

WTO Research Series No.2

# ICRIER

## Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement

Anwarul Hoda  
Rajeev Ahuja

July 2004



**INDIAN COUNCIL FOR RESEARCH ON INTERNATIONAL ECONOMIC RELATIONS**

Core-6A, 4<sup>th</sup> Floor, India Habitat Centre, Lodi Road, New Delhi-110 003, [www.icrier.org](http://www.icrier.org)

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## **Abbreviations**

ARO	Advance Release Orders
ASCM	Agreement on Subsidies and Countervailing Measures
AUL	Average Useful Life
BIFR	Board of Industrial and Financial Reconstruction
CCRA	Canadian Customs and Revenue Agency
CIF	Cost, Insurance & Freight
CIRR	Commercial Interest Reference Rate
CVD	Countervailing Duty
DEPB	Duty Entitlement Pass Book
DFRC	Duty Free Replenishment Certificate
DSB	Dispute Settlement Body
DSU	Dispute Settlement Understanding
DTA	Domestic Tariff Area
EC	European Communities
EHTP	Electronic Hardware Technology Park
EOU	Export Oriented Unit
EP	Export Performance
EPCG	Export Promotion Capital Goods
EPZ	Export Processing Zone
EXIM	Export–Import
FOB	free on board
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
GNP	gross national product
GOI	Government of India
HS	Harmonised System
IDBI	Industrial Development Bank of India
IDRA	Industries (Development and Regulation) Act
IFCI	Industrial Finance Corporation of India
IISCO	Indian Iron and Steel Company
ISO	International Organization for Standardization
LDCs	Least developed Countries
LIBOR	London Inter-Bank Offer Rate
NFEP	Net Foreign Exchange as a percentage of Exports
OECD	Organisation for Economic Co-operation and Development
PBS	Pass Book Scheme

PET	Polyethylene Tetraphthalate
PLR	Prime Lending Rate
PSCFC	pre-shipment credit in foreign currency
PSE	public sector enterprise
QRs	Quantitative Restrictions
RBI	Reserve Bank of India
SAIL	Steel Authority of India Limited
SDF	Steel Development Fund
SIDBI	Small Industries Development Bank of India
SION	standard input-output norms
STP	Software Technology Park
USDOC	US Department of Commerce
WTO	World Trade Organization

## **Foreword**

ICRIER's objective is to foster improved understanding of policy choices for India in an era of growing international economic integration and interdependence. ICRIER undertakes research in areas of international economic relations of current and future interest.

The commencement of the new round of multilateral trade negotiations at Doha in November 2001 has brought to the fore a number of issues that impinge on the trade and economic prospects of India as well as its trading partners. In this context ICRIER has undertaken a programme of research to study from India's perspective the approaches being suggested for further liberalisation of trade, the proposals for improvement and clarification of existing rules and the initiatives for developing multilateral disciplines in new areas. The objective is to equip stakeholders and policymakers with full analytical information so as to enable them to take a view on where India's interests lie on each issue and to decide on the positions that India must adopt at the negotiations. The studies would also serve the purpose of enlightening the public at large on various facets of the subjects being negotiated.

This paper, 'Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement', by Anwarul Hoda, Professor, ICRIER and Dr Rajeev Ahuja, Senior Fellow, ICRIER, is part of a series of studies under this programme. The study was funded by the Sir Ratan Tata Trust.

The Doha Ministerial Declaration envisages that the negotiations in the area of WTO rules would be aimed at *inter alia* 'clarifying and improving disciplines under the Agreements on Implementation of Article VI of GATT 1994 and on Subsidies and Countervailing Measures'. This study evaluates the Agreement on Subsidies and Countervailing Measures (ASCM) from the perspective of India and identifies improvements and clarifications that India must seek during the Doha Round.

The ASCM is one of the most complex instruments in the WTO Agreement. The study first analyses the provisions of the ASCM in order to bring out rights and obligations particularly of the developing countries. The study then examines the implementation of the Agreement with particular reference to the treatment that the export incentives and other support programmes, of Central and state governments, have received in countervailing duties investigations in major importing countries. On the basis of this examination, they develop specific proposals and suggestions for improvements and clarifications from the perspective of India.

Arvind Virmani  
Director & Chief Executive  
ICRIER

July 2004





## **Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement**

The Doha Ministerial Declaration that launched a new round of multilateral trade negotiations in 2001 envisages that the negotiations in the area of WTO rules would be aimed at ‘clarifying and improving disciplines under the Agreements on Implementation of Article VI of GATT 1994 and on Subsidies and Countervailing Measures’. The Declaration enjoins that in this exercise ‘the basic concepts, principles and effectiveness of these Agreements and their instruments and objectives’ would be preserved and ‘the needs of developing and least-developed participants’ would be taken into account. This study is aimed at assessing the Agreement on Subsidies and Countervailing Measures (ASCM) from the perspective of the developing countries such as India and identifying the improvements and clarifications that these countries must seek during the Doha Round. It is divided into three sections. Section 1 analyses the provisions of the ASCM, Section 2 assesses that agreement from India’s perspective and describes the experience of India with the implementation of the ASCM, and Section 3 contains the recommendations on clarification and improvements that India must seek.

### **1 The Agreement on Subsidies and Countervailing Measures (ASCM)**

GATT 1947, in its original design, imposed different levels of obligation on the contracting parties on the three main commercial policy instruments, viz. quantitative restrictions, tariffs, and subsidies. Quantitative restrictions (QRs) were prohibited as they are considered the most trade distorting. Tariffs that distort less than quantitative restrictions were permitted, but contracting parties were encouraged to enter into successive rounds of tariff negotiations to bring down the general level. On subsidies, which are considered to be the lowest in the hierarchy of trade policy instruments as far as their trade distorting potential is concerned, the level of obligation was light. The obligation was only to notify and consult if the practice caused ‘serious prejudice’, a concept that was ill defined.

Over the period of almost four decades of the operation of GATT 1947 before the Uruguay Round was launched, the provisions relating to subsidies evolved more than those relating to QRs and tariffs. Following the Review Session in 1955–6, a provision was introduced envisaging a prohibition on the use of export subsidies on manufactured products. A number of industrialised countries adopted a Declaration in 1962 giving effect to this prohibition. Developing countries were not invited to join the undertaking prohibiting recourse to export subsidies. At the Review Session, a weak attempt was made to put some discipline on the use of export subsidies on primary products, but the provision proved to be largely ineffectual during subsequent years. The Tokyo Round resulted in the negotiation of a plurilateral agreement, which was binding only on the signatory developed and developing countries. This agreement tightened the application of disciplines on export subsidies on manufactures and extended the prohibition on export subsidies to primary mineral products. It also introduced detailed rules on the procedures for investigations for imposition of countervailing duties. It was only in the Uruguay Round that a comprehensive attempt was made to elaborate detailed rules that were applicable to all the WTO Members<sup>1</sup>.

The WTO provisions on subsidies and countervailing measures in respect of trade in goods are contained in Articles VI and XVI of GATT 1994, the ASCM, and the Agreement on Agriculture. Articles VI and XVI of GATT 1994 lay down the rights and obligations very broadly and define related concepts like subsidy, export subsidy, material injury, and domestic industry in terms that are susceptible to a wide range of interpretations. The intention in the ASCM (as in its precursor Tokyo Round Subsidies Code) was to bring about greater uniformity in interpretation of these concepts and lend precision and predictability to the rights and obligations.<sup>2</sup> Article 32.1 states that no specific action against a subsidy of another Member can be taken except in accordance with the provisions of GATT 1994, as interpreted by the ASCM. A general interpretative note to Annex 1A to the WTO Agreement adds that in the event of conflict between GATT 1994 and another agreement in Annex 1A (such as the ASCM), the provision of the latter must prevail to the extent of the conflict. Clearly the ASCM provisions have been given a pre-eminent position in the WTO framework in defining the rights and obligations of Members in this area.

However, agricultural subsidies are regulated by the WTO Agreement on Agriculture and the ASCM exempts agricultural products from the applicability of some of its provisions, either permanently or temporarily. Where agricultural products are so exempted, the Agreement on Agriculture applies, as we shall see later.

<sup>1</sup> *The States and territories that are members of the WTO are referred to in the WTO Agreement as Members.*

<sup>2</sup> *See Brazil–Coconut, Panel Report, WT/DS22/R.*

## 1.1 Definition of Subsidy

GATT 1994 talks about subsidies without developing a comprehensive definition of a subsidy. Article 1.1 of the ASCM defines a subsidy and spells out the elements that the concept covers. A subsidy is deemed to exist if there is a financial contribution by a government or any public body, or there is any form of income or price support and a benefit is thereby conferred. An important point to note is that there has to be both a financial contribution from government and the conferral of a benefit in order for a practice to be treated as a subsidy.

The ASCM lists the actions and practices that constitute a transfer of economic resources by government and then gives some examples of these. A financial contribution may occur by means of a direct transfer of funds (e.g. grants, loans, and equity infusion), a potential transfer of funds or liabilities (e.g. loan guarantees), foregoing of government revenue that is otherwise due (e.g. fiscal incentives such as tax credits), or the provision of goods and services other than general infrastructure, or purchase of goods. A financial contribution by the government may also take the form of government making payments to a funding mechanism, or entrusting or directing a private body to carry out the type of functions listed above.

To understand the notion of conferral of benefit one needs to refer to Article 14 of the ASCM, which provides guidelines for the calculation of the benefit conferred to the recipient pursuant to Article 1.1 in an investigation for the imposition of countervailing measures. Government provision of equity capital is not to be considered as conferring a benefit unless the investment decision can be regarded as inconsistent with the usual investment practice of private investors in the country. The provision of goods or services or purchase of goods by a government is not to be considered as conferring a benefit unless the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration. Similar guidelines apply to loans and loan guarantee provided by government. As the WTO panels have noted, Article 14 clearly establishes a commercial benchmark for determining whether there is a conferral of benefit. In *US–Export Restraints*, the panel observed:

‘In our view, the only logical basis for determining the position the recipient would have been in absent the financial contribution is the market. Accordingly, a financial contribution will only confer a “benefit”, i.e., an advantage, if it is provided on terms that are more advantageous than those that would have been available to the recipient on the market.’<sup>3</sup>

One of the basic provisions that existed in GATT 1947 and was carried forward into GATT 1994 stipulates that ‘[t]he exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy’.<sup>4</sup> The ASCM reiterates the continued validity of this pre-existing provision.

While in the ASCM subsidies are broadly defined, not all subsidies fall within the purview of its disciplines. The legal definition of a subsidy in the ASCM is narrower. Only those subsidies are covered which are specific to an enterprise or industry or group of enterprises or industries. The negotiators were particularly anxious to ensure that disciplines were imposed on subsidy practices designed to help specific industrial enterprises or groups of such enterprises and not generally available subsidies designed to achieve wider policy objectives. Where the granting authority or the relevant legislation explicitly limits access to a subsidy to certain enterprises, the subsidy is to be regarded as specific. On the other hand, where objective criteria or conditions are laid down governing the eligibility for a subsidy, specificity is deemed not to exist. It has been clarified in the Agreement that objective criteria or conditions ‘mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise’. It must be observed that despite this clarification some uncertainties remain on how these provisions would be applied. For instance, in order for the measure to be deemed to be non-specific, is it necessary that subsidies are provided equally to the entire goods sector, industrial as well as agricultural enterprises? A separate provision provides that export subsidies and subsidies contingent upon the use of domestic over imported goods must be deemed to be specific subsidies.

## 1.2 Classification of Subsidy

The obligations of Members in respect of subsidies are laid down in the ASCM in terms of what is known as the traffic lights approach—red, green, and amber. Some subsidies are prohibited, others are not only permissible but also immune from action by trading partners, and there is a third category of those that are generally permissible but actionable in certain situations.

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<sup>3</sup> *US–Export Restraints*, WT/DS194/R.

<sup>4</sup> GATT 1994, *Ad Article XVI*.

### **1.2.1 Prohibited Subsidies**

Article 3 of the ASCM puts in the prohibited category two subsidies that cause the maximum distortion to trade, namely export subsidies and subsidies on the use of domestic over imported goods. As noted earlier, a presumption is created that these subsidies are specific subsidies within the meaning of the Agreement. Members are mandated not to grant or maintain these subsidies. An Illustrative List of export subsidies is contained in an annex to the Agreement. The prohibition does not apply to the agricultural products to the extent that they are covered by the Agreement on Agriculture.

Article 3.1 prohibits subsidies that are contingent upon export performance, whether in law or in fact. Footnote 4 sets out the manner in which the *de facto* export contingency of a subsidy must be ascertained. The WTO Appellate Body has provided the following elucidation of the provision on export subsidies in the ASCM:

'In our view, the legal standard expressed by the word "contingent" is the same for both *de jure* and *de facto* contingency. There is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent. *De jure* export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or legal instrument. Proving *de facto* export contingency is a much more difficult task. There is no single legal document which will demonstrate, on its face, that a subsidy is "contingent...in fact...upon export performance". Instead, the existence of this relationship of contingency, between the subsidy and export performance, must be inferred from the total configuration of the facts constituting and surrounding the granting of the subsidy, none of which on its own is likely to be decisive in any given case.

.... We note that satisfaction of the standard for determining *de facto* export contingency set out in footnote 4 requires proof of three different substantive elements: first, "the granting of a subsidy"; second, "is...tied to..."; and third, "actual or anticipated exportation or export earnings".<sup>5</sup>

While the language of Article 3.1(a) of the ASCM explicitly covers subsidies that are contingent on export performance 'in law or in fact', Article 3.1(b) does not mention *de facto* contingency in respect of subsidies contingent upon the use of domestic over imported goods. However, the WTO Appellate Body has ruled as follows:

'The fact that Article 3.1(a) refers to "in law or in fact", while those words are absent from Article 3.1(b), does not necessarily mean that Article 3.1(b) extends only to *de jure* contingency.

Finally, we believe that a finding that Article 3.1(b) extends only to contingency "in law" upon the use of domestic over imported goods would be contrary to the object and purpose of the ASCM because it would make circumvention of obligations by Members too easy.<sup>6</sup>

### **1.2.2 Illustrative List of Prohibited Export Subsidies**

Article 3.1(a), which spells out the conditions under which subsidies become prohibited export subsidies, also refers to Annex I of the ASCM, which contains a list of examples of prohibited export subsidies. A WTO panel has assessed the legal value of the Illustrative List as follows:

'A measure that falls within the scope of the Illustrative List is *deemed* to be prohibited export subsidy. In other words, a Member may establish that a measure is a prohibited export subsidy by going directly to the Illustrative List, without first demonstrating that a measure falls within the scope of Article 3.1(a). This is confirmed from the words "subsidies contingent...upon export performance, *including* those illustrated in Annex I" (emphasis added), which in their ordinary meaning tell us that measures identified in the Annex are *ipso facto* "subsidies contingent upon export performance".<sup>7</sup>

The Illustrative List is fairly detailed and somewhat complex. Four of the 12 items listed, however, are straightforward and they are reproduced below:

- (a) The provision by governments of direct subsidies to a firm or an industry contingent upon export performance;
- (b) Currency retention schemes or any similar practices which involve a bonus on exports;
- (c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments; and
- (d) Any other charge on the public account constituting an export subsidy in the sense of Article XVI of GATT 1994.

<sup>5</sup> Canada–Civilian Aircraft, Appellate Body Report, WT/DS70/AB/R.

<sup>6</sup> Canada–Automotive, Appellate Body Report, WT/DS139/142/AB/R.

<sup>7</sup> Brazil–Aircraft—Article 21.5, WT/DS46AB/RW.

Item (d) on the List deals with the supply by governments or their agencies of imported or domestic products or services for the production of exported goods. Such supply becomes an export subsidy if two conditions are fulfilled. First, the terms and conditions should be more favourable than those for the production of goods for domestic consumption. Second, these terms and conditions should be more favourable than those commercially available on world markets to their exporters.

Five of the items on the list (e, f, g, h, and i) which relate to fiscal incentives interpret the provision in Article XVI of GATT 1994 that the exemption of an exported product from duties and taxes borne by the like product, or the remission of such duties or taxes, is not a subsidy. It came to be recognised over the years in GATT 1947 that indirect taxes were borne by the product whereas direct taxes were not.<sup>8</sup> Consequently, full or partial remission of direct taxes specifically related to exports or the allowance of special deductions in relation only to exports are treated as export subsidies. In the case of indirect taxes, the practice of exemption or remission becomes an export subsidy only if it involves exemption or remission in excess of the taxes levied on the product destined for domestic consumption. Indirect tax rebate schemes in respect of prior-stage cumulative indirect taxes constitutes an export subsidy only if these result in the exemption, remission, or deferral of such taxes in excess of the amount levied on inputs that are consumed in the production of the exported product. Similarly the remission or drawback of import charges in excess of those levied on inputs that are consumed in the production of the exported product constitute export subsidies. Such remission is also permissible in substitution drawback systems in which a firm uses a quantity of home market inputs as a substitute for imported inputs. However, it is provided that the home market inputs must be equal to and must have the same quality and characteristics as the imported product and that the import and the corresponding export transactions must occur within a reasonable period not exceeding two years. In the case of both indirect tax rebate schemes and substitution drawback systems, it is permissible to make normal allowance for waste.

Annexes II and III provide further guidelines for the interpretation of items (h) and (i) of the Illustrative List relating to indirect tax rebate schemes and substitution drawback systems. Besides physically incorporated inputs, energy, fuels and oil used in the production process, and catalysts, which are consumed in the course of their use to obtain the exported product, are considered to be inputs used in the production process. Clearly capital goods are not regarded as being used in the production process even to the extent of depreciation.

WTO panels have pointed out that in respect of fiscal concessions related to exports it is not a valid defence that the measure is intended to level the playing field vis-à-vis foreign competitors. The *Brazil–Aircraft* panel held as follows:

‘In items (e), (f), (g), (h) and (i) of the Illustrative List, all of which relate to exemptions, remissions or deferrals of taxes or import charges, there is no hint that a tax advantage would not constitute an export subsidy simply because it reduced the exporter’s tax burden to a level comparable to that of foreign competitors.’<sup>9</sup>

The ASCM does not seek to prescribe the tax system that a Member may maintain: it only stipulates that Members must not grant exemptions from direct taxes based on export performance. In *US–FSC*, the panel held as follows:

‘Thus, the United States is free to maintain a world-wide tax system, a territorial tax system or any other type of system it sees fit. This is not the business of the WTO. What it is not free to do is to establish a regime of direct taxation, provide an exemption from direct taxes specifically related to exports, and then claim that it is entitled to provide such an export subsidy because it is necessary to eliminate a disadvantage to exporters created by the US tax system itself. In our view, this is no different from imposing a corporate income tax of, say, 75 per cent, and then arguing that a special tax rate of 25 per cent for exporters is necessary because the generally applicable corporate tax rate in other Members is only 25 per cent.’<sup>10</sup>

Two of the items in the Illustrative List (j and k) are about export credit and related programmes run by governments or by special institutions controlled by governments. The crucial test to be applied in determining whether a certain programme is an export subsidy is whether the programme is being operated on a commercial basis. In the case of export guarantee or insurance programmes, if the premium rates are inadequate to cover the long-term operating

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<sup>8</sup> In both the 1960 Declaration Giving Effect to the Provisions of Article XVI:4 (GATT, BISD 9S/32) and the Illustrative List of prohibited export subsidies contained in the Tokyo Round plurilateral agreement, the remission of direct taxes in relation to exports was treated as an export subsidy, while that of indirect taxes was not. There was no unanimity, however, in the Working Party on Border Tax Adjustments (GATT, BISD 18S/97) and some representatives maintained that direct taxes also were at least partly passed on into prices.

<sup>9</sup> *Brazil–Aircraft*, Panel Report, WT/DS46/R.

<sup>10</sup> *US–FSC*, Panel Report, WT/DS108/R.

costs and losses of the programme they are to be treated as export subsidy. In the case of export credits, the programme is an export subsidy if the credit is extended at rates which are below the rates paid for obtaining the funds for lending purposes. The rules provide for using the alternative benchmark of the rates at which the lending agency could have borrowed on international capital markets funds of the same maturity and other credit terms and denominated in the same currency. If the credit is given at rates that are lower than the rates on international capital markets, the practice becomes an export subsidy. Payment by governments or special institutions of all or part of the costs incurred by exporters or financing institutions in obtaining credit is also an export subsidy if such payment gives a 'material advantage in the field of export credit terms'.

Notwithstanding the criteria for determining whether an export credit practice is an export subsidy, the second paragraph of item (k) of the Illustrative List provides as follows:

'Provided, however, that if a Member is a Party to an international undertaking on official export credits to which at least twelve original Members to this Agreement are Parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original Members), or if in practice a Member applies the interest rate provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.'

This provision effectively creates a safe haven for the OECD Arrangement on Guidelines for Officially Supported Export Credit. The Arrangement lays down the minimum interest rates (defined as Commercial Interest Reference Rates or CIRRs) applicable to officially-supported export credit which the parties to the Arrangement have accepted for their officially supported export credit programmes. A WTO Panel has held that:

'Full conformity with the "interest rate provisions"—in respect of "export credit practices" subject to the CIRR—must be judged on the basis not only of full conformity with the CIRR but in addition full adherence to the other rules of the Arrangement that operate to support or reinforce the minimum interest rate rule by limiting the generosity of the terms of official financing support.'<sup>11</sup>

The WTO Appellate Body has relied on the provision relating to the OECD Arrangement to give the following interpretation of the term 'material advantage' in the first paragraph of item (k) described above:

'We believe that the OECD Arrangement can be appropriately viewed as example of an international undertaking providing a specific market benchmark by which to assess whether payments by governments, coming within the provisions of item (k) are "used to secure a material advantage in the field of export credit terms". Therefore, in our view, the appropriate comparison to be made in determining whether a payment is "used to secure a material advantage", within the meaning of item (k), is between the actual interest rate applicable in a particular export sales transaction after deduction of the government payment (the "net interest rate") and the relevant CIRR.'<sup>12</sup>

In line with the above view, the Panel in the same case held that:

'Even if a developing country Member cannot in practice afford to provide direct export credit financing at the CIRR rate, it can take advantage of the safe harbour in the second paragraph of item (k) by providing interest rate support in order to bring export credits provided by commercial lenders down to the CIRR rate.'<sup>13</sup>

As a general remark, it must be mentioned that the second paragraph of item (k) is somewhat anomalous in that it grants an exemption from a provision of a multilateral agreement on the basis of a plurilateral agreement among a subset of Members. A WTO Panel has observed as follows:

'We note first that the second paragraph of item (k) is quite unique in the sense that it creates an exemption from a prohibition in a WTO Agreement, the scope of which exemption is left in the hands of a certain subgroup of WTO Members—the Participants, all of which as of today are OECD Members—to define, and to change as and when they think fit. Given this, it is important that the second paragraph of item (k) not be interpreted in a manner that allows that subgroup of Members to create for itself *de facto* more favourable treatment under the ASCM than is available to all other WTO Members. The OECD Arrangement, as a plurilateral arrangement to which most WTO Members are not Participants, clearly has the potential to give rise to such differential treatment of Participants and non-participants.'<sup>14</sup>

<sup>11</sup> Canada–Civilian Aircraft, Compliance Panel Report, Article 21.5, WT/DS70/RW.

<sup>12</sup> Brazil–Civilian Aircraft, Appellate Body Report, WT/DS46/AB/R.

<sup>13</sup> Brazil–Civilian Aircraft, Compliance Panel Report, WT/DS46/RW.

<sup>14</sup> Canada–Civilian Aircraft, Report of Article 21.5 Panel, WT/DS70/R.

The Illustrative List is a non-exhaustive inventory of prohibited export subsidies and generally speaking, no inference can be drawn that a practice that does not fit in the description given in the List is not an export subsidy. This aspect has been clearly brought out in the *Brazil–Aircraft* Compliance Panel, which stated as follows:

‘The primary role of the Illustrative List is not to provide guidance as to when measures are not prohibited export subsidies – although footnote allows it to be used for this purpose in certain cases – but rather to provide clarity that certain measures are prohibited export subsidies. Thus, it would be possible to demonstrate that a measure falls within the scope of an item of the Illustrative List and was thus prohibited without being required to demonstrate that Article 3, and thus Article 1, was satisfied. To borrow a concept from the field of competition law, the Illustrative List could be seen as analogous to a list of per se violations.’<sup>15</sup>

As mentioned in the above-quoted Panel Report, it is specifically provided in footnote 5 that measures that are referred to in the List as not constituting export subsidies shall not be prohibited under the ASCM. Another WTO Panel has provided the following interpretation of the scope of footnote 5:

‘In its ordinary meaning, footnote 5 relates to situations where a measure is referred to as not constituting an export subsidy. Thus, one example of a measure that clearly falls within the scope of footnote 5 involves export credit practices that are in conformity with the interest rate provisions of the *Arrangement on Guidelines for Officially Supported Export Credits* (“Arrangement”). The second paragraph of item (k) provides that such measures “shall not be considered an export subsidy prohibited by this Agreement”. Arguably, footnote 5 in its ordinary meaning could extend more broadly to cover cases where the Illustrative List contains some other form of *affirmative* statement that a measure is not subject to the Article 3.1(a) prohibition, that is *not* prohibited, or that it is allowed, such as, for example, the first and last sentences of footnote 59 and the proviso clauses of items (h) and (i) of the Illustrative List.’<sup>16</sup>

The first sentence of footnote 59 contains the recognition that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The last sentence clarifies that paragraph (e) is not intended to limit a Member from taking measures to avoid the double taxation of foreign-source income earned by its enterprises or the enterprises of another Member. The proviso of item (h) exemption, remission, or deferral of prior stage cumulative indirect taxes on exported products and item (i) allows substitution drawback of import charges, provided certain conditions are met.

It is apparent that the provisos to items (h), (i), and (k) and the first and last sentences of footnote 59 refer to practices that are to be deemed as not constituting prohibited export subsidies. But that does not mean that they are not to be treated as subsidies at all. For arriving at a conclusion on whether these practices are subsidies it needs to be seen whether they fulfil the conditions laid down in the ASCM definition of a subsidy. Obviously the subsidies covered by the proviso to item (k) are still subsidies even if they are not prohibited export subsidies. The safe haven that has been created in that proviso provides an immunity from action under Articles 3 and 4 of the ASCM and not from action (such as countervailing duty action) under other provisions of the ASCM. On the other hand, exemption, remission, or deferral of prior stage cumulative indirect taxes on the exported product is not even covered by the definition of subsidies, by virtue of footnote 1 to Article 1.1 of the ASCM. Such exemption, remission, or deferral is not actionable not only under Articles 3 and 4 but also under any other provision of the ASCM. In the case of the proviso to item (i) and the first and last sentences of footnote 59, it could be argued that no benefit is conferred as a result of the government foregoing taxes and therefore they do not constitute subsidies at all. They may also be immune to action under any of the provisions of the ASCM.

### **1.2.3 Remedies against Prohibited Subsidies**

In order to understand the full implication of prohibition of export subsidies it is necessary to look at the remedies available to a WTO Member against another Member using such subsidies. Article 4 of the ASCM provides for the affected Member to raise a dispute in such cases. Where a complaint has been made, the full procedures of the Dispute Settlement Understanding (DSU) apply, involving the stages of consultation, panel proceedings, appellate review, surveillance, and, in appropriate cases, authorisation of countermeasures. There is provision for the panel to seek assistance of the Permanent Group of Experts with regard to whether the measure complained against is a prohibited subsidy. The Group’s conclusions on whether or not a measure is a prohibited subsidy have to be accepted

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<sup>15</sup> *Brazil– Aircraft, Report of Article 21.5 Panel, WT/DS46/RW.*

<sup>16</sup> *Brazil–Civilian Aircraft, Report of the Article 21.5 Panel, WT/DS46/RW.*

by the panel on a mandatory basis. Another variation from the DSU is the provision of an accelerated time frame for completion of the procedures, giving the panel 120 days (as against the DSU norm of 6–9 months) and the Appellate Body 60 days to submit their reports. More importantly, in the case of a positive finding on the existence of a prohibited export subsidy practice by a Member, the panel and the Appellate Body are mandated to recommend ‘withdrawal’ of the measure. WTO panels have held that ‘withdrawal’ of the export subsidy involves not only prospective but also retrospective action. In *Australia–Automotive Leather*, the Compliance Panel took the following view:

‘We do not believe that Article 19.1 of the DSU, even in conjunction with Article 3.7 of the DSU, requires the limitation of the specific remedy provided for in Article 4.7 of the ASCM to purely prospective action. An interpretation of Article 4.7 of the ASCM which would allow exclusively “prospective” action would make the recommendation to “withdraw the subsidy” under Article 4.7 indistinguishable from the recommendation to “bring the measure into conformity” under Article 19.1 of the DSU, thus rendering Article 4.7 redundant.’

The severity of the ASCM rule that envisages prohibition of export subsidies can also be gauged by comparing the provision on the time frame for compliance of the recommendation for withdrawal of an export subsidy in Article 4.7 with the relevant provision in the DSU. Article 21.1 of the DSU requires ‘prompt compliance with recommendations or rulings of the DSB [Dispute Settlement Body]’, and Article 21.3 allows an implementing Member ‘a reasonable period of time’ to implement the recommendations or rulings of the DSB, where it is impracticable to comply immediately. On the other hand, Article 4.7 envisages that the export subsidy must be withdrawn ‘without delay’.

In case the subsidising Member does not withdraw the subsidy, the complaining Member has the right to ask for the usual authorisation of countermeasures as envisaged in the DSU. It is provided that the countermeasures must be ‘appropriate’ but a footnote further clarifies that ‘[t]his expression is not meant to allow countermeasures that are disproportionate in light of the fact that the subsidies dealt with under these provisions are prohibited’. The rules allow for the possibility of arbitration on the appropriateness of countermeasures. In *Brazil–Aircraft*, the arbitration panel considered whether the countermeasures must be based on the level of nullification or impairment (harm caused to the industry in the complaining country) or the amount of the subsidy, and selected the latter yardstick. That countermeasures must equal the amount of subsidy has now become the WTO practice in cases involving prohibited subsidies and has been followed in *US–FSC* as well.

In the event of prohibited subsidies causing material injury to the domestic industry, the importing Member has the option of imposing countervailing duties instead of raising a dispute in the WTO. For details, see the section on countervailing duties below.

#### **1.2.4 Actionable Subsidies**

All specific subsidies other than those that are prohibited fall in the category of actionable subsidies. The substantive obligation in respect of such subsidies are contained in Article 5 of the ASCM, which also stipulates that the provision does not apply to agricultural products that are governed by the provisions of the Agreement on Agriculture.

Members are enjoined not to cause ‘adverse effects’ to the interests of other Members by the use of these subsidies. Such adverse effects may take the form of injury to the domestic industry of another Member importing the subsidised product or nullification or impairment of a tariff or other commitments made by the subsidising Member or serious prejudice to the interests of another Member. The concept of serious prejudice, which was initially embodied in Article XVI of GATT 1947, has been considerably elaborated in the ASCM. According to Article 6.3 of the ASCM, serious prejudice may arise in one or several of the following situations:

- ‘(a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidising Member;
- (b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market;
- (c) the effect of the subsidy is a significant price undercutting by the subsidised product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market;
- (d) the effect of the subsidy is an increase in the world market share of the subsidising Member in a particular subsidised primary product or commodity as compared to the average share it had during a previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted.’



It would be noted that the concept of serious prejudice as elaborated by the ASCM considerably expands the implication of the term 'adverse effect' in all markets. Thus, in the market of the subsidising country, adverse effect is caused not only when a specific tariff or other commitment is nullified or impaired. It is caused even in the absence of a tariff or other commitment when the effect of the subsidy is to displace or impede imports of a like product of another Member. Significant price undercutting of non-subsidised suppliers by the subsidised product, or significant price suppression or depression is actionable not only in the market of the complaining country but in the market of the subsidising country as well as in third country markets. For primary products or commodities, there is not only the concept of displacement or impediment being caused in individual third country markets but also the notion of increase in the world market share of the subsidised exports.

The ASCM contains detailed provisions on how the displacement or impeding of exports in third country markets and price undercutting in any market can be demonstrated. An important provision is that displacement or impedance of exports in third country markets must include cases in which it has been demonstrated that there is a change in relative shares of the market to the disadvantage of the non-subsidised like product. There are also provisions spelling out the circumstances under which serious prejudice arising from the displacement or impeding of exports must not be deemed to arise.

Article 6.1 originally provided for the presumption of serious prejudice in the following cases of egregious subsidy practices of Members:

- (a) the total *ad valorem* subsidisation of a product exceeding 5 per cent;
- (b) subsidies to cover operating losses sustained by an industry;
- (c) subsidies to cover operating losses sustained by an enterprise, other than one-time measures; and
- (d) direct forgiveness of debt, whether in the form of forgiveness of government-held debt or of grants to cover debt repayment.

This paragraph of Article 6 had been given a limited life of five years and Article 31 required it to be reviewed before the end of that period with a view to determining whether to extend its application, as originally drafted or in a modified form. When the matter was reviewed there was no consensus on its continuance with the result that the provision ceased to have validity after 31 December 1999.

### **1.2.5 Remedies against Actionable Subsidies**

As in the case of prohibited subsidies, the ASCM provides for an accelerated dispute settlement process in the event of adverse effects being caused to the interests of other Members by way of injury to domestic industry, or nullification or impairment, or serious prejudice. However, there is a major difference in the burden on the complaining Member in cases involving prohibited and actionable subsidies. In the case of prohibited subsidies, what is needed only is to demonstrate the existence of a subsidy. In the case of actionable subsidies, the complaining Member has to demonstrate in addition that adverse effect has been caused to its interests. If it is determined that adverse effects are indeed being caused, the subsidising Member is enjoined to 'take appropriate steps to remove the adverse effects' or to withdraw the subsidy. The option given to the subsidising Member to remove the adverse effect considerably blunts the edge of the dispute settlement process in the case of actionable subsidies as compared to prohibited subsidies. In the event that steps are not taken by the subsidising Member to remove the adverse effect or withdraw the subsidy, the ASCM envisages an agreed compensation by the subsidising Member. If there is no agreement on compensation then the complaining Member gets the right to request authorisation of countermeasures.

As in the case of prohibited subsidies, when actionable subsidies cause material injury to the domestic industry the importing member has the option of imposing countervailing duties instead of raising a dispute. See Section 1.3 on countervailing duties for details.

### **1.2.6 Non-actionable Subsidies**

All subsidies that are not specific are not actionable. In addition, initially Article 8 of the ASCM had provided that certain categories of specific subsidies would also be non-actionable. Non-actionability implied that they could not be proceeded against either under Part III of the ASCM (remedies under Article 7) or under Part V (imposition of countervailing duties). However, as in the case of Article 6.1, this provision had a limited life of five years and its validity has not been extended beyond 31 December 1999. Non-specific subsidies remain non-actionable by virtue of Article 2 of the ASCM.

Although Article 8, which provided for certain specific subsidies to be non-actionable, has lapsed, it is useful to recall the essential features of the provision. Three categories of specific subsidies were covered, viz., assistance for research activities by or on behalf of the firms, assistance to disadvantaged regions, and assistance to promote environmental adaptation. Strict conditions applied in order for these specific subsidies to be treated as non-actionable. Assistance for industrial research could not exceed 75 per cent of the costs of industrial research or 50 per cent of the costs of pro-competitive development activity. In addition, the assistance had to be limited to certain categories of expenses. Assistance to disadvantaged regions had to be within a general framework of regional development and non-specific within the region. Each disadvantaged region had to be a clearly designated contiguous geographical area with a definable economic and administrative identity. The region was regarded as disadvantaged on the basis of neutral and objective criteria, which included a measurement of economic development. Assistance for environmental purposes had to have the objective of promoting adaptation of existing facilities to new environmental requirements by law and/or regulations. Among the limitations imposed were the requirements that the assistance was a one-time non-recurring measure and that it was limited to 20 per cent of the cost of adaptation.

For invoking Article 8 in respect of specific subsidy practices, Members had the obligation to notify the measure to the WTO in advance of its implementation. However, it was provided (in footnote 35) that even where such a notification was not made, such subsidy must be treated as non-actionable if it was found to be fulfilling the conditions of non-actionability laid down in the relevant provisions.

Although Article 8 subsidies were designated as non-actionable, Article 9 of the ASCM provided for other Members to seek remedies if such subsidies caused serious adverse effects for them. It would be noted that while in the case of actionable subsidies it is necessary to demonstrate 'adverse effect', in the case of non-actionable subsidies the obligation was to show 'serious adverse effect'.

In actual operation of the ASCM no Member made a notification claiming the benefit of Article 8 during the period 1995–9 when the provision was in force. One reason for this could have been that footnote 35 provided that a Member would get the benefit of non-actionability if the measure was found to conform to the standards laid down in the provision, even if the notification obligation had not been discharged.

### **1.3 Countervailing Duties (CVDs)**

In the case of prohibited or actionable subsidies causing adverse effects in the market of the country importing the subsidised product the importing country has two options. It may either take recourse to the dispute settlement procedures as explained above or it may consider imposing countervailing duties to neutralise the effect of the subsidy.

Countervailing duty means a special duty levied for the purpose of offsetting any subsidy 'bestowed directly or indirectly upon the manufacture, production or export of any merchandise'. It can be imposed only if subsidised imports cause or threaten material injury to the domestic industry of the importing country. The ASCM (footnote 35) provides that the provisions of Part II (remedies against prohibited subsidies) or Part III (remedies against actionable subsidies) can be invoked in parallel with those of Part V (imposition of countervailing duties), but in respect of the subsidy causing injury to domestic industry only one relief would be available. The Member will thus have the ability either to impose countervailing duties or to obtain remedies available in Articles 4 or 7 of the ASCM. The main rules governing the imposition of countervailing duties are outlined below:

- (i) Formal investigations have to be initiated to consider the imposition of such duties. While in special circumstances investigations may be initiated *suo moto* by the investigating agency, generally this can be done only upon the written application by or on behalf of the domestic industry. This application must have sufficient evidence of the existence of (a) a subsidy, (b) material injury or the threat of such injury to the domestic industry, and (c) a causal link between the subsidised imports and the alleged injury. The application is deemed to have been made by or on behalf of the domestic producers if it is supported by those producers whose collective output constitutes more than 50 per cent of the total production of that segment of the domestic industry expressing support or opposition to the application. No investigation must be initiated when domestic producers expressly supporting the application account for less than 25 per cent of the total production. The investigation must be terminated if the amount of subsidy is *de minimis*, that is, less than 1 per cent *ad valorem*.
- (ii) Interested Members and interested parties in a countervailing duty investigation must be given notice of all the information required of them and ample opportunity to present in writing all evidence. Before the commencement of investigations, consultations must be held with the WTO Member whose product is subject to the investigation.

- (iii) The calculation of the amount of a subsidy for the purpose of imposing countervailing duty must be done in terms of the benefit to the recipient. Government provision of equity capital is to be considered as conferring a benefit only if the investment decision is inconsistent with the usual investment practice of private investors. A loan or a loan guarantee by a government, or the provision of goods or services, or purchase of goods by a government can be considered to be conferring a benefit only if the terms are more advantageous than comparable commercial transactions.
- (iv) The determination of injury must be based on an examination of both (a) the volume of subsidised imports and the effect of the subsidised imports on prices in the domestic market and (b) the consequent impact of these imports on domestic producers. With regard to the volume of the subsidised imports, what has to be seen is whether there has been a significant increase in subsidised imports and with regard to the effect on prices, whether there has been a significant price undercutting of the domestic product or price depressing effect. For the examination of the impact of the subsidised imports on the domestic industry, an evaluation has to be made of all relevant economic factors and indices having a bearing on the state of the industry. Some of these factors are actual or potential decline in output, sales, market share, return on investment, utilisation of capacity, etc. or negative effect on cash flow, inventories, employment, wages, etc. For the determination of a threat of material injury, factors to be taken into account are: the nature of subsidy, a significant rate of increase of subsidised imports, availability of freely disposable or an imminent substantial increase in capacity in the exporting country, expectation of significant price depressing or suppressing effect on domestic prices, or inventories of the product being investigated. Domestic industry for the purposes of determination of material injury is defined as domestic producers as a whole or those of them whose collective output of the product constitutes a major proportion of the total domestic production of the product. When the producers are related to the exporters or importers of the allegedly subsidised product, the term 'domestic industry' is to be interpreted as referring to the rest of the producers.
- (v) Investigations have to be completed normally in one year and in no case in more than 18 months. Provisional duties, applicable for the shortest period possible, not exceeding four months in any case, may be imposed no sooner than at least 60 days from the date of initiation of the investigation, if the authorities reach a preliminary conclusion that a subsidy exists and that there is injury to domestic industry caused by subsidised imports. When the investigation is completed with affirmative determination on both subsidy and injury it is left to the discretion of the Member concerned to decide whether to impose a duty or whether the amount of countervailing duty must be the full amount of subsidy or less. It is, however, stated that it is desirable that the duty should be less than the total amount of the subsidy, if such lesser duty would be adequate to remove the injury to the domestic industry. It is also provided that it is desirable that procedures be established which allow the authorities to take into account representations made by domestic interested parties whose interests might be affected by the imposition of a countervailing duty. Countervailing duty proceedings may be terminated if the government of the exporting country undertakes to eliminate or limit the subsidy or to take other measures concerning its effects or if the exporter undertakes to revise its prices so as to eliminate the injurious effect of the subsidy.
- (vi) Countervailing duties can generally be imposed only on the goods imported (entered for consumption) after the determination on the existence of subsidy and injury. In some limited situations, the definitive duties may be levied retroactively for the period for which provisional measures have been applied. In critical circumstances, in which injury that is difficult to repair is caused by massive imports in a relatively short period of subsidised products, the definitive countervailing duties may be assessed retrospectively on imports which entered into consumption not more than 90 days prior to the date of application of provisional measures.
- (vii) The ASCM provides for Administrative Review of countervailing duties from time to time by the authorities either on their own or upon request by any interested party. Any interested party has the right to submit positive information substantiating the need for review and request the authorities to examine 'whether the continued imposition of the duty is necessary to offset subsidization, whether the injury would be likely to continue or recur if the duty were removed or varied, or both'. The standard of examination in an administrative review is not the same as in the original investigation. Thus the *de minimis* rule does not apply in administrative reviews. In *US-Bismuth Steel*, the Appellate Body ruled as follows:
- 'We believe that it is important to distinguish between the original investigation leading to the imposition of countervailing duties and the administrative review. In an original investigation, the investigating authorities must establish that all conditions set out in the ASCM for the imposition of countervailing duties are fulfilled. In an administrative review, however, the investigating authority must address those issues raised before it by the

interested parties or, in the case of an investigation conducted on its own initiative, those issues which warranted the examination.<sup>17</sup>

A separate rule provides for Sunset Review. All countervailing duties must be terminated after five years from its imposition (or from the date of the most recent review) unless it is determined in a review initiated before that date 'that the expiry of the duty would be likely to lead to continuation or recurrence of subsidisation or injury'. The language of the rules allows an interpretation that the countervailing duty can be continued even if no subsidy is being paid at the time of the review, provided that the investigating authority can demonstrate that subsidisation will recur in case of expiry of the countervailing duty. In this respect, the language of the provision on Sunset Review (Article 21.3) is different from the language of the provision on Administrative Review (Article 21.2).

- (viii) Detailed guidelines have been laid down in Annex II of the ASCM for the investigating authorities to determine in countervailing duty investigations that the prior stage indirect tax rebate schemes or remission or drawback of import charges do not provide for excess rebate. It must be first determined if the WTO Member concerned has in place and applies an effective system or procedure to confirm which inputs are consumed in the production of the exported product and in what amounts. Where such a procedure is applied, the investigating authorities have to examine them to see if they are reasonable, effective, and based on generally accepted principles in the country of export. The investigating authorities may also carry out investigations in the country of export to verify information or to satisfy themselves that the system or procedure is being effectively applied. Where no procedures exist or where these are not considered to be reasonable, the exporting Member may need to carry out a further examination based on the actual inputs involved for determining whether an excess payment occurred. Annex II also provides guidelines on when inputs must be regarded as physically incorporated and what should constitute a normal allowance for waste.
- (ix) Annex III of the ASCM lays down guidelines for the determination of substitution drawback systems as export subsidies. The provisions in this Annex are a mirror image of the provisions in Annex II as far as the stipulated steps are concerned on the verification of existing procedures.

### **1.3.1 Special Provisions for Developing Countries**

The provisions dealt with in the foregoing paragraphs apply to the developing countries also except to the extent described below:

- (a) Article 27.2 provides that the prohibition of export subsidies does not apply to the least developed countries (LDCs) and poor developing country Members listed in Annex VII. Annex VII mentions LDCs designated as such by the United Nations, which are Members of the WTO. It also enumerates some of the low-income countries, which were the original Members of the WTO, and stipulates that they would be covered by the exemption until their per capita income had reached \$1000 per annum. At the Doha Ministerial Meeting, an agreement was reached in principle that the Members listed in Annex VII would remain eligible for the exemption until their Gross National Product (GNP) per capita reached US\$ 1000 in constant 1990 dollars for three consecutive years.<sup>18</sup>
- (b) Under Article 27.2 (b), other developing country Members have been given eight years from the date of entry into force of the WTO Agreement to phase out their export subsidies. However, Article 27.4 stipulates that during this period they must not increase the level of their export subsidies. In *Brazil–Civilian Aircraft*, the Panel took the view that as Brazil had increased the level of subsidies it did not fulfil the conditions for the exemption provided in Article 27.4 and consequently the prohibition of export subsidies envisaged in Article 3.1(a) applied to it. On the question of benchmark for determining whether there had been an increase in export subsidisation the same panel considered that the calendar year preceding 1 January 1995, when the WTO Agreement entered into effect, was appropriate.
- (c) If any developing country Member considers it necessary to apply the subsidy beyond the eight-year period, it must make an application a year before the end of the period, and such an application will be considered on the basis of the concerned Member's relevant economic, financial, and development needs. If extension is granted, the Member concerned has to hold annual consultations with the Committee on Subsidies and Countervailing Measures to determine the necessity of maintaining the subsidies. If no such determination is

<sup>17</sup> WT/DS138/AB/R

<sup>18</sup> WTO Document, WT/MIN(01)/W/10.

made, the developing country Member must phase out the export subsidies within two years of the last authorised period. On the basis of this provision, it can be said that all developing country Members, apart from those listed in Annex VII, have been granted virtually automatic rights to continue export subsidies for a period of 10 years. At the Doha Ministerial Meeting, it was decided that certain developing countries (whose share of world merchandise export trade was not greater than 0.10 per cent, and total Gross National Income was at or below US\$ 20 billion) would be granted annual extensions through 2007 for the export subsidy programmes that involved full or partial exemptions from import duties and internal charges, that were in existence not later than 1 September 2001.<sup>19</sup>

- (d) There is less flexibility given in respect of subsidies for the use of domestic goods over imported goods. Developing country Members were exempted from its application for five years from the date of entry into force of the WTO Agreement and the LDCs for eight years.
- (e) A developing country that has reached export competitiveness in respect of a product must phase out the export subsidy in respect of the product over a period of two years. Annex VII countries have eight years to gradually phase out the export subsidy upon achieving competitiveness. Export competitiveness in a product is deemed to exist if the developing country exports of that product have reached a share of at least 3.25 per cent in world trade of that product for two consecutive calendar years. For the purposes of this provision, a product is defined as a 'section heading' of the Harmonized System (HS). Use of the term 'section heading' has undoubtedly caused some confusion as the HS is divided into 21 Sections, 98 Chapters, and much larger numbers of four-digit Headings and six-digit Sub-Headings. Contact with the participating delegates in the Uruguay Round has revealed that the level of aggregation they had in mind was Sections and not Headings. In selecting the figure of 3.25 per cent, some of the developed countries took into consideration the fact that India's share in world trade of textiles and clothing (which falls under one section of the HS) at that time was in the range of 2–2.5 per cent. They felt that India was within a striking distance of the yardstick of 3.25 per cent of the world market share and could be expected to reach that figure in the not-too-distant future. On India's side, the assessment was that if the discriminatory restrictions on trade were really removed, the elimination of export subsidies would be a challenge worth accepting. It has also to be considered whether it is feasible for any government to operate export promotion programmes on the basis of four-digit lines. Industries and exporters generally carry out their operations across several tariff Headings and it would be impracticable for any Member to insist that another Member that has reached a level of 3.25 per cent of the world market share in respect of a Heading must give up the export subsidies in respect of that Heading. For the purpose of capital goods subsidies or subsidy related to export credit, for instance, it would not be feasible to implement a prohibition on export subsidies in respect of goods falling under a Heading of the HS.
- (f) Export subsidies given by developing countries that are in conformity with the provisions of the ASCM, although not prohibited, are still actionable by other Members. If another Member has recourse to the dispute settlement machinery against the measure, adverse effect will have to be demonstrated by positive evidence as in the case of actionable subsidies for all Members. In case of a positive finding, the developing country Member concerned does not have compulsorily to eliminate the measure but instead it may only take appropriate steps to remove the adverse effect (Article 27.7).
- (g) In respect of other actionable subsidies, developing country Members have been given immunity from remedies against 'serious prejudice'. Article 27.9 provides that countermeasures may be authorised against them only if there is nullification or impairment of a tariff concession or other obligations under GATT 1994 as a result of such a subsidy in such a way as to displace or impede imports from another Member into the market of the subsidising country Member or if injury to a domestic industry in the market of an importing country occurs. Thus, action can be taken against developing countries only for actionable subsidies falling under Articles 5(a) and 5(b), not 5(c).
- (h) Originally, Article 27.9 provided that for the egregious subsidy practices listed in Article 6.1 disputes could be raised against developing country Members also. Even in such cases, Article 27.8 provided that the presumption of serious prejudice did not apply, and it had to be demonstrated by positive evidence that adverse effects had indeed been caused. The expiry of Article 6.1 has had two legal consequences for the application of Part III (actionable subsidies) to developing countries. First, the special treatment of developing countries in respect of presumption of serious prejudice has disappeared, and indeed has become unnecessary, as the provision on

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<sup>19</sup> WTO Documents WT/MIN(01)/DEC/W/1 and G/SCM/W/471/Rev.1.

presumption has itself disappeared. Second, and quite independently of the provision on presumption, the list of measures in respect of which serious prejudice applied earlier to developing country Members (in Article 27.9) has also disappeared. Thus, after the expiry of the life of Article 6.1 on 31 December 1999, developing country Members cannot be proceeded against for serious prejudice at all.

In the *Indonesia–Automobiles* dispute, the panel had found that the European Communities (EC) had demonstrated by positive evidence that certain measures taken by Indonesia had indeed caused serious prejudice to its interests. But that case was decided in 1998, at a time when Article 6.1 was still valid. Even in that case the Panel had clearly pronounced that ordinarily the ASCM did not provide any remedy against serious prejudice caused by developing countries:

'Article 27.9 provides that, in the usual case, developing country Members may not be subject to a claim that their actionable subsidies have caused serious prejudice to the interests of another Member. Rather, a Member may only bring a claim that benefits under GATT have been nullified or impaired by a developing country Member's subsidies or that subsidized imports into the complaining Member have caused injury to a domestic industry.'<sup>20</sup>

Clearly in using the term 'usual case', the panel had in mind the words 'other than those referred to in paragraph 1 of Article 6' in Article 27.9. No other interpretation of this pronouncement will be reasonable.

- (i) In countervailing duty investigations against subsidised exports from developing countries, the proceedings have to be terminated if the overall level of subsidies is less than 2 per cent (as against one per cent for others), or if the volume of subsidised imports is less than 4 per cent of the total imports. The rule of exemption from countervailing duty proceedings if the volumes of subsidised imports are less than 4 per cent does not apply if the cumulative share of imports from individual countries accounting for less than 4 per cent is more than 9 per cent. For developing country Members listed in Annex VII and other developing countries that have undertaken to phase out their export subsidies over a shorter period than eight years stipulated in the rules, the *de minimis* figure of 2 per cent in respect of the level of subsidies has been increased to 3 per cent for a period of eight years.
- (j) In order to encourage implementation of privatisation programmes, it has been provided that direct forgiveness of debt, subsidies to cover social costs, in whatever form, including relinquishment of government revenue and other transfer of liabilities, directly linked to a privatisation programme in a developing country shall not be actionable under Part III of the ASCM. Thus action for nullification and impairment of tariff commitments cannot be taken against such subsidies, nor can disputes be raised on the basis of injury to the domestic industry of another Member. But obviously, countervailing duty can still be imposed under Part V of the ASCM.

## **2 India's Experience with the ASCM**

India did not face any request for remedial action under Articles 4, 7, and 9 of the ASCM in the WTO during the period 1995–2002. However, Indian products did have countervailing duties imposed on them, particularly in three major industrialised economies, viz., the US, the EC, and Canada. We examine below the status *vis-à-vis* the ASCM of the important programmes of support for the industry in the Central and state governments. We take up first the Central Government programmes for export promotion, using as our point of departure the treatment that different elements in this programme have received from the investigating authorities in the large developed importing countries during countervailing duty proceedings. We then describe some of the other features of government assistance to domestic industry.

### **2.1 Export Promotion Programmes**

#### **2.1.1 Advance Licence**

Allowing duty-free imports of inputs used in the production of the exported product has been a traditional item on India's export promotion programme. The scheme has been evolving but in its current form it allows duty free import of inputs, which are physically incorporated in the export product (making normal allowance for waste) as well as fuel, oil, energy, catalysts, etc.<sup>21</sup> Some of the other features of the 2002–07 EXIM policy in respect of the scheme are described below:

- (i) Advance Licence for duty free import of inputs is subject to 'actual user' condition. In other words, the actual

<sup>20</sup> *Indonesia–Automobile*, Report of the Panel, WT/DS54/55/59/64/R.

<sup>21</sup> *Export & Import Policy, 1st April 2002–31st March 2007, Ministry of Commerce and Industry, Government of India, New Delhi.*

<sup>22</sup> *Ibid.*

user alone may import such goods. Advance Licences or the materials imported under the licence are not transferable.

- (ii) Advance Licence may be issued for 'physical exports' to a manufacturer-exporter or a merchant-exporter tied to a supporting manufacturer(s). It may also be issued 'for intermediate supply to a manufacturer-exporter for the import of inputs required in the manufacture of goods to be supplied to the ultimate exporter'.<sup>22</sup> Such licences are also permissible for 'deemed exports', in which the goods do not leave the country, but are extended the privileges of exports as they make the supplies in competition with international suppliers. Examples of 'deemed exports' are supply of goods against Advance Licence and supply of goods to projects financed by multilateral or bilateral agencies against competitive international bidding.
- (iii) Imports against advance licences are exempted from payment of basic customs duty, additional customs duty, anti-dumping duty, and safeguard duty, if any. Imports against Advance Licence for deemed exports are eligible for exemption from basic customs duty and additional customs duty only.
- (iv) As a part of its periodic EXIM policy, the Government of India publishes the standard input-output norms (SION) applicable to the Advance Licence and other duty exemption programmes (with which we shall deal later). Advance Licence may be requested also for products for which SION has not been fixed but in those cases additional data has to be furnished along with certificates from Chartered Accountant/Cost and Works Accountant and Chartered Engineer. In most cases, the norms indicate the quantity of inputs but in some cases value limits also apply.
- (v) An Advance Licence specifies *inter alia* 'the quantity of each item to be imported or wherever the quantity cannot be indicated, the value of the item shall be indicated'.<sup>23</sup>
- (vi) Advance Licences are issued with a time bound export obligation, which is monitored by the licensing authority. Within two months of the date of expiry of the period of obligation, the licence-holder is required to submit evidence that it has discharged its obligation. The documents to be submitted include a 'statement of exports giving details of shipping bill wise exports indicating the shipping bill number, date, FOB value as per shipping bill and description of the export product' and a 'statement of imports indicating bill of entry wise item of imports, quantity of imports and its CIF value'.<sup>24</sup>
- (vii) A variant of the Advance Licence is the Advance Release Order. An Advance Licence holder has the option of obtaining the inputs from indigenous sources and for this purpose it can apply for an Advance Release Order.

The experience in respect of the Advance Licence Scheme in investigations for countervailing duties in developed importing countries since the entry into effect of the WTO Agreement has been mixed. In the 'Certain Metal Castings From India: Final Results of Countervailing Duty Administrative Review' (6 December 1996) and 'Certain Iron-Metal Castings From India: Final Results and Partial Rescission Countervailing Duty Administrative Review' (18 November 1998), the US Department of Commerce held that Advance Licences allowed companies to import, net of duty, raw materials which were physically incorporated into the exported products and were equivalent to duty drawback. However, in the 'Final Affirmative Countervailing Duty Determination: Certain Cut-to-Length Carbon-Quality Steel Plate From India' (29 December 1999), the US Department of Commerce countervailed against the duty exemption under Advance Licence. It held that the Government of India (GOI) did not have a system in place confirming that inputs imported under the advance licence were used to produce the exported product. The GOI merely presumed that the imported inputs were consumed in the production of the exported product because these products were needed for production of cut-to-length plate. The US Department of Commerce concluded as follows:

'In summary, the GOI has no way to know whether imported inputs are consumed in subsequently exported products as required under Annex III to the SCM agreement or whether an amount imported was equal to the home market substitutes consumed in the exported product. Consequently, the entire amount of the benefit conferred is countervailable, as directed under section 351.51 of the CVD Regulations and reflected in Annexes II and III to the SCM Agreement.'

Later in the 'Final Affirmative Countervailing Duty Determination: Certain Hot-Rolled Carbon Steel Flat Products from India' (20 April 2001), US Department of Commerce took into account the changes in the advance licence programme since its finding in 'CTL Plate from India'. In the CTL Plate case, the duty exemption was based on the value of imported inputs while in Hot-Rolled Carbon Steel Products the Advance Licences were quantity-based. In respect of

<sup>23</sup> Handbook of Procedures, Vol. 1, 1<sup>st</sup> April 2002–31<sup>st</sup> March 2007, Ministry of Commerce and Industry, Government of India, New Delhi, paragraph 4.11.

<sup>24</sup> *Ibid.*, paragraph 4.25.

the practice of sale of Advance Licence, the US Department of Commerce stated that it did not make a difference whether the original applicant of the licence or a purchaser used the licence. It reasoned that since the amount of exemption granted was determined at the time of import and was based on the type and quantity of a specific good used in the production of the exported product, the amount of duty exemption ultimately granted did not need to be claimed by the original licensee. More significantly, the US Department of Commerce came to the following conclusion on the system of verification inherent in the Scheme:

'Moreover, we found at verification that this new type of advance license program has a built-in monitoring system by virtue of the application process and the manner in which the amount of duty exemption to be granted is limited by the quantity stipulated in the licence. The GOI now grants an advance license only for items listed on the SION for that industry. When a company applies for a license, it must list the specific items and quantities, which it intends to import. The GOI will grant the license for the requested items and quantities only if the items and amounts requested are listed on the SION for the product. Due to this change, the GOI is able to base the duties to be exempted (when those imports are made using the license) on the amounts of imported inputs necessary for producing the product. The items specified in the advance license as items to be imported are item (*sic*) that used (*sic*) in the production of the relevant exported merchandise.'

In light of the above finding, the US Department of Commerce concluded that the GOI had in place and applied a system to confirm which inputs were consumed in the production of the exported products and in what amounts, and that the system was reasonable and effective. However, it countervailed against the exemption from duty in respect of rolls for rolling mills, on account of the fact that under the US law, as under the ASCM, capital goods are not treated as being consumed in the production process.

In the EC, the Advance Release Orders (ARO) Scheme came under scrutiny in the investigation against sulphonic acid originating in India. In the EC Council Regulation No. 1338/2002 of 22 July 2002, the EC countervailed against duty exemption under the ARO scheme because (i) there was no system or procedure in place to confirm whether and which inputs, obtained against AROs, were consumed or whether an excess benefit of import duties occurred; (ii) the exporter was under no obligation to actually consume the inputs obtained against AROs in the production process; and there appeared to be no requirement of importing inputs. The EC held that a scheme could be considered as a *bona fide* duty drawback scheme only in cases in which an import element existed, that is, when there was a link between the imported input and the exported goods.

In Canada, the Advance Licence scheme has figured in two countervailing duty cases. In May 2000, in the final determination in Certain Hot-Rolled Carbon Steel Plate, the Canadian Customs and Revenue Agency (CCRA) had confused the Advance Licence scheme with the Duty Entitlement Pass Book (DEPB) credits and came to the erroneous conclusion that it was countervailable. Moreover, it countervailed against the Advance Licence exemption even though the exporter claimed that the imports made against the licence had not been used for the production of the exported goods under investigation. In July 2001, in Certain Hot-Rolled Carbon and Alloy Steel Sheet and Strip, the CCRA held that Advance Licence that were sold were not used in the production of the exported goods and were therefore countervailable. This verdict is at variance with that of the US Department of Commerce in the final determination in Certain Hot-Rolled Carbon Steel Flat Products, as described earlier.

It would seem from the above analysis that the Advance Licence scheme in its current form has withstood the tests for non-countervailability applied in the US and the EC, for exemption of duties on imported raw materials and consumables, but not capital goods. The ARO variant has, however, not passed the test, mainly on account of the fact that there is no requirement that the inputs obtained against AROs are used in the production of the exported product or that inputs of the same quality and characteristics are subsequently imported. The treatment of the amount obtained from the sale of Advance Licence varies in importing countries, but the proceeds received from the sale of such licences would seem to be a subsidy as a financial contribution from government. In any case, under the current policy of the GOI, Advance Licences are non-transferable.

### **2.1.2 Duty Entitlement Pass Book (DEPB) Scheme**

This is another scheme aimed at 'neutralising the incidence of customs duty on the import content of the exported product'. Its earliest version, the Pass Book Scheme, introduced in 1995, lapsed in 1997. For the policy period 1997–2002, the DEPB scheme was introduced in two forms, pre and post export. In 2000, the pre-export DEPB scheme was discontinued and consequently we consider only the post-export variant as currently in force.



Under the DEPB scheme, the exporter may apply for duty credit as a specified percentage of the FOB value of exports. The value of such duty credit is determined and notified by the Director General of Foreign Trade on the basis of the 'deemed import content of the said export product as per SION and the basic custom duty payable on such deemed imports'.<sup>25</sup> Where the value of such credits is not notified or where there is a case for change in the rates, the exporter may apply for fixation of rates by furnishing data on import and export. The DEPB credits or the items imported against them are freely transferable, but the import against them can be made only at the port from where exports have been made. Importantly, the credit under DEPB may be utilised for payment of customs duty on any item which is freely importable except capital goods. The period of validity is 12 months.

DEPB benefits have been countervailed by the US in 'Cut-to-length Carbon-Quality Steel Plate From India' (1999) and 'Certain Hot-Rolled Carbon Steel Flat Products' (2001). In the former case, the US Department of Commerce determined that the GOI did not meet the criteria laid down in US CVD Regulations regarding the remission, exemption, or drawback of import duties. It did not have in place a system or procedure to confirm which imports were consumed in the production of the exported product and in what amounts. Neither had it carried out an examination of actual imports involved to confirm which imports are consumed in the production of the exported product. In the latter case, the exporters had argued that the GOI system met the substitution drawback provisions through the establishment and review of the SIONs, by compiling extensive information on the imported inputs and exported products from evidence such as the bills of entry and shipping bills, and through annual reviews and even revisions of DEPB credit rates. They had also argued that the use of standard norms to facilitate fixed rate drawback programmes was reasonable. Among the arguments put forward by the petitioners challenging the characterisation of the scheme as a viable drawback system was the fact that the GOI granted a single DEPB credit rate for all producers of the subject merchandise, regardless of their respective production processes. The US Department of Commerce had concluded that the Indian system was not reasonable and effective in the context of actual experience of particular companies. In particular, the Department had noted that the DEPB credit rates were not always tied to a company's actual import experience.

In the EC, the post-export DEPB scheme has been countervailed against in all the cases where it has been investigated, viz. Certain Broad Spectrum Antibiotics (1998), Polyethylene Terephthalate (PET) Film (1999), Certain Polyethylene Terephthalate (2000), Certain Flat Rolled Products of Iron or Non-alloy Steel (2000), and Sulphanilic Acid (2002). The reasons given in all these cases are substantially the same but these have been most succinctly stated in the Sulphanilic Acid case:

'The analysis revealed that DEPB on post-export basis is not a drawback or a substitution drawback scheme. This scheme lacks a built-in obligation to import only goods that are consumed in the production of the exported goods (Annex II of the basic Regulation) which would ensure that the requirements of Annex I of item (i) were met. Additionally, there is no verification system in place to check whether the imports are actually consumed in the production process. It is also not a substitution drawback scheme because the imported goods do not need to be of the same quality and characteristics as the domestically sourced inputs that were used for export production (Annex III of the basic Regulation). Lastly, exporting producers are eligible for the DEPB benefits regardless of whether they import any inputs at all. In order to obtain the benefits, it is enough for an exporter to simply export goods without showing that any input material was imported. Thus, exporting producers which procure all the inputs locally and do not import goods which can be used as inputs are still entitled to the DEPB benefits. Hence, the DEPB on post-export basis does not conform to any of the provisions of Annexes I to III.'<sup>26</sup>

In Certain Polyethylene Terephthalate, the EC had specifically determined that the standard input-output norms did not measure up to the standard of an acceptable verification system:

'Even if the DEPB were to meet the criteria of Annex II and III, it would be concluded that no verification system exists. The input/output norms are a list of possible items that can be consumed in the production process and in what amounts. However, the input-output norms are not a verification system within the meaning of paragraph 5 of Annex II of the basic Regulation. These norms do not provide for a verification of the inputs that are actually consumed in the production process and do not provide for a verification system whether these inputs were effectively imported.'<sup>27</sup>

In Canada, the treatment of the DEPB scheme has varied from case to case. In May 2000, in the CVD investigation

<sup>25</sup> *Ibid.*, paragraph 4.37.

<sup>26</sup> Council Regulation (EC) No. 1338/2002 of 22 July 2002, paragraph 18.

<sup>27</sup> Council Regulation (EC) No. 2603/2000 of 27 November 2000, paragraph 23.

with respect to Certain Hot-Rolled Carbon Steel Plate exported from India, the Commissioner of the CCRA took the view that the DEPB scheme was not a duty refund or drawback programme because the GOI did not have a system or procedure to confirm which imported inputs were consumed in the production of the exported goods. It had recognised that the GOI relied on SIONs for determining DEPB rates and the monitoring system it followed ensured conformity with the norms. However, the system did not go beyond that to verify whether the actual proportion of each input to the finished product reflected the norm. It also pointed out that the CCRA had considered that the system to confirm import content was not applied effectively. It had sought further information from the GOI to understand the verification system, specifically to link the norms with the actual use of inputs to produce the exported goods. Based on the information provided, it had determined that the verification system was not effectively applied.

In the final determination in Certain Stainless Steel Round Bar in September 2000, the CCRA gave a different treatment to the DEPB benefits and did not hold it to be countervailable in toto. The reason for this was that unlike in the Hot-rolled Carbon Steel Plate case, exporters of stainless steel round bar not only imported the inputs but also maintained sufficient records to enable the investigating authority to relate the DEPB credits on the goods exported with the duty paid on the inputs imported and used to produce exported goods. Based on these records, the CCRA imposed CVD only to the amount of excess refund.

In a more recent case in July 2001 in the final determination in the CVD case, Certain Flat Hot-Rolled Carbon and Alloy Steel Sheet and Strip, the CCRA did not agree with the point made by the GOI that the sale of credits did not change the nature of the DEPB credits. It held that the DEPB credits that were sold were not used in duty exemption programmes, and that revenue from the sale of unused DEPB credits constituted a countervailable subsidy.

Clearly the post-export DEPB policy of the GOI is akin to substitution drawback because the exporter first uses inputs from domestic sources. But it lacks a fundamental element of substitution drawback schemes envisaged in item (i) of the Illustrative List in Annex I and Annex III of the ASCM. There is no obligation to import the inputs for which domestic substitutes have been used. The EXIM policy specifically allows the DEPB credits to be used for the imports not only of the inputs used for the production of the exported product but also of any freely importable goods. DEPB benefits fail to stand up to even the preliminary test stipulated in the ASCM for substitute drawback schemes because there is no built-in obligation to import the inputs having the same quality and characteristics as the domestic substitutes used. As the EC has noted, exporting producers which procure all the inputs locally and do not import goods which can be used as inputs are still entitled to the DEPB benefits. It is significant that in one case Canada admitted the DEPB benefits as a legitimate substitution scheme because the exporter had actually imported the input against DEPB credits, even though it was not compelled to do so.

Another important point that emerges from these CVD determinations in the EC and Canada is that the input-output norms did not constitute a verification system within the meaning of paragraph 5 of Annex II. In particular, the EC had noted in Certain Polyethylene Terephthalate that '[t]hese norms do not provide for a verification of the inputs that are actually consumed in the production process and do not provide for a verification system whether these inputs were effectively imported'. Canada has recognised that the GOI relied on SIONs for determining the DEPB rates and followed a monitoring system to ensure conformity with the norms. However, the system did not go beyond that to verify whether the actual proportion of each input to the finished product reflected the norm. It is possible that in not recognising that the determination of DEPB rates in accordance with SIONs represented a verification system, the EC had been influenced by the absence of an obligation to import the inputs of which domestic substitutes were initially used. But it is not clear that even with such a requirement the EC would have regarded the fixation of DEPB rates in accordance with SIONs as a verification system. Judging from the treatment given to DEPB benefits in the Certain Stainless Steel Round Bars case, it appears likely that if there were a requirement to import the inputs, Canada would conclude that a verification system existed. A point of concern in Canada's practice is that it considers the revenue from the sale of unused DEPB credits to constitute a countervailable subsidy as sale implies that the credits were not used in duty exemption programmes. Canada ignores the fact that in substitution drawback schemes there is only an obligation that the inputs having the same quality and characteristics as the domestic substitutes used be imported. It is not necessary for the imported inputs to be used by the exporter. So the sale of DEPB credits should be perfectly legitimate as long as they are used to import the same inputs that have been used.

### **2.1.3 Duty Free Replenishment Certificate (DFRC)**

This scheme, introduced in April 2000, envisages import of inputs used in the manufacture of exported goods without payment of basic customs duty and special additional duty. However, import of inputs is subject to the payment of

additional customs duty equal to the excise duty. Duty Free Replenishment Certificates are issued only in respect of products covered by the SIONs notified by the Director General of Foreign Trade (DGFT) and are subject to a minimum value addition of 33 per cent. The validity of DFRCs is 18 months and they are freely transferable.<sup>28</sup>

The exporter requesting for grant of DFRCs is required to indicate in the Export Performance (EP) copy of the Shipping Bill the serial number and product group of SION of the exported product. The DFRC is generally issued with a single port of registration, which is the same port from which the export has taken place. The application has to be made in the prescribed form giving *inter alia* details of the product exported, items sought to be imported under the DFRC, and materials used from other sources, domestically or otherwise. The licensing authority has to ensure while issuing the DFRC that the Shipping Bill(s) and description of the exported product are endorsed on the reverse of the DFRC. Before allowing the imports against DFRC, the Customs are required to verify that the details of the exports as given in the DFRC tally with their records.<sup>29</sup>

The DFRC scheme fits well into the substitution drawback system envisaged in the ASCM. Unlike the DEPB scheme, it has a built-in obligation for the import of items for which domestic substitutes have been initially used for the production of the exported product. The licensing authority allows import of items according to the SION and the only way in which the benefit of the DFRC can accrue is by importing the items. At the time of import against the DFRC, the Customs are required to check that the exports of the product as described in the application and as endorsed on the reverse of the DFRC have indeed taken place. The scheme fulfils the essential requisites of a substitution drawback system. As to other aspects it can be said that the standard SIONs and the procedures for application by the exporter and of checks by the Customs can be regarded as constituting a reasonable and effective verification system. The scheme has not yet been examined by the investigation agencies in any country, but it can be reasonably expected that, unlike the DEPB, it would not fall on the first hurdle of not fulfilling the basic requirements of a substitution drawback scheme. Based on the US Department of Commerce view on the Advance Licence scheme it can be expected also that the scheme will qualify as having a reasonable and effective verification system, but this cannot be said with certainty of other jurisdictions. Furthermore, if the agencies examine the books of the exporting companies under Article 12.6 of the ASCM, it is possible that they find over-rebate to the extent that an individual firm is found to be deviating from the SION in its production process. If the investigating agency finds that there is a verification system and the system is reasonable and effective, it may impose CVD only on the over-rebate portion, if there is such over-rebate.

A question could also be raised on the implications of transferability of the DFRC or of the material that has been imported. A good case can be made to defend such transferability. The requirement in item (i) and in Annex III is that in a substitution drawback scheme, domestic inputs equal in quantity and having the same quality and characteristics as the imported inputs must have been used. It is nowhere stipulated that the exporter must itself import the imported input. In fact, if the export has been made on a one-off basis the exporter may have to sell the imported input in any case. Whether it sells the imported input or sells the DFRC itself, it should not make any difference.

Another point could be raised with respect to the requirement of 33 per cent value addition in the scheme. It is not very clear from the scheme as to why a value addition requirement has been stipulated if the duty free imports allowed against the DFRC are only in accordance with the SIONs. If the SION is technically sound, there should be no need for a value addition requirement. One justification could be its use as a safeguard against malpractice, whereby imported goods are re-exported only to get the benefit of the DFRC. The value addition requirement does not make the scheme countervailable but there could be a challenge about its WTO consistency on the basis of Article 3.1(b) of the ASCM, which prohibits subsidies contingent upon the use of domestic over imported goods. If the justification is to safeguard against malpractice as mentioned above then the requirement could be justified under Article XX(d) of GATT 1994.

#### **2.1.4 Export Promotion Capital Goods (EPCG) Scheme**

This scheme was first introduced on 1 April 1990 and has evolved since then. Under the EXIM policy for the current policy period (2002–2007), the scheme allows import of new capital goods at 5 per cent customs duty subject to the importer undertaking an export obligation equivalent to five times of the CIF value of the capital goods, to be fulfilled over a period of 8 years from the date of issuance of the licence. If the EPCG licence is for Rs 1000 million or more, the longer period of 12 years is allowed for discharging the export obligation. Imports of capital goods are subject to the Actual User condition until the export obligation is completed. In other words, the capital goods can be sold or leased after that period.

<sup>28</sup> Source: *Export & Import Policy, 1<sup>st</sup> April 2002–31<sup>st</sup> May 2007, Ministry of Commerce and Industry, New Delhi, 2002.*

<sup>29</sup> Source: *Handbook of Procedures, Vol. 1, 1<sup>st</sup> April 2002–31<sup>st</sup> March 2007, Ministry of Commerce and Industry, New Delhi, 2002.*

The export obligation is required to be fulfilled by the export of goods capable of being manufactured or produced by the use of the capital goods imported under the scheme. It is also permissible to fulfil the obligation by the export of the same goods, manufactured or produced in different manufacturing units of the license holder. If the exporter is already exporting the same product for the production of which it has obtained the capital goods, the export obligation can be discharged only by increasing the exports over and above the average level of exports achieved in the preceding three licensing years for the same products.<sup>30</sup>

The EPCG scheme has been countervailed against in all the three major developed countries where it has been investigated. In the final CVD determinations in Certain Cut-to-Length Carbon Steel Plate from India (1999) and Certain Hot-Rolled Carbon Steel Flat Products from India (2001), the US Department of Commerce countervailed against the scheme. The US practice is to distinguish between the benefits for the capital goods in respect of which the export obligation has been discharged and those for which such obligation has not been discharged. For the former, the entire duty foregone is taken to be a non-recurring benefit and is allocated over the Average Useful Life (AUL) of the capital goods (15 years). For the latter where the export obligation remains to be fulfilled, the Department of Commerce has treated the unpaid duties as an outstanding contingent liability and assumed the entire liability to be an interest free loan. The benefit of the assumed interest-free loan has been calculated on the basis of the long-term interest rate, and the sum of the benefit during the period of investigation is divided by the total exports during the same period to arrive at the rate of CVD.

In the EC, the scheme has been found to be countervailable in the CVD investigations relating to Certain Broad Spectrum Antibiotics (1998), PET film (1999), Certain Flat Rolled Products of Iron or Non-alloy Steel (2000), and Certain Polyethylene Terephthalate (2000). The EC has calculated the benefit by spreading the benefit over a period, which reflects the normal depreciation of such capital goods in the industry of the concerned product. In all these cases, the GOI had represented that any benefit conferred under the scheme should be allocated over the total production as the imported capital goods were used not only for the production of the exported goods but also for the production for domestic consumption. However, the argument was not accepted and the following EC observation in the final CVD determination on Certain Polyethylene Terephthalate reflects the line taken:

'In reply to this argument, it should be stressed that, as explained in recital 5.2 of the provisional Regulation, depending on the level of export commitment which the company is prepared to undertake, the company will be allowed to import capital goods at either a zero rate of duty or at a reduced rate. The scheme is therefore contingent in law upon export performance since no benefit can be obtained without a commitment to export goods. As such it is deemed to be specific under the provisions of Article 3(4)(a) of the basic Regulation. Since the subsidy is an export subsidy, it is considered to benefit only export sales. In conclusion the correct denominator is total export sales.'<sup>31</sup>

Canada has also countervailed against the EPCG scheme in the final CVD determination against Certain Stainless Steel Round Bars exported from India (2000). As in the US and the EC, Canada too spread the duty savings over the useful life of the imported capital equipment.

The argument for treating the EPCG scheme as a countervailable subsidy is valid as the government undoubtedly makes a financial contribution by partially exempting the duty. Since the benefit is contingent upon export performance it is an export subsidy and such a subsidy is deemed to be specific. The only question that arises is whether the investigating authorities were right in allocating the entire benefit to the exports and not taking into account the fact that the same capital equipment was also used to manufacture goods destined for domestic consumption.

The EPCG scheme as currently in operation results in two types of benefit for the exporter. First, there is a direct benefit arising from the use of the capital good for the production of the exported product. Second, there is an indirect benefit arising from the use of the same capital equipment for the manufacture of goods for domestic consumption. This benefit arises from the reduced cost of the capital goods used in production for such sales but it is an export subsidy nevertheless because of its linkage with the export obligation. The increased profits from domestic sales could be a factor in pricing the products exported under the export obligation.

Technically, the EC authorities and others who follow the same practice can be faulted for not spreading the benefit over the entire production in calculating the rate of CVD. But it has to be borne in mind that they have not taken into consideration the indirect benefit as explained above, which could raise the level of CVD. The calculation of the

<sup>30</sup> Source: *Export & Import Policy, 1<sup>st</sup> April 2002–31<sup>st</sup> March 2007, Ministry of Commerce and Industry, New Delhi, 2002.*

<sup>31</sup> Council Regulation (EC) No. 2603/2000 of 27 November 2000.

benefit in respect of the production for domestic sales linked to the export obligation could be complex and one cannot be certain what would be the level of CVD if this aspect were also taken into account. Another way of allocating the benefit of duty reduction would be to spread it over the exports during the period of fulfilment of the export obligation, which is normally eight years. That would result in higher rates of duty than is the case at present, as the benefit is allocated over the useful life of the capital goods in the relevant industry, which is generally more than eight years.

Another implication of the double benefits for exports resulting from the EPCG scheme is that the scheme in its current form cannot qualify as a legitimate drawback scheme under item (i) of the Illustrative List, even if there is agreement in future to amend footnote 61 so as to include capital goods (to the extent of depreciation) in the definition of inputs consumed in the production process. We have to take into consideration the fact that although the general requirement is that the capital goods must be used to produce the goods for export, there is also the possibility in the current scheme for the exporter to fulfil the export obligation from the production in other units, which are obviously not using the capital equipment imported under the EPCG scheme.

### **2.1.5 Export Oriented Units (EOUs), Export Processing Zones (EPZs), Electronic Hardware Technology Parks (EHTPs), and Software Technology Parks (STPs)**

As in the past, the 2002–2007 EXIM Policy allows units that undertake ‘to export their entire production of goods and services’ to be set up under the EOU, EPZ, EHTP, or STP schemes. Such units could be engaged in ‘manufacture, services, repair, remaking, services, repair, remaking, reconditioning, re-engineering including making of gold/silver/platinum jewellery and articles thereof, agriculture, animal husbandry, bio-technology, floriculture, horticulture, pisciculture, viticulture, poultry, sericulture, and granites’.<sup>32</sup>

The EOU/EPZ/EHTP/STP units are entitled to import, without payment of duty, all types of goods, including capital goods, required by them for carrying out the activities listed above. They are required to earn a minimum of Net Foreign Exchange as a percentage of Exports (NFEP) and also show a minimum of EP as specified in Appendix I of the Policy. The EP requirement is generally expressed in terms of a specified amount or a multiple of the CIF value of the imported capital goods whichever is higher.

A feature of these schemes is that the units are entitled to buy their requirements of capital goods and other materials from the Domestic Tariff Area (DTA), free of internal taxes. The Central Excise Duty is reimbursed if the purchase is not already exempted and the Central Sales tax is reimbursed. The units (except those manufacturing goods such as motor cars, alcoholic beverages, etc.) are also allowed to sell their produce to the DTA, but such sales are subject to the payment of the full import duty as well as the fulfilment of minimum NFEP. Sales to the DTA are restricted to 50 per cent of the FOB value of exports (10 per cent in the case of gems and jewellery units). Sale of rejects may be made up to 5 per cent of the FOB value of exports but is not subject to the achievement of the NFEP.<sup>33</sup>

The entire operations of EOU/EPZ/EHTP/STP units are conducted in customs bonded premises, unless specifically exempted from physical bonding. The initial period of bonding is five years, but extendable for further periods of five years at a time. At the time of each extension, the authorities determine the NFEP and EP to be achieved during the extended period. On debonding, the unit has to pay duties of customs and excise in force at the time of debonding. Depreciation norms are laid down for being applied for calculation of the payable duty at the time of debonding.<sup>34</sup>

Units benefiting from these schemes have not been investigated in the US and Canada and therefore the investigating agencies in these countries have not given any verdict on their countervailability. However, the EC authorities have done so. In the Council Regulation (EC) No. 2164/98 of 5 October 1998 imposing a definitive countervailing duty on imports of Certain Broad Spectrum Antibiotics originating in India, the EC countervailed against the exemption of import duty of capital goods on account of the fact that capital goods are not regarded as being consumed in the production process of the exported product. The EC also countervailed against the exemption of duty on raw materials in that case because it was not possible for the investigating authority to assess ‘on the basis of the verifiable information whether the raw materials which were imported without payment of import charges by this company were consumed and physically incorporated in goods produced for export’.

In the Council Regulation (EC) No. 2597/1999 of 6 December 1999 imposing definitive CVD on PET film imported

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<sup>32</sup> *Export & Import Policy, 1<sup>st</sup> April 2002–31<sup>st</sup> March 2007, Ministry of Commerce and Industry, New Delhi, 2002.*

<sup>33</sup> *Ibid.*

<sup>34</sup> *Handbook of Procedures, 1<sup>st</sup> April 2002–31<sup>st</sup> March 2007, Ministry of Commerce and Industry, New Delhi, 2002.*

from India, the EC countervailed on the basis of exemption of capital goods from import duty. In the Council Regulation (EC) No. 573/2002 of 3 April 2002 on imports of Sulphanilic acid from India, the EC did not impose CVD on the basis of exemption of import duties on raw materials as it was found during investigation that the exemption was granted in accordance with Annexes I to III of the basic Regulation. However, it countervailed against the reimbursement of central sales tax on goods procured from the DTA.

As far as imports of raw materials on a duty free basis is concerned, the EOU/EPZ/EHTP/STP scheme has all the elements of the framework envisaged in item (i) of the Illustrative List and Annex II of the ASCM for non-excessive remission of import charges. These raw materials are imported for being used in the production for exports, as the units undertake to export their entire production. Even if they are permitted to supply to the domestic tariff area, it is only after payment of full duties. Supplies to the domestic tariff area are no different from exports and they should be treated as exports. In light of this, the EC has not countervailed against the scheme for exemption of duty on raw materials where the case has been presented properly and verifiable information furnished.

In view of the definition of 'inputs consumed in the production process', imposition of CVD on the basis of exemption of duty on imports of capital goods is justified. However, there is no justification for the imposition of CVD on the basis of reimbursement of central sales tax procured from the domestic tariff area. This reimbursement is in respect of prior-stage cumulative indirect taxes on goods and services used in the production of exported products, which should not have been treated as a benefit in terms of item (h) of the Illustrative List and Annex II of the ASCM. Since the entire operations of these units are in customs bonded premises, it can be said that a reasonable and effective verification system is in existence as required in Annex II of the ASCM. In the Council Regulation (EC) No. 2164/98 imposing definitive CVD on broad spectrum antibiotics, there is a reference to the representation made by the GOI that export processing zones are not unique to India. The EC did not contest the practice of export processing zones as such but found the scheme countervailable due to the absence of verifiable information that the duty exempted raw materials were used in the production for exports. It follows that it is necessary in CVD investigations to demonstrate in each case that the requirements of items (h) and (i) of the Illustrative List, Annex II, and, where necessary, Annex III have been met.

### **2.1.6 Duty Drawback Scheme**

Another important scheme of remission of indirect taxes and import duties is the Duty Drawback Scheme operated by the Department of Customs under Section 75 of the Customs Act 1962. The scheme provides for refund of duties of customs and central excise on basic inputs like raw materials, components, intermediates, and packing material used in various stages of manufacture/production. No relief is provided for duties on capital goods, fuels, and consumables. Other taxes and charges such as sales tax or octroi are also not taken into account. The excise duties on the finished export product are also reimbursed under the drawback scheme and there are separate provisions for the rebate of these duties under the Central Excise and Salt Act 1944. Drawback rates are notified either on a general basis (all industry rates) or for individual exporters (brand rates).

There is a two-tier system for the administration of the scheme involving (i) fixation of rates by the Directorate of Drawback in the Central Board of Excise and Customs and (ii) disbursement of drawback amount by the Customs Houses and/Central Excise Commissionerate. The all-industry rates of drawback are normally announced on 1 June every year or three months after the budget. They are applicable to manufacturer-exporter as well as merchant-exporters. These rates are determined on the basis of the industry-wide averages of consumption of inputs, incidence of duties, wastage, FOB prices of the exported product, etc. If in any category of goods the all-industry rates have not been determined or if any exporter finds the duty incidence to be higher than the all-industry rate, it can apply for fixation of brand rates.<sup>35</sup>

Article 3(2) of the Customs and Central Excise Duties Drawback Rules states that in determining the amount or rate of drawback the Central Government must have regard to:

- '(a) the average quantity or value of each class or description of the materials from which a particular class of goods is ordinarily produced or manufactured in India;
- (b) the average quantity or value of the imported materials or excisable materials used for production or manufactured in India of a particular class of goods;
- (c) the average amount of duties paid on imported materials or excisable materials used in the manufacture of semis, components and intermediate products which are used in the manufacture of goods;

<sup>35</sup> Source: <http://www.cbec.gov.in/cae/customs/dbk-schedle/dbk-mainpg.htm>

- (d) the average amount of duties paid on materials in the process of manufacture and catalytic agents:  
Provided that if any such waste or catalytic agent is re-used in any process of manufacture or is sold, the average amount of duties on the waste or catalytic agent re-used or sold shall also be deducted;
- (e) the average amount of duties paid on imported materials or excisable materials used for containing or packing the export goods;
- (f) any other information which the Central Government may consider relevant or useful for the purpose.'

Payments made under the drawback scheme have not been countervailed against in any importing country. Payments made under the brand rates fulfil all the conditions laid down in items (h) and (i) of the Illustrative List and Annex II of the ASCM. Averaging in computation of all-industry rates introduces an inherent weakness in the payments against the all-industry rates. It was on account of this that the scheme was subjected to rigorous questioning during the Trade Policy Review of India in 2002. However, since in the fixation of rates systematic procedures are followed, it should be possible to argue in a future case that the criteria laid down in Annex II regarding the existence of a reasonable and effective verification system are fulfilled.

### **2.1.7 Income Tax Exemption Scheme**

Section 80HHC of the Income Tax Act, 1961, as amended up to the Finance Act, 2002, provides as follows:

'(1) Where an assessee, being an Indian company or a person (other than a company) resident in India, is engaged in the business of exports out of India of any goods or merchandise to which this section applies, there shall, in accordance with and subject to the provisions of this section, be allowed, in computing the total income of the assessee, a deduction to the extent of profits, referred to in sub-section (1B), derived by the assessee from the export of such goods or merchandise'.

Sub-section (1B) of section 80HHC, which was inserted in the Finance Act, 2000, and further amended in the Finance Act, 2001, provides for the extent of deduction to be on a reducing scale, so as to reach 50 per cent for the assessment year beginning 1 April 2003 and zero in the assessment year beginning 2005. Thus this incentive is due to be phased out with effect from 1 April 2004.

Another income tax benefit, which is an export subsidy, has been given in Section 10A of the Income Tax Act, 1961. Newly established undertakings in Free Trade Zones and Export Processing Zones were allowed 100 per cent deduction of profits from exports in the computation of income for a consecutive period of 10 years. The Finance Act, 2002 restricted the deduction to 90 per cent for pre-existing units. For new units set up after 1 April 2002, deduction is allowed at 100 per cent for five years and 50 per cent for two years thereafter. No deductions are to be allowed for the assessment years beginning on 1 April 2010 and later. Section 10B of the Act extends the same benefits to Export Oriented Units. As in the case of Free Trade Zones, the benefit is available only up to 1 April 2010.

These benefits fit squarely into the description of export subsidies in item (e) of the Illustrative List. For this reason these benefits, and particularly those under Section 80HHC, have been countervailed in all jurisdictions whenever it has been found that particular firms availed of the benefits. At present it is envisaged that the Section 80HHC benefit would be phased out in the assessment year beginning 2005 and Section 10A and 10B benefits in the assessment year beginning 2010.

### **2.1.8 Export Credit Schemes<sup>36</sup>**

Export credit on preferential terms has been a long-standing export incentive programme in India. The Reserve Bank of India (RBI) issues directions under Sections 21 and 35A to commercial banks to provide export credit both at pre-shipment and post-shipment stage. Pre-shipment credit, also known as packaging credit, is advanced by commercial banks to the exporters for purchase of raw materials or the finished product upon the presentation of confirmed export orders or letters of credit. Such credit can be in rupees or foreign currency. Post-shipment credit is granted to an exporter after shipment of goods, against either the shipping bills or drawback claims. As in the case of pre-shipment credit, the advance can be in rupees or foreign currency, except that when the pre-shipment credit is in foreign currency the post-shipment credit is also in the same currency.

The RBI specifies the maximum (ceiling) rate that commercial banks can charge on export credit in rupee terms. The RBI in turn refinances part of the outstanding export credit that the commercial banks extend to the exporters. In the

<sup>36</sup> Information on this is derived mainly from the Credit Policy of India, available at [www.rbi.org.in](http://www.rbi.org.in)

credit policy for 2001–02 announced by the RBI, the ceiling rate was linked to the Prime Lending Rates (PLRs) of banks. For pre-shipment credit up to 180 days, the maximum that banks can currently charge is the PLR minus 2.5 percentage points. For pre-shipment credit beyond 180 days and up to 270 days, the current ceiling rate is PLR plus 0.5 percentage points. Beyond the 270<sup>th</sup> day, banks are free to charge appropriate commercial rate.<sup>37</sup> Similarly, for post-shipment credit given on demand bills and usance bills there is ceiling rate linked to PLR of a bank. Credit against demand bills is generally for a very short period (the normal transit period). In contrast, credit against usance bills is for a longer period and the length of the period depends as per an arrangement between an exporter and an importer. The current ceiling rate on demand bills is PLR minus 2.5 percentage points. On usance bills, this rate on credit up to 90 days was PLR minus 2.5 percentage points, and on credit beyond 90 days and up to 6 months, the rate was PLR plus 0.5 percentage points.<sup>38</sup>

In case of export credit in foreign currency, the RBI allows the banks to charge internationally competitive rate, linked to the London Inter-Bank Offer Rate (LIBOR). The RBI puts a cap on the spread around this internationally competitive rate that the banks can charge. As per the April 2002 credit policy, pre-shipment credit up to 180 days can be availed by the exporters at a ceiling rate of LIBOR+0.75 per cent. For credit beyond 180 days and up to 360 days, 2 percentage points get added to the rate charged for the initial 180-day period. For post-shipment credit in foreign currency, ceiling rate for credit on demand bill (for transit period) is LIBOR+0.75 per cent. On usance bills (for total period, i.e. usance period, transit period, and grace period) up to 6 months from the date of shipment, the rate cannot exceed LIBOR+0.75 per cent.<sup>39</sup> However, the rate charged on export bills (demand or usance) realised after the due date and up to the date of their realisation is 2 percentage points over the rate charged on the usance bills. On export credit not otherwise specified, banks are free to charge any rate.

In its mid-term review of the monetary and credit policy in October 2002, the RBI has announced its intention to liberalise interest rates on rupee export credit in two phases. In the first phase, the ceiling rate (of PLR plus 0.5 per cent) on pre-shipment credit beyond 180 days and up to 270 days and post-shipment credit beyond 90 days and up to 180 days will be deregulated from 1 May 2003. Thereafter, banks will enjoy freedom to decide whether to charge PLR or sub-PLR rates subject to approval of their boards. In the second phase, the RBI intends to deregulate ceiling rates on pre-shipment credit up to 180 days and post-shipment credit up to 90 days. Given this trend of deregulation, the indications are that the preferential export credit denominated in foreign currency would also be phased out in the not-too-distant future.

The US Department of Commerce (USDOC) and the Canadian Customs and Revenue Agency (CCRA) have countervailed against the export credit programme in India in every investigation in recent years, while the EC has not even examined the practice in any case. In the United States and Canada, the benchmark used for calculating the subsidy is generally the normal commercial interest rate. In the Final Result of CVD Administrative Review of the Certain Iron-Metal Castings From India (6 December 1996), the USDOC took the benchmark to be the short-term loan rate for small businesses (Small-Scale Industries) even though that rate itself was lower than other commercial interest rates.

In the Final Determination in the CVD Administrative Review in Certain Iron Metal Castings (18 November 1998), the USDOC made some key pronouncements on the benchmark in the case of pre-shipment credit in foreign currency (PSCFC) availed of by exporters. The exporters had represented that the benchmark should be determined on the basis of the cost-to-government standard of item (k) of the Illustrative List. The USDOC opined that the Illustrative List had no direct application to the CVD portion of the ASCM and the use of cost-to-government standard in items (k) and (l) of the Illustrative List was inappropriate for CVD purposes. In the view of the USDOC, in order to determine whether the export credit rates conferred a countervailable benefit, it had to be seen whether 'there is a difference between the amount the recipient of the PSCFC pays on the loan and the amount the recipient would have to pay on a comparable commercial loan that the recipient could obtain on the market'. Since the PSCFC loans were limited to exporters, and non-exporters did not have access to the low-cost financial loans with interest rates linked to LIBOR, the USDOC determined that these rates could not be regarded as 'comparable commercial loans that the recipient

<sup>37</sup> If shipment does not take place within 360 days of the disbursement of the loan, then banks are free to charge interest applicable to 'Export Credit Not Otherwise Specified' from day one of the advance.

<sup>38</sup> In the credit policy 2001–02, the ceiling rates on both pre-shipment and post-shipment credit was uniformly 1 percentage point higher than the current rates. The ceiling rates were uniformly reduced by 1 percentage point in order to mitigate the adverse effect on India's exports of the September 11 attack. This reduction, which became effective from 26 September 2001, will remain in force till end-April 2003.

<sup>39</sup> According to the credit policy of 2001–02, the RBI allowed the maximum spread around LIBOR to 1.0 per cent (instead of the current 0.75 per cent).



could actually obtain on the market'. As the benchmark rate, the USDOC had a preference for a company-specific interest rate for the rupee-denominated short-term working capital loans, but in the absence of a company-specific rate the USDOC used the interest rate for domestic working capital (cash credit rate).

In the final determination in *Certain Hot-Rolled Carbon Steel Flat Products from India* (20 April 2001), the USDOC also relied on the commercially available rates for determining the extent of subsidy. For the pre-shipment export credit denominated in rupees, the benchmark rate used was the company specific short-term interest rates. With regard to the rupee-denominated post-shipment rates, the same methodology was used. For US dollar-denominated post-shipment credit, the benchmark used was the weighted-average interest-rate of the company-specific, US dollar-denominated short-term loans received from commercial banks by the exporting company, the Steel Authority of India Limited (SAIL).

The main question that arises from the USDOC determinations on the export credit programme in India is whether it is right for them to disallow the cost-to-government approach in determining the existence and extent of subsidy, when such an approach is implicit in item (k) of the Illustrative List. Here it must be stressed that the Illustrative List is not an exhaustive list and it enumerates only some of the measures that are *per se* prohibited export subsidies. If the rate of export credit were lower than the deposit or borrowing rates, then clearly the practice would constitute an export subsidy. But if the rates are higher but not high enough to cover the costs associated with the borrowing and lending operations then the practice could still constitute an export subsidy. Even if for the sake of argument we were to assume that the cost-to-government approach is the right approach, it cannot be said with confidence that it would be advantageous for the Indian exporters. In the context of Indian banking, it would be necessary to add to the cost of funds the substantial cost on account of non-performing assets. It may turn out that the benefit-to-recipient approach, which is borne out by a reasonable interpretation of the ASCM, is more advantageous.

Since item (k) is enumerated on the Illustrative List, it is not reasonable to assert that what does not fit into the description given therein is not an export subsidy. No doubt footnote 5 of the ASCM states that measures that are referred to in the Illustrative List as not constituting an export subsidy shall not be prohibited under Article 3 or any other provision of, but the Brazil-Aircraft Compliance Panel held as follows:

'The first paragraph of item (k) does not contain any affirmative statement that a measure is *not* an export subsidy nor that measures not satisfying the conditions of that item are *not* prohibited. To the contrary, the first paragraph of item (k) on its face simply identifies measures that *are* prohibited export subsidies. Thus, the first paragraph of item (k) on its face does not in our view fall within the scope of footnote 5 read in conformity with its ordinary meaning.'<sup>40</sup>

In other words, the first paragraph of item (k) cannot be used a *contrario* to establish that a measure is permitted or even as a basis for asserting that a cost-to-government approach must be used to determine the existence or extent of subsidy.

For determining whether the export credit programme constitutes a countervailable export subsidy, reliance has to be placed on Article 1 and 2 of the ASCM, which define subsidies and lay down the criteria for specificity that have to be fulfilled in order for a subsidy to be actionable under the ASCM. Undoubtedly, in the export credit programme there is a financial contribution from government and a benefit is conferred. Since the subsidy is linked to export performance, it is a specific subsidy. As to the benchmark for interest rates, Article 14 of the ASCM clearly stipulates that 'a loan from a government shall not be considered as conferring a benefit, unless there is a difference between the amount that the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market'. In light of this, one cannot fault the line that the USDOC has generally taken as far as benchmark rates are concerned.

## **2.2 Other Central Government Programmes of Domestic Support to Industry**

### **2.2.1 Small-Scale Industries<sup>41</sup>**

Support to small-scale industrial units has been a main plank of India's industrial policy for a long time, and the position has not changed substantively after the economic reforms of the early 1990s. The Industries (Development and Regulation) Act, 1951 (IDR Act) provides the statutory framework for the control of industry in India. Section 11-B enables the Central Government to specify the requirements, which should be complied with by small-scale industrial

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<sup>40</sup> WTO Document WT/DS46/RW.

<sup>41</sup> Information on this is taken mainly from the site: <http://www.ssi.nic.in/welcome.html>

undertakings for special measures of support by government. The provision stipulates that the factors to be taken into account for designating undertakings for favourable treatment are, *inter alia*, the investment in plant and machinery; nature of ownership; smallness, in respect of the number of workers employed; and nature, cost, and quality of the product.

Under the latest notification of the Central Government, a small-scale industrial undertaking is one in which the investment in fixed assets in plant and machinery, whether held on owners terms on lease or on hire purchase, does not exceed Rupees 10 million. The condition applies that the unit is not owned or controlled by or is a subsidiary of any other industrial undertaking. Detailed rules explain the concepts of ownership, control, and subsidiary status and further lay down the norms for calculating the value of plant and machinery. A sub-set of small-scale industrial undertakings is the ancillary industrial undertaking, which is engaged in the manufacture or production of parts, components, sub-assemblies, tooling, or intermediates, or rendering services and undertaking supplies to one or more other industrial undertakings.

The main benefit that small-scale industries receive from the Central Government is the statutory reservation of items/products for exclusive production by them. The provisions relating to reservation are contained in sections 29B (2A) to (2H) of the IDR Act. The list of reserved items has been trimmed down after the economic reforms. Some of the main financial benefits for which the small-scale units are eligible are enumerated below:

- (i) Capital subsidy of 12 per cent for investment in technology in select sectors;
- (ii) Grant of Rupees 75,000 to each unit opting for ISO 9000 certification;
- (iii) Exemption from excise duty up to a limit of Rupees 10 million;
- (iv) Assistance for marketing through vendor development programmes, buyer–seller meets, and exhibitions; and
- (v) One-time capital grant of 50 per cent to small-scale associations for the development of testing laboratories of international standards.

Ancillary industrial undertakings are eligible to all the above plus benefits from the other undertakings to which they are attached.

Clearly, all the above schemes represent financial contributions from the government and a benefit is conferred. But these subsidies do not seem to meet the test of specificity, which is essential for the subsidies to be subject to the substantive provisions of the ASCM. Article 2.2(b) stipulates that 'W[here] the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to.' Further, a footnote adds that '[o]bjective criteria or conditions, as used herein, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise'. The only criterion for designating small-scale industrial units is that the investment in plant and machinery be less than Rupees 10 million. This certainly is objective and neutral and also horizontal in application. There appears, therefore, to be an arguable case that subsidies given to small-scale enterprises by virtue of their being such enterprises are not actionable under the ASCM. However, as we have observed earlier, the parameters of specificity have not been defined with sufficient precision in Article 2 for us to come to a firm conclusion on this.

There is a problem, however, with the exemption from excise duty, not under the ASCM but under Article III of GATT 1994. This article obliges WTO Members to give the same treatment to imported products as to domestic products with respect to 'internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions'. Not only the same internal taxes must be applied to domestic as to imported products, but the manner of their application must also be the same. Paragraph 8(b) of Article III no doubt contains the following exception to the general obligation of the Article:

'The provisions of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchase of domestic products.'

The general sense of this caveat appears to be that the national treatment obligation of GATT 1994 does not oblige Members to extend subsidies on domestic products to imported products as well. In interpreting this provision, however, GATT 1947 panels have made a distinction between tax exemptions and remissions, on the one hand, and producer

subsidies, on the other. In the 1992 Report on *United States-Measures Affecting Alcoholic and Malt Beverages*, the Panel examined a United States tax measure providing a credit against excise taxes for small United States producers of beer and wine, which was not available for imported beer and wine. It took the view that the words 'payment of subsidies' in paragraph 8(b) of Article III referred only to direct subsidies involving a payment, not to other subsidies such as tax credits or tax reductions. It held that '[t]he specific reference to "payments ... derived from the proceeds of internal taxes ... applied consistently with the provisions of this Article" relates to after-tax-collection payments and also suggests that tax credits and reduced tax rates inconsistent with Article III: 2, which neither involve a "payment" nor result in "proceeds of internal taxes applied consistently with ... this Article", are not covered by Article III: 8(b)'.<sup>42</sup>

In another Report, *United States-Measures Affecting the Importation, Internal Sale and Use of Tobacco*, the Panel observed as follows:

'The Panel was cognizant of the fact that a remission of a tax on a product and the payment of a producer subsidy could have the same economic effects. However, the Panel noted that the distinction in Article III: 8(b) is a formal one, not one related to the economic impact of a measure.'<sup>43</sup>

The distinction made in the GATT panels between producer subsidies and tax exemptions and remissions seems to have been overtaken by the definition of subsidies in the ASCM, which characterises both a direct transfer of funds and revenue foregone as financial contributions by a government. However, the Indonesia-Automobiles panel has taken a view which follows the GATT panels and overlooks the ASCM definition of a subsidy. The panel observes as follows:

'We consider that the purpose of Article III: 8(b) is to confirm that subsidies to producers do not violate Article III so long as they do not have any component that introduces discrimination between imported and domestic products. In our view the wording "payment of subsidies exclusively to domestic producers" exists so as to ensure that only subsidies provided to producers, and not tax or other form of discrimination of products, be considered subsidies for the purpose of Article III: 8(b) of GATT.'

It has, therefore, become necessary to seek an interpretation of Article III: 8(b) in the light of Article 1.1 of the ASCM, so that exemption of domestic producers from the internal tax is treated on the same footing as payment of subsidies. It follows from the Panel Reports cited above that if the excise duty is first collected and then reimbursed, it would be covered by the exemption contained in paragraph 8(b) of Article III. However, if the duty is not collected at all, the practice would not be covered by paragraph 8(b) and would fall foul of the obligation in Article III: 2 of GATT 1994.

It needs to be mentioned here that although some of the industrial units, which have been under countervailing duty investigations, particularly in the United States, are small-scale industries, the domestic subsidies that they receive as small-scale industries have not been countervailed against.

### **2.2.2 Public Sector**

Between the adoption in 1956 of the Industrial Policy Resolution and the introduction of economic reforms in 1991–2, public sector industrial enterprises expanded strongly in India, driven by the policy of self-reliance and import substitution, which constituted the core of India's economic policy. As they were established generally without an examination of their commercial viability in an open economic environment, a large majority of them have been in financial trouble in recent years and dependent on public subsidies for survival. In addition to establishing uneconomic units, governments (both at the Centre and in the States) also took over in 'public interest', many sick units that had been abandoned by the private sector. These units have been an even greater financial burden on the governments. After the economic reforms there has been a major change in government policy in respect of the public sector industrial enterprises and the Central Government has moved strongly to privatise, restructure, or close the enterprises. It is not within the scope of this work to survey the general situation of public sector undertakings or the progress in implementation of the new policy. We look at only the implications of the obligations under the ASCM for the financial support of the public sector as government moves to restructure or privatise them. For illustrative purposes, we have selected the public sector enterprises (PSEs) of the Central Government in the Ministries of Heavy Industry and Steel.

The Department of Heavy Industry is responsible for 48 of the 240 public sector enterprises of the Central Government. With the solitary exception of the Bharat Heavy Electricals Limited, which is a successful undertaking, most others are

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<sup>42</sup> GATT Document DS23/R, BISD 39S/206.

<sup>43</sup> GATT Document DS44/R, BISD/ 41S.

in bad shape. According to the Fifth Report submitted by the Expenditure Reforms Commission on 20 September 2000, as many as 32 enterprises made large losses in 1998–9. The Report makes the following recommendation on the future policy to be adopted on these enterprises by the government:

'A broad principle that may be adopted is to treat those companies whose current operations, relieved of the burden of old debts, are profitable as potential candidates for restructuring to make them viable. If the current operations are profitable and could be expected to continue to be profitable in future, such an enterprise should be made viable through financial restructuring by lifting the burden of debts piled up from loans extended by government to finance previous losses.'<sup>44</sup>

The scale of financial support by government can be gauged from Table 1 relating to some of the enterprises that are already in the process of restructuring on the basis of the plans drawn up by the Board of Industrial and Financial Reconstruction (BIFR).

**Table 1: Government Inputs in PSEs under Revival Plans Sanctioned by BIFR**

(in Rs million)										
No.	PSE	Date of sanction	Fresh infusion of funds	Release of funds	Write-off by government	Conversion of loan into equity	Government guarantee	Total	Accumulated losses	Annual output
1	Heavy Engineering Corporation	Aug 1996	2520	1906	2721	994	2530	8765	-6476	2716
2	Jessop & Co.	Sept 1997	430	430	1199.8	211	706.8	2547.7	-1707	680.8
3	Burn Co.	April 1999	1500	1344.9	3296.4	1357.2	650	6803.6	-1609.7	2724

Source: Expenditure Reforms Commission, Fourth Report (20<sup>th</sup> September 2000), Department of Heavy Industry, <http://expenditurereforms.nic.in/main2.htm>.

It would be seen that three types of financial support have been undertaken in the past and if the recommendations of the Expenditure Reforms Commission are followed more support of the same type will follow.

The Ministry of Steel is another ministry that administers a number of public sector undertakings, including five large integrated steel plants. According to the information made available in the Sixth Report of the Expenditure Reforms Commission (20 June 2001), a major rehabilitation programme has been undertaken to ensure the long term viability of SAIL, which controls the five integrated plants. The rehabilitation programme involves the waiving of loans advanced from the Steel Development Fund or by the Government of India, provision of 50 per cent interest subsidy, and guarantee for loan of Rs 15,000 million to be raised by SAIL from the market to finance reduction in manpower through voluntary retirement schemes and provision of guarantee for a loan of Rs 15,000 million to be separately raised for meeting repayment obligations of past loans. The process of divestment has been initiated in respect of some of the non-core assets and the Indian Iron and Steel Company (IISCO), a subsidiary of SAIL, is being converted into a joint venture with SAIL holding a minority share. According to the policy of divestment announced by the government, public sector enterprises that are not in the category of strategic industries will be privatised by divesting up to 75 per cent of the government shareholding. Those that are not viable to be privatised in this manner will either be closed down or sold outright. Obviously the government regards steel industry as strategic and therefore sizeable financial support is likely to continue.

What is the implication of the obligations under the ASCM for the support of the public sector in India? It is clear that the forgiveness of loans as well as interest subsidy or even loan guarantees is actionable subsidies under Articles 5, 6, and, 7 of the ASCM. However, as we have seen in the earlier analysis, the provisions of these articles read with Article 27.9 ensure that no action can be taken against India for 'serious prejudice' as defined in Article 5(c). Action can, however, be taken under Article 5(a) if goods produced by the public sector units are exported and they cause injury to the domestic industry in importing countries. These subsidies are also actionable under Article 5(b) if tariff commitments have been undertaken on the relevant products and the subsidies provided are in excess of the level of subsidy prevailing at the time the binding was made. But, as already mentioned earlier, under Article 27.13, 'direct forgiveness of debts, subsidies to cover social costs, in whatever form, including relinquishment of government revenue and other transfer of liabilities' made in the context of privatization programmes of developing countries are immune from

<sup>44</sup> Expenditure Reforms Commission, Fourth Report (20<sup>th</sup> September 2000), Department of Heavy Industry, <http://expenditurereforms.nic.in/main2.htm>

action under Part III of the ASCM, provided 'that both such programme and the subsidies involved are for a limited period and notified to the Committee and that the programme results in eventual privatization of the enterprise concerned'. The immunity under Article 27.13 does not extend to the imposition of countervailing duty. The Panel in the US-Countervailing Measures Concerning Certain Products from the European Communities had initially determined that once privatisation had taken place, no benefit resulting from past financial contribution passed through to the new owner, observing as follows:

'Once an importing Member has determined that a privatization has taken place at arm's length and for fair market value, it must reach the conclusion that no benefit resulting from the prior financial contribution (or subsidization) continues to accrue to the privatized producer'.<sup>45</sup>

However, the Appellate Body argued that the Panel's ruling 'may be defensible in the context of transactions between two private parties taking place in reasonably competitive markets; however, it overlooks the ability of governments to obtain certain results from markets by shaping the circumstances and conditions in which markets operate'. Consequently, it reversed the Panel's findings and ruled as follows:

'Therefore, we find that the Panel erred in concluding that "[p]rivatisations at arm's length and for fair market value must lead to the conclusion that the privatized producer paid for what he got and thus did not get any benefit or advantage from the prior financial contribution bestowed upon the state-owned producer." (emphasis added). Privatisation at arm's length and for fair market value may result in extinguishing the benefit. Indeed, we find that there is a rebuttable presumption that a benefit ceases to exist after such a privatisation. Nevertheless, it does not necessarily do so. There is no inflexible rule requiring that investigating authorities, in future cases, automatically determine that a "benefit" derived from pre-privatization financial contributions expires following privatization at arm's length and for fair market value. It depends on the facts of each case.'<sup>46</sup>

While no problem has been raised by any WTO Member on nullification or impairment of tariff concessions on account of financial support of the public sector, Indian products exported by public sector steel enterprises have already faced CVDs on account of forgiveness of loans and government guarantees for loans raised from the commercial banks. In the Final Affirmative Countervailing Duty Determination: Certain Hot-Rolled Carbon Steel Flat Products from India, the USDOC determined that the advancement of loans from the Steel Development Fund (SDF), the write off of those loans, as well as of loans advanced by the GOI constituted countervailable subsidy practices. In an earlier case (CTL Plate from India), the USDOC had determined that since the SDF was financed by producer levies and other non-government sources, advancement of loans from the fund did not constitute a countervailable subsidy. However, in the Hot-Rolled Carbon Steel Flat Products case, it reversed the earlier determination on the ground that the levies originated from the producer price increases that were mandated and determined by the Joint Plant Committee of which the Secretary in the Ministry of Steel was the Chairman. During the period under investigation, steel prices were controlled in India and it was the government that had mandated the JPC to increase the price in order to generate funds for the SDF to be used for concessional financing.

The USDOC also determined that government guarantees for the loans raised by SAIL from the market were countervailable. In the case of loans written off by government, the amount was allocated over a 15-year period to determine the countervailing duty, and in the case of loan guarantee or advances from the SDF the interest saving during the period of investigation was taken into account for the purpose. Even after spreading the benefit over 15 years, the amount of CVD determined for the forgiveness of SDF loans was more than 6 per cent.

The financial support given by government for the 'restructuring' of public sector enterprises in future will continue to be vulnerable to similar action in future. Conversion of loan into equity or infusion of fresh equity funds will need to meet the market test in order not to invite similar penalties. Market test implies that the infusion of funds will have to be justified on the basis that the investment decision was consistent with the usual investment practice of the private investors in the country.

Any decision to privatise or to close the loss making public sector units will present no problems as far as the obligations under the ASCM are concerned. If in the course of privatisation, the standards stipulated in Article 27.13 are followed, the privatised unit will not be burdened with the consequences of past subsidies in future CVD investigations.

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<sup>45</sup> WTO Document WT/DS212/R.

<sup>46</sup> WT/DS212/AB/R.

### **2.2.3 Other Industrial Subsidies**

There are some other subsidy programmes of the Government of India that could potentially be actionable under the ASCM. Two programmes deserve to be mentioned here. One of the most expensive subsidy programmes is the Retention Price Scheme for urea. Under the scheme, individual manufacturing units are paid subsidy to the extent of the difference between the sale price and retention price (the cost of production as assessed by the government plus reasonable return on net worth). In the case of some units, the subsidy is 100 per cent or more of the sale price. The subsidy is potentially actionable under Articles 5(a) and 5(b). But India does not export urea, nor has it undertaken any tariff commitment on the product.

The other scheme that is relevant is the US\$ 6 billion Technology Upgradation Fund set up on 1 April 1999 to promote the modernisation of the textiles and clothing industry. Under the scheme, manufacturing units are eligible for long and medium term loans from the IDBI, SIDBI, and IFCI, at interest rates that are 5 per cent lower than the normal lending rates of banks. The Fund is used to reimburse the interest subsidy to the lending institutions. Clearly, the scheme is actionable under both Articles 5(a) and 5(b).

### **2.3 Actionable Subsidies Granted by State Governments**

Several state governments grant subsidies to attract investment to backward regions or to the state as a whole. Schemes are generally in the form of exemption from or refund of local taxes. Some of these schemes have figured in CVD determinations, particularly in the EC, and it is instructive to analyse the treatment that they have received, even though the relevant provision in the ASCM has ceased to be valid. As already mentioned earlier, Article 8 of the ASCM (now defunct) had envisaged that if regional subsidies fulfilled certain criteria they would be non-actionable. These criteria were that the assistance must be given pursuant to a general framework of regional development, the region must be a clearly designated, contiguous geographical area and it must have been considered as disadvantaged on the basis of neutral and objective criteria, such as the per capita GDP being not above 85 per cent, or the unemployment rate being at least 110 per cent of the average of the territory as a whole.

The Government of Maharashtra grants incentives to industrial units in the backward regions of the state by way of sales tax benefits. In the definitive CVD determination on imports of sulphanilic acid from India,<sup>47</sup> the EC found that the scheme did not meet the criteria for non-actionability laid down in the ASCM. Although the per capita income of backward eligible regions of the state was said to be less than 75 per cent of the state as a whole, the EC took into account the fact that the per capita GDP of Maharashtra was 60 per cent higher than the national average of India. The EC held (rightly) that the benchmark for measuring the per capita GDP of the backward region was the average per capita GDP of the country as a whole.

The Government of Maharashtra also grants refunds of octroi to companies that invest in backward areas of the state. In the definitive CVD determination on imports of PET film from India,<sup>48</sup> the EC found that the scheme was countervailable because the Government of India did not produce any evidence to establish that the criteria for designating backward regions laid down in the ASCM had been met.

In the PET film case, the electricity duty exemption given to eligible industrial enterprises in Gujarat and Maharashtra was also examined and initially, provisional duties were imposed, treating the exemption as a subsidy. However, when evidence was led to show that in Gujarat all new industrial enterprises were exempted from the duty, the investigating authority came to the conclusion that the measure was not a specific subsidy at all because all new undertakings in the state were eligible. It is worth noting that for determining whether the measure was horizontal in application the EC did not require that the measure be applicable to the country as a whole.

### **2.4 Other Aspects of the Countervailing Duty Investigations in Importing Countries**

One practice of the EC, which results in an increase in the incidence of CVDs, is the addition of interest calculated for the period under investigation, to the subsidy amount actually received or deemed to have been received by the exporter. The EC has added such interest in a routine fashion in all cases in which schemes have been found to be countervailable. The argument, reproduced from the provisional CVD determination on imports of Certain Broad Spectrum Antibiotics from India, runs as follows:

'The benefit to the exporters has been calculated on the basis of the amount of customs duty normally due on imports

<sup>47</sup> Council Regulation (EC) No. 1338/2002.

<sup>48</sup> Council Regulation (EC) No. 2597/1999.

made during the investigation period but which remained unpaid under the Pass Book Scheme (PBS). In order to establish the full benefit to the recipient under the scheme, this amount has been adjusted by adding interest during the investigation period. Since the benefits from import duty exemptions are obtained regularly during the investigation period, they are equivalent to a series of grants. It is the normal practice to reflect the benefit to the recipient of one-time grants by adding the annual commercial interest to the nominal amount of the grant, on the assumption that the grant is considered to have been made on the first day of the investigation period. However, in the present case, it is clear that individual grants can be made at any time between the first and the last day of the investigation period. Consequently, instead of adding annual interest to the whole amount, it is considered appropriate to assume that an average grant would have been received at the mid-point of the investigation period and, therefore, the interest should cover a period of six months, equivalent to half of the annual commercial rate during the investigation period in India, i.e. 7.575 per cent. This amount (i.e. unpaid customs duty plus interest) has been allocated over total exports during the investigation period.<sup>49</sup>

The relevant provision of the ASCM is Article 19.4, which stipulates that the countervailing duty must not be 'in excess of the amount of the subsidy found to exist, calculated in terms of subsidization per unit of the subsidized and exported product'. In terms of the wording of this provision, it is difficult to find fault with the EC practice. However, the practice in the EC of adding an amount for interest brings out an asymmetry in the operation of the ASCM. In items (h) and (i) of the Illustrative List, there is a strict requirement that there must not be any excess in the remission or drawback of import charges or prior-stage cumulative indirect taxes, if the practice is not to be regarded as a prohibited export subsidy. Thus, if interest is paid by government because of delay in payment of drawback, strictly speaking it would be countervailable, as it would be treated to be in excess of the import charges or prior-stage cumulative indirect taxes actually borne by the product.

### **3 Conclusions and Recommendations on Need for Clarifications and Improvements**

In this section, we present a summarised assessment of the ASCM from India's perspective, based largely on the foregoing analysis, and then identify the aspects on which there is a need for clarifications and improvements in the agreement.

#### **3.1 Part II of ASCM: Prohibited Subsidies**

Subsidies contingent upon export performance or upon the use of domestic over imported goods are prohibited by the ASCM. However, under Article 27.2(a), India, along with other low-income countries listed in Annex VII of the ASCM, is exempt from the prohibition in respect of export subsidies as long as its per capita income remains below US\$ 1000. Other developing countries have been given an eight-year transition period for phasing out export subsidies, with the possibility of further extension on a case by case basis.

The exemption implies that India can continue with its export subsidy practices, consistently with its WTO obligations. Other Members cannot take action against India under Article 4 of the ASCM and ask it to withdraw export subsidies, as India does not have the obligation to discontinue such subsidies. On the other hand, developed country and other developing country Members (after the transitional period is over) have the obligation to discontinue such subsidies and they can be asked to withdraw such subsidies if a dispute is raised under Article 4.

Other Members may, however, raise a dispute against India under Article 7 of the ASCM if exports from India benefiting from export subsidies cause adverse effect to them in their domestic market or in third country markets. As far as their domestic market is concerned, they can in any case impose countervailing duties if injury is caused to their domestic industry. The real benefit that India gets is in respect of third country markets. If India were covered by the prohibition of export subsidies, it would have to terminate the practice if an export subsidy practice was found to exist in a dispute raised by another Member under Article 4. However, since India is exempted from the prohibition, another Member will have to show in the course of a dispute under Article 7 that its interests are adversely effected in a third country market, and this would generally be a very onerous task. Market shares are determined by so many factors that it is very difficult to ascribe a loss in such share to the export subsidy practices of another Member. Moreover, even if such adverse effect to the interest of another Member is identified, India would not be under a compulsion to withdraw the subsidy. Article 7 gives an option to the Member found to be causing adverse effect through its export subsidy practices to withdraw the measure or take appropriate step to remove the adverse effects.

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<sup>49</sup> Commission Regulation (EC) No. 1204/98 of 9 June 1998.

On the other hand, Members to whom the prohibition applies cannot maintain the measure at all and must withdraw it if they are found to be maintaining such a measure in the course of a dispute. In a WTO dispute (Australia–Automotive Leather), a Member was asked to withdraw an export subsidy retrospectively, that is to obtain refund of payments that had been made. No such consequence can follow from a dispute raised under Article 7. Furthermore, under Article 4 the measure has to be withdrawn without delay. Under Article 7 there is no mention of any timeframe and therefore the provisions of the Dispute Settlement Understanding (DSU) apply. Article 21.1 of the DSU requires ‘prompt compliance with recommendations or rulings of the DSB’, and Article 21.3 allows a Member ‘a reasonable period of time’ to implement the ruling or recommendation where it is not feasible to comply immediately.

Thus, exemption from the prohibition of export subsidy results in a major benefit for India. The provision is the product of a time when many developed countries were sympathetic to the need of developing countries like India for special and differential treatment. Many WTO Members, including developing country Members, would like to see this provision diluted or even extinguished. Rather than attempting to improve the provision relating to prohibited subsidies, including the related provisions on special and differential treatment, India must resist any attempt to ‘improve’ it.

### **3.2 Illustrative List**

The Illustrative List of prohibited export subsidies is a non-exhaustive inventory of prohibited export subsidies, and generally speaking, no inference can be drawn that a practice that does not fit in the description given in the List is not an export subsidy. The most controversial provision on the List is the proviso to item (k), which states that export credit practices that conform with the interest rate provisions of an international undertaking on official export credit ‘shall not be considered an export credit prohibited by this Agreement’. The reference here is to the OECD Arrangement on Guidelines for Officially Supported Export Credits. It has to be understood that even if the measures covered by the proviso are not prohibited export subsidies they are still subsidies as they fulfil the conditions laid down in the ASCM definition of subsidies. The safe haven that has been created in the proviso to item (k) provides immunity from action under Article 4 of the ASCM and not from action under other provisions of that Agreement such as Part V on Countervailing Duties. Moreover, countries other than the participants in the OECD Arrangement have also been given the facility of subscribing to the interest rate provisions of the Arrangement. The controversy regarding the proviso to item (k) arises less from the substantive dilution of the basic ASCM commitment of prohibition of export subsidies and more from the fact such dilution has been based on an agreement among a few of the WTO Members. It has become symbolic of the way in which the multilateral rules of the WTO have been manipulated to respond to the interests of the industrialised country Members. As noted by the Compliance Panel in *Canada–Civilian Aircraft*, the provision is quite unique as it creates an exemption from a prohibition in a WTO Agreement and the scope of the exemption is left in the hands of a subgroup of WTO Members, ‘to define, and to change as and when they think fit’.

From the point of view of India’s trade interest there is no reason to seek any change in the provisions of the Illustrative List. However, India must raise the question of converting the proviso to item (k) into a truly multilateral rule, delinked from the OECD.

### **3.3 Actionable Subsidies**

The WTO rules on actionable subsidies require that no Member should cause adverse effects to the interests of other Members, and mention three categories of adverse effect as follows:

- (a) injury to the domestic industry;
- (b) nullification or impairment of benefits;
- (c) serious prejudice.

The ASCM rules on (a) and (b) above merely codify the pre-existing rules and practice of GATT 1947, but the rules on serious prejudice have expanded considerably the remit of the earlier provisions in GATT 1947. For example, serious prejudice could be caused by the displacement or impedance of imports from another Member into the market of the subsidising country or the displacement or impedance of another Member’s exports from a third country market. A big benefit given to all developing countries is that by virtue of Article 27.9 they have been given immunity from remedial action for causing ‘serious prejudice’ to the interest of other Members. Until the end of 1999 certain egregious subsidy practices of developing countries listed in Article 6.1 were actionable for serious prejudice, as Article 27.9 did not exempt developing countries from the application of serious prejudice in respect of the practices listed therein. But the position changed after the lapse of that Article on 31 December 1999. Now action can be taken against developing countries only for actionable subsidies that undermine a tariff commitment or those that cause



injury to the domestic industry of an importing country. The extravagant subsidies given by the Government of India (such as support of the public sector or the Retention Price Scheme for urea) were liable until the end of 1999 to be proceeded against under the ASCM under the broad scope of 'serious prejudice'. Now they are actionable only in the limited situations of 'nullification and impairment' or injury to the domestic industry of an importing country. If there are no exports or if there are no tariff commitments of any of the subsidised products there can be no action under the ASCM. Disputes for nullification or impairment of future tariff commitments can only be raised if there is an increase in the level of subsidies and that is unlikely, in view of the general trend in India of reduction of public subsidies.

The provisions in the ASCM on actionable subsidies are quite satisfactory from the point of view of developing countries and from India's perspective there is no need for clarification or improvement.

### **3.4 Part IV: Non-actionable Subsidies**

There were two categories of non-actionable subsidies when the WTO Agreement entered into effect in 1995: non-specific subsidies and certain listed specific subsidies (assistance provided for research activities, disadvantaged regions and for adaptation to new environmental requirements) that fulfilled the conditions laid down in Article 8 of the ASCM. However, Article 8 along with Article 6.1 had a limited initial life of five years. These provisions were subject to renewal but due to disagreements among Members no such renewal took place. It is important to bear in mind that the drafters of the WTO Agreement conceived of the stricter discipline in Article 6.1 and the concession on non-actionability under Article 8 as a package and therefore their future was bound together.

The immunity from remedies and countervailing duties was accorded to the research, regional, and environmental subsidies because of their having positive externalities or of their public good character. The objective was to promote applied research, develop backward regions, or protect the environment. We have seen that the state governments in India have been granting regional subsidies during countervailing duty investigations although these were not found to be fulfilling the strict conditions laid down in Article 8. Business associations have also spoken favourably about the possibility of the government taking advantage of the provisions in respect of research and environmental subsidies. Given this background, should India propose the revival of Article 8 for all Members or for developing country Members, with or without changes?

As stated above, a proposal for reviving Article 8 would be justified because of the positive externalities or a public good nature of the items under the article. However, there is a risk that other Members propose the simultaneous revival of Article 6.1. We have seen that the expiry of the latter article has been highly beneficial to developing countries as they have been given immunity from remedies for serious prejudice against actionable subsidies. Given the fact that India has some subsidies (public sector and Retention Price Scheme for urea) which will become potentially actionable for serious prejudice, this is not a risk worth taking.

### **3.5 Part V: Countervailing Duties**

India is operating several export promotion programmes, which are being countervailed against in developed importing countries. Some of these schemes have inherent deficiencies from the point of view of the provisions of the ASCM while on some aspects it can be said that the provisions themselves have shortcomings. In order to identify the need for clarifications and improvement in the provisions of the ASCM we first summarise the treatment that India's export promotion schemes have received in the countervailing duty investigations in some important economies.

#### **3.5.1 Schemes for Exemption, Remission, etc. of Indirect Taxes and Import Duty on Inputs**

WTO rules allow exemption or remission of indirect taxes and import charges levied on 'inputs consumed in the production of the exported product'. Such exemption or remission does not constitute an export subsidy (or even a subsidy) and is therefore not countervailable. Annex II of the ASCM defines 'inputs consumed in the production process' as 'inputs physically incorporated, energy, fuels and oils used in the production process and catalysts consumed in the course of their use'. Thus, capital goods have been left out even though they can be said to have been used to the extent of their depreciation.

The rules allow substitution drawback schemes also whereby domestic substitutes for the imported product equal in quantity and having the same quality and characteristics are used initially, provided the corresponding imports are made within two years.

Annexes II and III of the ASCM lay down procedures for the investigating authority to determine whether there is over-

rebate in a remission or exemption scheme. Whether it is a scheme for indirect tax or import duty rebate or for substitution drawback, a four-step procedure is prescribed for determining whether there is an over-rebate.

1. The investigating authority must first see whether the exporting Member has in place a system or procedure (verification system) to confirm which inputs are consumed in the production of the exported product and in what amounts. In the case of substitution drawback, it has also to be seen whether the domestic market inputs are equal in quantity and have the same quality and characteristics as the imported input.
2. If there is a verification system in existence, the investigating authority has to see whether the system is reasonable, effective, and based on the commercial practices in the country.
3. The investigating authority may carry out certain practical tests in order to verify the information or to satisfy themselves that the system or procedure is being effectively applied.
4. If there is no verification system or it is not reasonable or applied effectively, a further examination by the exporting Member needs to be carried out, followed by another examination by the investigating authority.

Of the exemption and remission schemes in operation in India, the Advance Licence scheme in its current form has withstood the test for non-countervailability in the US and the EC, for exemption of duties on raw materials and consumables, but not capital goods. As far as imports of raw materials on a duty free basis is concerned, the EOU/EPZ/EHTP/STP scheme also has all the elements of the framework envisaged in the ASCM for non-excessive remission of import charges. As in the case of Advance Licence, duty free import of capital goods remains countervailable. The Duty Drawback system has also not been countervailed against, either in the case of brand rates or all industry rates.

The schemes that are akin to substitution drawback schemes have however been generally countervailed in importing countries. The Duty Entitlement Passbook (DEPB) Scheme lacks a fundamental element of substitution drawback schemes envisaged in the ASCM in that there is no obligation to import the inputs for which domestic inputs have been used. The EXIM policy specifically allows the DEPB credits to be used for the imports not only of the inputs for which domestic substitutes have been used for the production of the exported product but also of any freely importable goods. DEPB benefits fail to stand up even to the preliminary test stipulated in the ASCM for substitution drawback schemes because there is no built-in obligation to import the inputs of the same quantity and having the same quality and characteristics as the domestic substitutes. The Advance Release Order (ARO) variant of the Advance Licence Scheme also has the same infirmity. Another substitution drawback scheme, the Duty Free Replenishment Certificate (DFRC) does not have this infirmity because there is a built-in obligation for the import of items for which domestic substitutes have been used.

All the schemes of exemption or remission of indirect taxes or import duties in India rely on standard input-output norms (SION) or some equivalent systematic procedure for finding out the average consumption of inputs. The question that arises is whether reliance on such norms can be said to fulfil the requirement for having in place a reasonable verification system that is applied effectively. The US authorities have treated adherence to SION as representing a reasonable verification system, but other jurisdictions have not. Authorities in the EC and Canada have made determinations to the effect SION did not constitute a verification system within the meaning of the relevant paragraph of Annex II. In particular, the EC has noted in one case relating to the DEPB scheme that 'these norms do not provide for the verification of the inputs that are actually consumed in the production process and do not provide for a verification system whether these inputs were effectively imported'. Canada has recognised that the GOI relied on SIONs for determining the DEPB rates and followed a monitoring system to ensure conformity with the norms. However, it noted that the system did not go beyond that to verify whether the actual proportion of each input to the finished product reflected the norm. It is possible that in not recognising that the determination of DEPB rates in accordance with SIONs represented a verification system, the EC was influenced by the absence of an obligation to import the inputs for which domestic substitutes were initially used. But one cannot come to a definite conclusion on this and the variation in the practice of various Members will in future continue to be a source of uncertainty.

There is another point of concern in the Canadian practice to consider revenue from sale of unused DEPB credits as a countervailable subsidy. Canada seems to ignore the fact that in respect of substitution drawback schemes there is only an obligation that input of equal quantity and having the same quality and characteristics as the domestic substitutes that have been used be imported. It is not necessary for the imported inputs to be used by the exporter. So sale of DEPB credits should be perfectly legitimate as long as they are used to import the same inputs that have been used.

The reduction of duty under the Export Promotion Capital Goods (EPCG) scheme has been countervailed in every

case. This is so not only because capital goods are not included in the list of goods that are regarded as having been consumed in the production process but also because the scheme is not operated in a manner that segregates production for export from production for domestic consumption.

In the background of the above experience, India must seek the following clarifications and improvements in the ASCM:

- (i) Capital goods must be included in the list of goods that are consumed in the process of production to the extent of depreciation. A fundamental rule of GATT 1947 was that no product must be subject to countervailing duty 'by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes'. The basis of this rule was the destination principle of indirect taxation. By excluding capital goods from the list of goods deemed to be consumed in the production process the ASCM unjustifiably abridged the pre-existing GATT rights of the contracting parties. The improvement can be brought about by an appropriate amendment of footnote 61 of the ASCM.
- (ii) As regards the existence or otherwise of a reasonable and effective verification system, Members must have regard to the fact that a rule that requires the separate verification of the inputs that are actually consumed in the production process in each transaction for every unit is impracticable and unfair to countries that have a large number of small and medium enterprises. In 1970, the GATT 1947 Working Party on *Border Tax Adjustments*<sup>50</sup> had agreed in principle that 'it was administratively sensible and sufficiently accurate to rebate average rates for a given class of goods'. Wherever standard input-output norms or similar averaging procedures are developed fairly and systematically and used to determine the amount payable to the exporter on account of remission of indirect taxes or import duties, there must be a presumption that a reasonable and effective verification system is in existence. To require that the government of the exporting system must verify whether standard input-output norms are meticulously observed in each unit and for every transaction would place an intolerable burden on the exporting countries. In any case, the investigating agencies would be entitled under Article 12.6 of the ASCM to examine the books of each exporter to find whether the application of standard procedures has resulted in over-rebate in a particular instance. In those cases in which over-rebate is found, the countervailing duty must be limited to the extent of over-rebate. These clarifications must be incorporated in Annex II/III.
- (iii) Importing countries are justified in insisting that imports must be made in those cases in which domestic substitutes have been temporarily used and that the imported input must be in equal quantity and having the same quality and characteristic as the domestic substitute that has been used. If that is not done there can be no justification for remission of taxes on imported inputs. However, as argued earlier, they are not justified in insisting that the exporter must itself make the imports and that sale of the licence to make the duty free imports is a countervailable benefit. A clarification would be necessary to the effect that sale of the licence to obtain the duty free imported inputs in substitution drawback schemes must not be countervailable.

The clarifications and improvements identified in (ii) and (iii) above can be translated into benefits for India only if simultaneously a change is made in the DEPB scheme and in the ARO variant of the Advance Licence scheme so as to make it obligatory to import inputs equal in quantity and having the same quality and characteristic as the domestic input that has been used. The present rule that gives the flexibility to import any 'freely imported' goods must be changed.

### **3.5.2 Export Credit Schemes**

Export credit on preferential terms has been a long-standing export incentive programme in India. The EC has not imposed countervailing duties against export credit schemes, but the US and Canada have been doing so in every CVD determination. In some of the cases in the US, the GOI and exporters have been arguing that in calculating the benefit resulting from this scheme the cost-to-government approach must be adopted. However, it is clear from the earlier analysis in this note that there is no legal basis for such an argument. It is clear from Article 14 of the ASCM that the use of the benefit-to-recipient approach is valid.

A question could be raised as to whether it would be appropriate for India to seek a safe haven for the use of export credit concessions by the developing countries on the lines of what has been provided for the OECD Arrangement on Official Export Credit in item (k) of the Illustrative List. In this connection, it is necessary to bear in mind that the proviso

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<sup>50</sup> GATT, BISD 18S/97.

to item (k) provides a safe haven only from remedies under Article 4 of the ASCM, which can be invoked only for prohibited subsidies. As far as India is concerned the prohibition on export subsidies does not apply to it at all because of the benefit given to low income countries. To a large extent, we already have the benefit of safe haven for export credit subsidies. Seeking agreement on export credit concessions by developing countries being made non-actionable for all purposes including action under Part V for imposition of countervailing duty will be a tall order, considering that such a benefit has not been given in the ASCM to developing or developed countries for an export subsidy practice or for any specific subsidy. Taking an initiative in the matter becomes all the more incongruous in the situation in which the RBI has already commenced the process of de-regulation of interest rates for pre and post shipment rupee loans. The assessment is that this process will soon be extended to foreign currency denominated loans also. We recommend that the government should not make any proposal for clarification or improvement of the ASCM in respect of export credit.

### **3.5.3 Other Aspects Relating to Countervailing Duties**

The EC practice of adding interest on subsidies for the purpose of calculating the countervailing duty may be not be inconsistent with the ASCM but it is certainly protectionist. We recommend that India propose an interpretative decision terminating this practice. We should also seek another decision that permits the payment of interest on refund of indirect taxes and import duties on inputs consumed in the process of production of the exported product where there has been delay in such refunds. At present, on the basis of a strict interpretation of items (h) and (i) of the Illustrative List, payment of such interest would amount to over-rebate.

Two other clarifications would seem to be warranted by the foregoing analysis, although India has not yet suffered the consequences of the anomalies that have been noted. First, India should seek an interpretation that, in light of the definition of subsidies contained in the ASCM, payment of subsidies exclusively to domestic producers allowed in paragraph 8(b) of Article III of GATT 1994 includes exemption of such producers from internal tax. Second, under Article 21.3 of the ASCM, in a Sunset Review the countervailing duty must be terminated forthwith if it is found that the relevant subsidy practice is no longer in existence and must not be continued on the basis of an assessment that the subsidy is likely to recur.

### **3.6 Part VIII: Developing Countries**

The foregoing analysis shows that developing country Members, and particularly low income country Members such as India, have been given considerable benefits under Article 27 of the ASCM. As stated already, it would be difficult to improve this provision for the benefit of developing countries in the current environment prevailing in the WTO for developing countries other than the least developed countries. However, a case could be made for limited improvement of Articles 27.10 and 27.11. Article 27.10 provides for termination of countervailing duty proceedings if *inter alia* the level of subsidy is found to be less than 2 per cent. Article 27.11 had increased this to 3 per cent for those Annex VII countries and for other developing countries that eliminated export subsidies before the end of the transitional period of eight years. Article 27.11 was valid for eight years and expired at the end of 2002.

The disappearance of Article 8 has deprived developing countries of the possibility to use regional and environmental subsidies without risking countervailing action. There is justification, therefore, to raise the limit of 2 per cent on a permanent basis to a level of 3, if not 5, per cent. In order to get wide support for this suggestion, India must propose that the benefit should be extended to all developing countries.

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