wholesale reassessment of subsidies.

Specificity has several problems:

- There is no obvious “bright line” test for specificity beyond “you know it when you see it.” This leaves open the possibility of biased application, such as the politically motivated change of position on specificity from Softwood Lumber I to Softwood Lumber II when the facts had not changed, as well as the Department of Commerce’s finding (upheld by the Appellate Body) that more than 400 industries in China are specific because they are specifically named in a list—in contradiction to the Commerce regulation (19 CFR 351.502(d)) that agriculture by itself is not specific. This problem can be solved in good part by a neutral decision-maker with experience in cases.

¹⁶ Council Regulations (EEC) 3017/79 of 20 December 1979, 1979 O.J. (L339) 1-14; as amended by Council Regulation (EEC) 1580/82 of 14 June 1982, 1982 O.J. (L178) 9.

¹⁷ This is quite separate from whether special policy space might be needed for certain types of subsidies, for example where the effect is on a global commons.

¹⁸ Indonesia – Certain Measures Affecting the Automobile Industry, WT/DS54, 55, 59 and 64/R (adopted 23 July 1998).

¹⁹ See the Appellate Body ruling in United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China, WT/DS379/AB (adopted 25 Mar. 2011)

²⁰ EU competition/state aid law at the time (but not EU countervailing duty law) had a similar concept, “selectivity.”

- Most problematically, politicians, business people and lawyers facing the specificity doctrine for the first time intuitively reject it (“you mean if one person gets it, it’s a subsidy, but if everyone gets it, it’s not a subsidy to the first person?”), as reflected in the US decision *Cabot Corp. v. U.S.* (9 C.I.T. 489, 620 F. Supp. 722 (1985)) but later modified in *PPG Industries, Inc. v. U.S.* (11 C.I.T. 344, 622 F. Supp. 258 (1987)).
- There is a significant big-country, small-country (or big-economy, small-economy) problem, as smaller economies will inevitably have fewer industries than big ones, and thus appear more specific. So far only one case has raised the issue of “diversification of the economy” from ASCM, Article 2.1(c), and unsuccessfully at that, although a recent Appellate Body decision suggests that more such cases are on the way. Perhaps one option is to place the burden on the decision-maker to prove the limits of the economic diversity on the basis of positive evidence.
- Many resource-depleting energy subsidies could well be non-specific (e.g. furnishing cheap fossil fuel to a wide variety of industries) but so could renewable energy.

However, if specificity were to be eliminated, some sort of substitute would probably be necessary. Possibilities could include:

- A better economic measure of the effect of the subsidy, to take into account the economic effect of very broadly used subsidies with floating exchange rates. Or comparison with subsidies to the complaining industry. But this would eliminate the “filter” effect necessary to prevent an unlimited number of cases of “normal” government functions being investigated.
- *A priori* exclusions of government functions, such as education, roads and so on, would not solve the problem as a “positive list” would be extremely long and difficult to negotiate, while a “negative list” protecting “normal government functions” would simply require case-by-case adjudication of the same sorts of issues.

4. Process: Monitoring and Next Steps

The procedures for establishing, monitoring and resolving disputes for the different types of subsidies categorized in section 3 would not necessarily be identical, although there would be certain commonalities.

4.1. Who Decides?

The issue of who decides can be fraught. The ASCM takes a mixed approach. The multilateral dispute resolution process provided for in the WTO reflects the goal of having a neutral decision-maker determine whether members' interests have been harmed through the use of subsidies. The ASCM also allows for national decision-makers in the form of countervailing duty actions. When such a unilateral approach is taken, however, there is an inherent tendency in the decision-maker towards a protectionist bent. Moreover, only large market economies can use countervailing duties effectively (Clarke 2015). Thus, we consider that a neutral decision-maker is preferable.

4.1.1. Neutral decision-maker

There will always be “boundary” issues to be adjudicated. For example, if subsidies that aim to support “green energy” are treated differently, someone will have to decide in specific disputes about whether the object fits within the definition in the text of “green energy.” As another example, if there is a specificity rule, someone will have to decide if the programme at issue is specific or not. The advantage of a neutral decision-maker is that one can apply a broader definition of subsidy (i.e. one that encompasses more subsidies) that would discipline more effectively, because a neutral decision-maker is less likely to apply such a definition in a protectionist way than would national authorities.²¹ The WTO dispute settlement process is designed to establish neutral decision-makers for disputes, but the limited use of the process for subsidy complaints indicates that other options should be considered.

One possible neutral decision-maker would be the Permanent Group of Experts as established in ASCM, Article 24, or a similar multinational group of people with expertise. This has worked sufficiently well with the WTO Appellate Body and some of the PGE groups have been highly qualified. The following matters, however, would need to be addressed.

- Who could ask this new expert group (PGE) about a subsidy (WTO members, non-member governments, non-governmental organizations, individuals, direct competitors, upstream or downstream affected industries, etc.)?
- What remedies would the PGE have available (see section 4.3 below)?
- How could a set of procedures be set up to enable the processing of a large number of complaints (and very rapidly)?

Another option might be to use existing arbitration practices. Some disputes (possibly concerning prohibited subsidies) could be subject to binding arbitration. These arbitrations should be established on an expedited basis; perhaps with a 30-day consultation period between the disputing nations followed by a 90-day arbitration. Any damages found would be enforceable under the New York Convention on the Recognition of Foreign Arbitral Awards among signatories.

4.1.2. Unilateral decision-maker

The ASCM provides for unilateral subsidy discipline actions in the form of countervailing duties and outlines rules for how such actions are to be undertaken. Nevertheless, experience has proven that the rules allow sufficient leeway that decisions on the same subsidy will vary from country to country. As noted, the most important problem is that the administering authorities of such countervailing duties, even when they begin as neutral fact finders, tend to develop a protectionist bias over time.

These inherent problems argue for the elimination of a unilateral option. If, however, this proves to be politically untenable, the current system should (at a minimum) be re-examined and adjusted to apply to only the narrowest definition of subsidy and with tweaks to how the benefit is determined (perhaps as discussed in Box 1). Moreover, if unilateral measures are not eliminated, attention should be paid to establishing rules that would result in more neutral decision-making, such as offsetting only the effect of subsidies in excess of the subsidies received by competitors in the importing country. In addition, national decisions must be subject to a binding dispute resolution that is much faster than the current WTO system—beginning with initiation of a case when the commercial damage begins and restoring the status quo *ante* for the exporter (if it wins),²² unlike the current system that does not even repay the illegally collected duties in CVD cases.

4.2. Questions of Proof

The existence of most subsidies is not a secret—the governments (and politicians) providing them typically want political credit for handing them out.²³ The main exception seems to be questions surrounding whether a government covertly “directed or entrusted” the subsidy. An example would be the *Korea-DRAMs* national CVD cases and then the Korean challenges to those countervailing duties at the WTO. A close reading of the decisions seems to indicate that the Appellate Body allowed importing countries to consider the alleged subsidy to have been directed by the Korean government even though there seems to be no direct evidence of that involvement—“they knew it when they saw it.” If the goal is discipline on subsidies, then one would want a similarly relaxed standard of proof in such cases; while if one fears protectionist use of countervailing duties, then one would wish for a more normal standard of evidence, or possibly even the “positive evidence” required (albeit frequently ignored) under ASCM, Article 2.4, for findings of specificity. This, in turn, underlines the need for neutral decision-makers, who may be better trusted with the looser standards.

The same issue occurs with the question of “public body” if the definition is stretched too far. A recent US Department of Commerce decision that a military pension fund is a public body because its board of directors includes a high proportion of government officials (the military officers, active or retired, whose pension funds are at stake, with no evidence of government direction) may reflect more a problem with the notion of public body (if the decision is eventually challenged, then a question of proof will arise).

A similar problem arises from the implicit “local content” requirements probably occurring with almost all subsidies, precisely because such local content requirements would create a prohibited subsidy under ASCM, Article 3.1(b). Sometimes the political bargaining requires that these be made explicit.²⁴ More typically, however, those requirements are implicit—companies receiving the money know that it would be politically unwise to spend substantial portions of it on imported inputs. Presumably this is more a problem for large economies than small ones (where the voting population is more likely to understand the need for imported inputs), but it is understandably a difficult topic to research. Perhaps the answer is that a neutral decision-maker be given a certain degree of latitude (as well as the power to obtain facts or use adverse inferences).

The more general problem is that all (or almost all) subsidies have implicit “strings attached,” which typically reduce the value of the subsidy. For example, although local content subsidies are prohibited by ASCM, Article 3, the economic reality is that the trade they distort is not always (or even mostly) in the product being subsidized, as the LCR raises the cost of producing that good and therefore decreases

competition with unsubsidized competitors to the extent that the value of the subsidy is less than the additional cost (perhaps at that point the subsidy would be refused). The US initially recognized that the net value of the subsidy could be less than the gross value, but subsequent, more protectionist authorities in the US and elsewhere ignore this fact. The ASCM recognizes it only to the extent of “application fees, etc.”—the cost of which is trivial compared with “strings” such as keeping a plant open, employing too many workers, and so on. Most often, the value of the subsidy exceeds the value of the “strings” (or else the subsidy would not be taken) but it can be considerably less than the gross value.²⁵ Of course, measuring the value of those strings should be subject to a very high standard of proof, since the information is often hidden and almost invariably in the hands of the recipient of the subsidy.

4.3. Remedies

The remedies currently available for questions of subsidies discipline depend very much on the venue. At one extreme, the EU system—including the Court of Justice of the European Union—in most cases seems to be able to require the repayment of the subsidy and make it stick. At the other end, there are agreements among sub-central entities in the US not to compete for locational subsidies, which, so far, have almost invariably dissolved in the event of the contest for new investment.

To date, the WTO system does not seem to have been able to ensure repayment of subsidies (*Australia-Leather*), and in at least one case the two parties formally agreed not to comply with the rulings (*Brazil/Canada-Aircraft*). In another case, one member paid a large monetary compensation (but considerably less than the amount of the subsidy) instead of complying (*US-Cotton*). At most, the current system seems to be able at times to stop the future or continued granting of subsidies, but clearly has not been able to deal with large “one-time” subsidies granted prior to a dispute. Moreover, the possibility in the WTO system to provide compensation instead of complying with an unfavourable decision confers an advantage to richer countries that are able to buy their way out of decisions that have unfavourable political consequences at home—an option not available to poorer countries.

4.4. Definitions of Subsidy

A wide range of subsidies are not subject to current disciplines almost by implication. These include:

- Most obviously, non-specific subsidies (discussed in section 4.4.2);
- Subsidies that do not cause adverse effects or serious injury are subject to minimal discipline under the ASCM (in the form of notification requirements) unless they fall into the “prohibited” category—a narrow category including only export-contingent subsidies and subsidies contingent on the use of local goods (but not services);

- Perhaps more seriously, subsidies that do not cause “trade injury” but which harm the global commons are not disciplined under current subsidy discipline systems (although there may be other constraints on their use such as environmental standards).

There are a number of other subsidies that are also excluded from discipline, including those that fall outside the ASCM definition of subsidy, which we now briefly discuss.

4.4.1. Regulatory distortion

The most obvious exclusion from the ASCM is “regulatory distortion.” As conveyed in section 2 *supra*, this is probably a bridge too far to discipline comprehensively.

4.4.2. Cross-border subsidies

To date, cross-border subsidies as such have not been subject to specific discipline. An example would be a subsidy to Company A that operates in Countries 1 and 2. If the subsidy has no conditions (i.e. it is not “tied” to Company A operations in Country 1), then the subsidy would be allocated over all the operations of Company A (probably by dividing the annual value of the subsidy in some currency unit by the net turnover of Company A in both countries) to yield a value which could be applied to the product exported from Country 1 (and a complaint is brought to the WTO or for a countervailing duty against exports by Company A from Country 1). This concept has been codified, with certain exceptions, in the US countervailing duty regulations in 19 CFR 351.527, which states that a subsidy does not exist if the funding was provided by a government of a country other than the country in which the recipient firm is located or by an international lending or development institution.

The vast expansion in cross-border production (involving global value chains) requires some thought as to whether the mechanical approach described above is the best. The underlying assumption is that Country 1 would never subsidize activity outside its own borders. Is that still the case? Assume instead that the subsidy is from Country 1, but the export is from Country 2. Assume further that the exported goods involve no input imported from Country 1. Would that justify a countervailing duty case or WTO case (brought by Country 3) against Country X? Assume further that Country 3 does not produce the product at issue, but is only the corporate headquarters for Company B, a competitor of Company A.

The current agreement does not prevent applying discipline to cross-border subsidies (except perhaps through the specificity definition in Article 2.1). The Airbus case before the WTO raised this issue implicitly as it considered subsidies from four countries within the EU, but the issue was not raised explicitly (i.e. the EU did not challenge the applicability of subsidy disciplines to the four countries on those grounds). Moreover, some countries’ countervailing duty practices allow duties in response to cross-border subsidies in certain instances (such as the US provisions for “international consortia”), but such cases are unusual.

Therefore, the growth of GVCs argues for a full analysis of the impact of such cross-border subsidies and consideration of how, or whether, they should be disciplined.

4.4.3. General infrastructure

“General infrastructure” is excluded from the ASCM in Article 1.1(a)(1)(iii). The boundary issue inevitably arises. Can a road be a “specific” subsidy?²⁶ Are port facilities a specific subsidy?²⁷ The decision on specificity may also be a decision on benefit, with the measurement being the difference between the specific and the non-specific. The existence of boundary issues is not fatal: there is no mathematical formula for specificity (as with causation) but rather a need for neutral decision-making.

One could make the argument (similar to environmental subsidies) that general infrastructure subsidies have positive externalities and should be non-actionable. Another point, from the perspective of developing countries, might be that while developed countries have already built their infrastructure, they seek to discipline countries that are at an earlier stage of infrastructural development.

Box 2: Big and Rich vs. Small and Poor Country Issues

In general, wealthy countries can give more subsidies than poor nations. Some emerging countries, such as Brazil, China, and India, now have enough money at a national level to provide large subsidies. What is sometimes less appreciated is that only large markets have the ability to do much about other countries’ subsidies. While any WTO member can utilize the dispute settlement process against another members’ subsidies, in practice relatively few countries have done so and they tend to be the overwhelmingly large and relatively well off. Only Brazil, Canada, Korea, Japan, the EU and US have successfully litigated against other members’ subsidies.

More importantly, only large markets have the retaliatory capacity to force meaningful action after winning a WTO case against subsidies. As seen in the case of U.S.-Gambling (a non-subsidy case), even the threat of cross-sectional retaliation against intellectual property rights has been insufficient to move a large member such as the US, because the retaliation likely to be authorized will not be sufficiently large. This situation is even more pronounced with respect to countervailing duties. While a total of 21 countries have initiated countervailing duty investigations, in practice the calculation of a large WTO member (or recipient company of a large member) is to take the subsidy when the only threat is to pay back a tiny share in a countervailing duty imposed by a small member.

²⁶ Softwood Lumber from Canada, 70 Fed. Reg. 73,448 (Dec. 12, 2005).

²⁷ Groundfish from Canada, 51 Fed. Reg. 10,041 (Mar. 24, 1986); and AK Steel Corp. v. U.S., 192 F.3d 1367 (Fed. Cir. 1999).

Further, on the supply side, a small member is likely to have a narrower range of industries and is thus more likely to be found providing “specific” subsidies, notwithstanding the language in ASCM, Article 2.1(c), concerning “economic diversification.” The same is true for Footnote 3 in ASCM, Article 3, but in the other direction. In theory, Footnote 3 suggests that small countries can give subsidies that in effect are contingent on export; because the smaller the country the more likely it is that the vast bulk of production will be exported. Yet this presumed advantage has been wiped out by the broad reading of Footnote 3. For example, Canada in the Aircraft case²⁸ argued successfully that a subsidy to a product where over 90% of the production would be exported is protected by Footnote 3, which means that only very few countries are not thus protected.

4.5. How to Get There

It may seem surprising to be thinking about changes in current subsidies disciplines given the general stagnation in WTO rules negotiations and the relative lack of interest in making major amendments to the ASCM in the ongoing Doha Round (except with respect to fishing subsidies). Nevertheless, the issue deserves renewed attention and effort.

Interpretation of the ASCM by the Appellate Body would appear unlikely to bring about major change, as the Appellate Body in the best of cases is (mostly) trapped by the existing text. What about renegotiating the text to focus on economies big enough and rich enough to give large subsidies that affect international trade significantly? A lot of time and energy in the Uruguay Round was spent worrying about how to limit subsidies by countries too small to have an impact.

Are there approaches outside the WTO that could work? At first sight, no other organization covering most countries seems likely to tackle the issue. But this is misleading—it is almost certain that changes will be made in subsidy disciplines in the course of high-level negotiations over climate change, and, perhaps, disappearing fish stocks. However, the likelihood of this being done in a way that fits smoothly within the WTO system is low, unless the WTO *ex-post facto* waives whatever inconsistencies occur.

Gregory Shaffer et al. (2015) offer some promising soft law alternatives. The OECD export credit arrangements have been reasonably successful at achieving recognition of the rules and reaching compliance, although the rules are not as hard as WTO rules. Greater transparency would help. However, even widely publicized lists of subsidies have at best a mixed record in obtaining reform.²⁹

4.6. Data Collection

Getting better data is a key next step for the subsidies discipline debate. At present, the data is sparse, ad hoc and unreliable. The formal intergovernmental notification process has not produced the necessary breadth or depth of information about subsidies. It is unlikely to achieve this end as the people responsible for undertaking the work do not have the time or resources (or the incentive) to produce a deep and consistent set of data that would permit better policy discussions and decisions. The work produced by the OECD is perhaps as good a multilateral government effort as is currently possible. “Reverse” notification (e.g. by competitors or public interest groups) may achieve better results but not in a systematic manner.

While the ASCM encompasses some of the subsidies within its transparency and reporting requirements, experience has found that WTO reporting vastly understates the full extent of subsidization.³⁰ Extending beyond government-based notifications may be necessary.

Additional information (such as that produced in the Global Subsidies Initiative study of Germany) could be obtained through a coalition of universities and independent think tanks around the world (or the Worldstat statistical agency as proposed by the Oxford Martin Commission for Future Generations in 2013). A loose university consortium, supported by funding, could include a variety of institutions using common standards and definitions with graduate students and researchers seeking out the data.

4.7. Concluding Note

Reaching consensus on a comprehensive agenda of the type presented in this paper could firmly position the issue of international subsidies disciplines as an important vector for the improved coherence and effectiveness of the international trade system for sustainable development. This agenda includes revisiting disciplines under the ASCM by creating a category of non-actionable subsidies as well as a category of government support measures subject to absolute or presumed prohibition. It also calls for the formation of some discipline on services subsidies to be explored. In addition, the procedures for establishing, monitoring and resolving disputes should be recalibrated; with neutral decision-making strengthened and the option for unilateral action eliminated or restricted. Policy-makers interested in advancing reform are encouraged to consider these options for discussion and early implementation.

²⁸ Canada –Measures Affecting the Export of Civilian Aircraft, WT/DS70/AB/RW (Article 21.5) (21 July 2000) at paragraphs 48-51.

²⁹ Lists include the farm.ewg.org subsidy database in the US and farmsubsidies.org in the EU.

³⁰ For example, Germany notified 11 subsidies for 2006 to the WTO, worth a total value of €1.25 billion. Yet a case study carried out for the Global Subsidies Initiative of the International Institute for Sustainable Development (Thöne and Dobroshke 2008) identified some 180 specific subsidy programs, worth almost €11 billion, that should have been identified (and there is no reason to believe that Germany is an unusual case).

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Clarke, Peggy A. 2015. *Rethinking Countervailing Duties*. E15Initiative. Geneva: International Centre for Trade and Sustainable Development (ICTSD) and World Economic Forum.

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The papers commissioned for the E15 Task Force on Rethinking International Subsidies Disciplines can be accessed at <http://e15initiative.org/publications/>.

Annex 1: Summary Table of Main Policy Options

Policy Option	Current Status	Gap	Steps	Parties involved
Revisiting International Disciplines				
1. Create a category of narrowly defined non-actionable subsidies with clear boundaries and covering the following types of subsidies				
Subsidies to address climate change and similar environmental issues	Subsidies are actionable. Relatively narrowly defined exceptions for environmental subsidies, envisioned under ASCM, Art. 8.2, expired after the 1999 Seattle Ministerial Conference.	Need to scale up deployment of clean energy, support efforts towards climate change adaptation and address negative environmental externalities.	Difficult “boundary issues” to be handled by a mix of “hard” and “soft” law (e.g. the originally envisioned Permanent Group of Experts in the ASCM) Need to differentiate, for example, between subsidies promoting the use of clean energy from those targeting the manufacture of clean energy.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders (e.g. WTO, UNEP, environmental NGOs, think tanks) Private sector leaders
Regional development subsidies offsetting the additional cost of investment in a particular region compared to the rest of the country	Subsidies are actionable. Relatively narrowly defined exceptions for regional development subsidies, envisioned under ASCM, Art. 8.2, expired after the 1999 Seattle Ministerial Conference.	Many countries, especially developing countries, experience extreme disparities in the cost of investment in different regions and high variations in income and employment opportunities in those same areas. Some financial redistribution may be logical, as well as politically inevitable.	To prevent abuse, such subsidies should be limited to offsetting the additional cost of investment in a region. Another option is to give preference to the poorest countries. Use the type of provisions found in ASCM, Art. 27, to define inclusion and graduation as opposed to self-selection.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders (e.g. World Bank, development think tanks)
R&D subsidies for R&D which would not occur without support and the result of which is publicly available	Subsidies are actionable. Relatively narrowly defined exceptions for R&D subsidies, envisioned under ASCM, Art. 8.2, expired after 1999.	With some R&D, a company cannot expect to capture the full benefits. As a result, companies invest less in R&D than is desirable for society as a whole.	Since the public would be funding such R&D (through subsidies), the safe harbour could require that the results of the R&D be publicly available to any who seek to use it.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders
Natural - or other - disaster recovery (time-limited and not exceeding pre-disaster state)	Subsidies are actionable. Currently no explicit carve out for natural or man-made disaster recovery envisaged under the ASCM.	In recent years, the world has experienced natural disasters of such magnitude that recovery from them requires extraordinary investment. A similar rationale applies to time-limited use of subsidies to allow an economy to recover after certain man-made disasters	Would need to be time restricted, with metrics established to determine when the recovery period has ended. The safe harbour would need to be very specific on the magnitude of the natural disaster that would qualify for such treatment.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders (e.g. United Nations Office for Disaster Reduction)

Policy Option	Current Status	Gap	Steps	Parties involved
2. Expand the category of subsidies that could be subject to absolute prohibition or a presumption of prohibition (such as in the now-defunct ASCM, Article 6.1)				
Locational subsidies to attract investment (in goods and services)	Subsidies currently considered as actionable. Pervasive in the US, in particular at the state and local levels. The emergence of GVCs will exacerbate this trend worldwide. Sporadic attempts to discipline them have proven unsuccessful.	The competition to attract investment can lead to a race to the bottom. While politically difficult, there is a strong rationale for international cooperation to discipline such subsidies.	Focus on subsidies dependent on a specified/target company building a new or expanded facility; or subsidies dependent on a target company staying in an existing facility for a period of time (or indefinitely). May be desirable to use a broader definition than the ASCM to include other government actions, such as regulatory waivers, that have a similar effect.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders (e.g. UNCTAD, civil society organizations)
Subsidies for the exploration, production or use of fossil fuels, taking into account the importance of consumption subsidies for poor people	Subsidies currently considered as actionable. Limited transparency and subsidy reporting. WTO reporting vastly understates the extent of the subsidization that occurs.	Encourage the depletion of a non-renewable natural resource and lead to greater emissions of greenhouse gases. Yet, under current rules, cannot be challenged based on the environmental externalities they generate.	First steps could include better notification and peer review (e.g. within the OECD or G20) Pursue immediate stand-alone phase out of fossil fuel production subsidies, leading to an eventual ban on all fossil fuel subsidies.	Policy-makers interested in advancing reform (e.g. G20) Relevant IGOs and stakeholders (e.g. OECD) Private sector leaders
Other natural resource-depleting subsidies such as fisheries subsidies combining a prohibition of the most egregious ones (capital cost, variable costs, price support) and leaving others as actionable	Same as above	As above, typical illustration of the tragedy of the commons. Need to define hard law prohibition of specific types of subsidies that are most likely to increase resource-depleting activities, combined with a recognition that most other subsidies would be actionable	Pursue multilateral, regional or plurilateral avenues, including through a mix of soft and hard law disciplines, to address specific concerns on subsidies (e.g. sectoral initiative on sustainable fisheries).	Policy-makers interested in advancing reform (e.g. G20, SDG) Relevant IGOs and stakeholders (e.g. OECD, UNEP, FAO)

Policy Option	Current Status	Gap	Steps	Parties involved
3. Establish disciplines on certain subsidies currently not covered by the ASCM				
Establish some form of services subsidies discipline	GATS negotiations on the appropriateness of subsidy discipline have been unable to reach consensus on whether or what form subsidy discipline for services should take. Significant lack of data and transparency on services subsidies.	As with trade in goods, services subsidies can generate trade distortions but may also be used to correct market imperfections and ensure the delivery of certain public goods	Start with collection of better data. Definition of subsidy and potential remedy would have to be adjusted to account for the different nature of services trade and the different modes of delivery.	Policy-makers interested in advancing reform Relevant IGOs and stakeholders (e.g. OECD, World Bank, GTA)
Establishing, Monitoring, and Resolving Disputes				
4. Strengthen the role of a neutral decision-maker in the resolution of subsidies related disputes.	ASCM takes a mixed approach involving both a neutral decision maker (e.g. WTO Panel) and national decision maker (e.g. countervailing duties)	When a unilateral approach is taken, there is an inherent tendency in the decision-maker towards a protectionist leaning. Moreover, only large market economies can use countervailing duties effectively.	Establish a multinational group of experts as neutral decision-makers (e.g. Permanent Group of Experts in ASCM, Art. 24) Use expedited arbitration procedures with some disputes (perhaps concerning prohibited subsidies) subject to binding arbitration. Re-examine the question of proof, benefit, remedies, specificity and the impact of cross-border subsidies in a world of global value chains.	Policy-makers interested in advancing reform WTO members
5. Eliminate the option for unilateral action (e.g. countervailing duties) or at least constrain and make it more restrictive.	The ASCM provides for unilateral actions in the form of countervailing duties and provides rules for how such actions are to be undertaken.	Same as above	Redefine how the notion of benefit is determined Limit countervailing duties to offsetting only the effect of subsidies in excess of the subsidies received by competitors in the importing country.	Policy-makers interested in advancing reform WTO members

Policy Option	Current Status	Gap	Steps	Parties involved
6. Generate better data on subsidies through a consortium of universities/ independent think tanks	Data on subsidies and subsidy notification sparse, ad hoc, incomplete, and unreliable.	<p>The intergovernmental notification process has not produced the necessary breadth or depth of information about subsidies, and is unlikely to due to lack of resources and incentives.</p> <p>“Reverse” notification (e.g. by competitors or public interest groups) does better, but not in a systematic manner.</p>	Establish a loose university consortium including a variety of institutions around the world using common standards and definition with graduate students seeking out the data.	Consortium of universities and independent think tanks, supported by funding.

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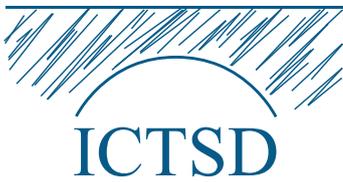
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