How Do International Trade and Investment Rules Affect Public Finance for Development?

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Summary

In the wake of the global financial crisis, there is increased interest in the role that development banks and other forms of public finance can play in supporting job creation and stable, sustainable development. Efforts to expand public finance, however, could clash with subsidies restrictions in international trade and investment agreements. The purpose of this paper is to raise awareness of the potential obstacles posed by World Trade Organization (WTO) agreements as well as regional and bilateral trade and investment treaties. It also provides brief summaries of some of the complaints that have been filed against governments over public financing programs.

Subsidies and Countervailing Measures (SCM) Agreement: This WTO agreement covers subsidies related to goods. It prohibits export subsidies and those that are conditioned on the use of a certain level of domestic content. It also allows governments to impose countervailing duties if they can demonstrate that another country's subsidies are having an adverse effect on their economic interests. Governments have filed numerous complaints related to public finance, including a series of tit-for-tat disputes over government loans and other supports to aircraft manufacturers.

General Agreement on Trade in Services (GATS): The WTO has not yet negotiated specific rules for subsidies related to services. But subsidies are not automatically exempted from the GATS general obligations, including national treatment. Governments may list limitations on these obligations in their schedules.

U.S. trade agreements and bilateral investment treaties (BITs): Under the investment chapters of U.S. trade agreements and some recent BITs, governments are prohibited from conditioning "an advantage" (likely interpreted to mean a subsidy) on compliance with export or domestic content requirements. In U.S. BITs, the United States has claimed exemptions from national treatment for its own subsidies, but in 25 cases the partner country did not, opening them up to possible "investor-state" challenges if they provide subsidies to domestic but not to U.S. companies.

I. Introduction

The global crisis that erupted in 2008 exposed the casino-like nature of financial markets and sparked a vibrant debate about how best to restore finance to its proper role of serving real economic needs such as job creation, innovation and development, and poverty alleviation. This debate, however, is often disconnected from developments in the trade arena that have significant implications for financial reform. Existing and proposed international trade and investment agreements present possible challenges in two ways:

1. By restricting the authority of governments to regulate private financial institutions and capital flows.
2. By restricting the authority of governments to utilize public finance to support national economic development goals.

This memo addresses the public finance issue. The financial crisis has sparked increased interest in the contribution public finance can make not only to long-term development, but also to crisis response. In several key emerging market countries, state-owned development banks have played an effective counter-cyclical role, lending more than private financial firms during the downturn. In Brazil, for example, national development bank support for long-term financing to industry and infrastructure is seen as a key factor in helping insulate Brazil from the contagion effect of the crisis.[1] According to *The Economist* magazine, the result in Brazil and several other countries is that "attitudes towards the state-controlled banks have changed for good."[2]

By contrast, the U.S. government's immediate response to the crisis focused on funneling hundreds of billions of bailout dollars into private financial institutions, with the hope that this would boost lending and economic recovery. By 2010, private U.S. banks had mostly returned to profitability and repaid much of their direct bailout support, but were still not lending at sufficient levels. Late that year, the Federal Reserve began another round of "quantitative easing" in an effort to push private investment into job creation, but with disappointing results.[3] Public frustration over this situation has sparked campaigns to establish government-owned banks in more than 20 of the 50 U.S. states. There are also many proposals for a U.S. national infrastructure bank.[4]

Of course public finance does not always play a positive role in stable, sustainable development. One need look no further than the billions spent every year by industrialized countries on subsidies to the fossil fuel industry for evidence of that. This memo, however, does not attempt to define good versus bad public finance. Rather, it merely aims to raise awareness of the potential obstacles posed by international trade and investment rules to governments' authority to use public finance for development, however that may be defined. It identifies the relevant provisions in World Trade Organization (WTO) agreements as well as regional and bilateral trade and investment treaties and provides brief summaries of some of the complaints that have been filed against governments over public financing programs. If the role of the public sector in supporting development expands, such cases could become more common.

II. WTO Subsidies Rules and Public Finance

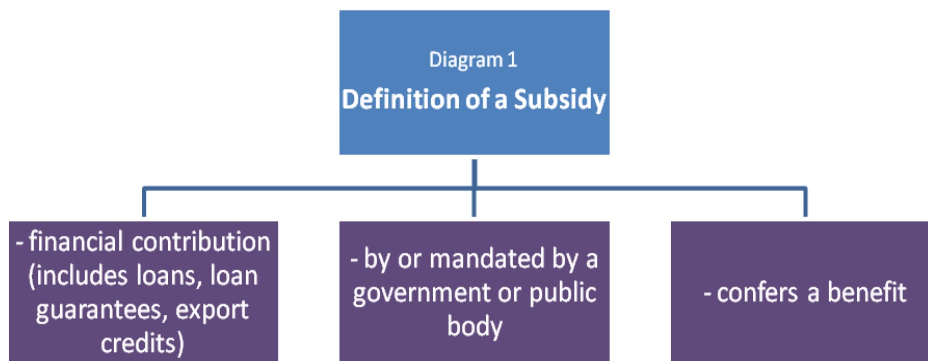
The primary way in which the WTO affects governments' authority to use public finance is through subsidies disciplines. The general goal of these rules is to eliminate trade-distorting government supports. The theory is that this will create a fair and even playing field for producers from all member states, thereby increasing competition and economic efficiency. Critics argue that this assumes that markets work perfectly, while in reality developed and developing countries have market failures that distort the real function of the economy. Economists Francisco Aguayo Ayala and Kevin P. Gallagher argue that "Targeted and disciplined subsidies can correct these distortions and make markets work more efficiently."[5] Critics also point out that all industrialized nations have utilized subsidies extensively as tools for economic development and that it is very difficult to distinguish subsidies that are purely domestic from those that affect international trade.[6]

To understand the extent to which WTO subsidies disciplines may affect public financing, it's important to understand the scope of the rules and the enforcement process. As illustrated in the table below, these rules differ for goods and services subsidies. The WTO's Subsidies and Countervailing Measures (SCM) Agreement covers subsidies related to manufactured products as well as agricultural goods. The SCM Agreement took effect in 1995 and built on subsidies rules established in the 1947 General Agreement on Tariffs and Trade (GATT). The WTO has not yet negotiated specific rules for subsidies related to services, but, as discussed below, this does not mean that services subsidies fall entirely outside WTO enforcement powers.

WTO Subsidies Rules for Goods versus Services		
	Subsidies to Goods Producers	**Subsidies to Service Providers**
1. Is there a definition of subsidies?	Yes. See diagram 1.	No.
2. Have specific subsidies rules been negotiated?	Yes. See diagram 2	No.
3. Do national treatment obligations apply?	No.	Yes – when governments have scheduled commitments for specific sectors and have not listed limitations for national treatment.
4. Are all WTO members covered?	Yes -- although some of the poorest countries have been given an extension on phasing out prohibited export subsidies.	No. Just those that have scheduled commitments.

WTO Rules on Goods Subsidies

The SCM Agreement, which covers goods subsidies, provides a definition of "subsidy" that includes three elements: (i) a financial contribution (e.g., grants, loans, equity infusions, loan guarantees, fiscal incentives, the provision of goods or services) (ii) by a government or any public body within the territory of a Member (iii) which confers a benefit. For WTO rules to apply, the subsidy must also be "specific," that is available only to an enterprise, industry, group of enterprises, or group of industries in the country that gives the subsidy. Subsidies that are widely available are presumed to be non-distortionary.

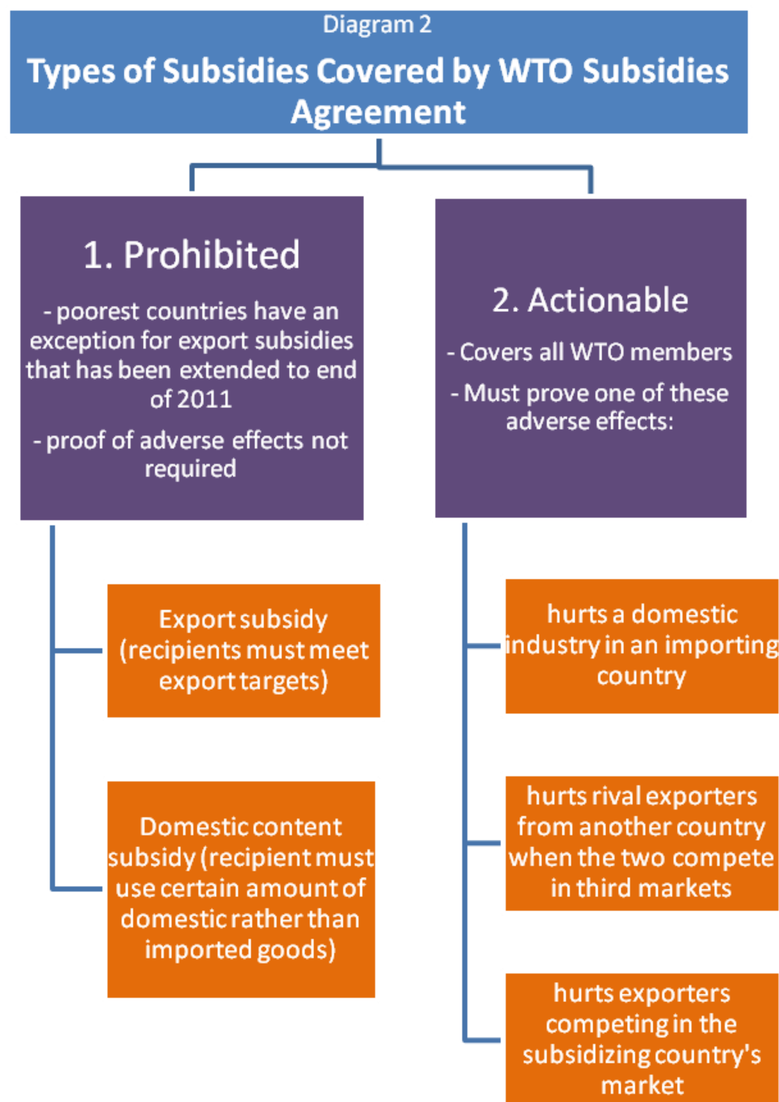


The agreement defines two categories of subsidies: prohibited and actionable.

Prohibited subsidies: These include subsidies that require recipients to a) meet certain export targets or b) use domestic goods instead of imported goods. The reasoning behind prohibiting these types of subsidies is that they are specifically designed to distort international trade. Subsidies requiring a certain level of domestic content are sometimes referred to as a form of "import substitution." The WTO also discourages such policies through the Trade-Related Investment Measures (TRIMs) agreement, which prohibits governments from requiring that foreign investors use a certain level of local supplies in their production process.

Least-developed countries and developing countries with less than $1,000 per capita GNP have been exempted from disciplines on prohibited export subsidies but these exemptions are being phased out and are due to expire at the end of 2011 (with the possibility of extension until 2013).[7]

Actionable subsidies: Subsidies that fall into this category are permitted unless the complaining country demonstrates that the subsidy is having an adverse effect on its interests in at least one of three ways (see diagram 2).



Between 1995 and 1999, the SCM Agreement gave the green light to certain types of "non-actionable" subsidies. These included supports for 1) research and development; 2) regional development (to lift up disadvantaged regions within the territory of a member state); and 3) environmental protection. While possible reinstatement of these subsidies had been placed on the agenda of the Doha Round, there has been no progress on that front. In part this is due to opposition from some emerging market negotiators, including India and Brazil, who argued that only developed countries had the funds for such subsidies.[8]

WTO Services Rules and Public Finance

When WTO negotiators began drafting a General Agreement on Trade in Services (GATS), some wanted to create new subsidies disciplines to avoid distorting effects on trade in services, but thus far, they have not been able to reach agreement on specific definitions or rules. However, one point that is widely misunderstood is that subsidies are not exempted from GATS general obligations. These include national treatment, which is the obligation to treat the services and service suppliers of any other WTO member no less favorably than domestic services and service suppliers. A government that wants to maintain any limitations on national treatment must indicate these limitations in their schedule.

This means that a country providing a subsidy to domestic but not to foreign suppliers of a service could be found to be in violation of the GATS. Canadian scholar Scott Sinclair has given the example that if the South African government were to provide preferential loans or loan guarantees that were favorable only to domestic health care providers, they could be exposed to challenges since South Africa made GATS commitments covering certain health services.[9] This is not the case for subsidies related to goods, because those subsidies are exempted from national treatment obligations under GATT Article III:8(b).[10]

The application of national treatment to services subsidies has not garnered much public attention, perhaps because of the GATS "positive list" approach. This means that WTO member governments are allowed to choose which service sectors they are willing to subject to GATS rules. This is sometimes referred to as a "bottom-up" approach. And in fact, in its 16 years of existence, there have only been 22 disputes filed under the GATS and none of these have been related to subsidies.

Nevertheless, this should be an important consideration for policymakers as the push to expand GATS coverage continues. Policymakers involved in public finance should also be careful in their analysis of the provision in the GATS annex on financial services that is intended to give some limited protection for "domestic prudential measures."[11] Prudential measures are typically defined as those that support the financial stability of individual institutions and systemic risk. Thus, this provision is unlikely to apply to development-oriented financial regulations which may involve some level of public finance, such as directed lending policies.

Enforcement

WTO member governments may file a complaint under the WTO's dispute settlement procedure over alleged illegal subsidies by another country. If a panel finds that the subsidies are indeed inconsistent, the offending government must withdraw the subsidy immediately or face possible trade sanctions. Governments can also launch their own investigation into the impact of another government's subsidy on their interests and then unilaterally apply countervailing duties on subsidized imports that are found to be hurting domestic producers.

All WTO disputes are handled between governments in a "state-state process." As explained in further detail below, most free trade agreements and bilateral investment treaties also allow "investor-state" dispute settlement, through which private foreign investors may file claims against governments for compensation over alleged violations of the investment provisions of the agreement.

III. Bilateral and Regional Trade and Investment Agreements and Public Finance

A comprehensive review of subsidies rules in all international trade and investment treaties is beyond the scope of this paper. However, a look at U.S. free trade agreements shows that these deals defer to the WTO as the global rules body on subsidies in some respects. For example, the North American Free Trade Agreement, which set the basic blueprint for other U.S. agreements, exempts subsidies for goods producers from national treatment and reinforces other WTO disciplines on goods subsidies. Under NAFTA's chapter on cross-border services, subsidies and grants are entirely exempted.

Where there are significant discrepancies is in the investment chapters of U.S. trade agreements and in bilateral investment treaties (BITs). NAFTA's investment rules exclude subsidies from national treatment and most-favored nation treatment obligations. However, Article 1106(3) prohibits certain performance requirements on foreign investors in relation to the "receipt of an advantage" (which, although not defined, would likely include subsidies, preferential loans, etc.).[12] The specific performance requirements that are restricted here reinforce the SCM Agreement rules on prohibited subsidies. Governments may not condition "an advantage" on meeting export or domestic content requirements.

Thus, for example, if the Ontario government in Canada provided low-interest loans, conditioned on local content, for producers of renewable energy technologies in that province, this could be grounds for a challenge. And then the real major difference with the SCM Agreement would come in, which is that U.S. bilateral and regional trade agreements allow "investor-state" dispute settlement. Unlike the state-to-state process under the WTO, this allows private foreign investors to bring claims directly to international tribunals to demand compensation over alleged treaty violations.

And so in this hypothetical case, private U.S. investors in a solar panel plant in Canada that wanted to use all Chinese supplies instead of local Canadian produced ones could sue for compensation under NAFTA.

Investor-state dispute settlement is controversial because private investors do not have the same responsibility as elected governments do to consider broader public interests or diplomatic sensitivities when considering such actions. The most frequently used tribunal for handling such cases is the International Center for Settlement of Investment Disputes (ICSID), which is associated with the World Bank. Other international commercial arbitration tribunals include the UN Commission on International Trade Law (UNCITRAL) and the International Chamber of Commerce.

Bilateral Investment Treaties

Bilateral investment treaties are similar to the investment chapters of the U.S. trade agreements. The two most recent U.S. BITs, with Rwanda and Uruguay, include national treatment exemptions for subsidies in the main text of the agreement. This is consistent with the U.S. model BIT, last revised in 2004.[13] However, such an exemption is not in the main text of the other 41 U.S. BITs currently in force. In annexes to these agreements, the United States claimed exemptions for national treatment of U.S. "subsidies or grants, including government supported loans, guarantees and insurance." But in 25 cases, the partner country did not claim the same exemption for itself.[14] This means that these countries, which include developing countries and former soviet bloc nations, are vulnerable to challenges if they provide a subsidy, such as a development bank loan, to domestic but not to U.S. companies.

Subsidies and U.S. Trade and Investment Agreements		
	U.S. Free Trade Agreements	**U.S. Bilateral Investment Treaties**
Do national treatment obligations apply to subsidies?	No.	Not for the U.S. because they have claimed exemptions, but many treaty partners have not.
Do restrictions on performance requirements apply to subsidies?	Governments may not condition "an advantage" (likely interpreted to mean a subsidy) on compliance with export or domestic content requirements.	Some of the more recent treaties include language identical to the trade agreements.

Some of the U.S. BIT partners that have not claimed blanket national treatment exemptions for all subsidies have claimed such exemptions for specific sectors (e.g., for broadcast media or fisheries). This should allow them to provide preferential subsidies for these particular domestic enterprises. Nevertheless, the danger of provoking claims over domestic subsidies is still serious, particularly given the fact that the BITs offer "investor-state" dispute settlement.

On the issue of performance requirements, the more recent U.S. BITs include language identical to NAFTA to require foreign investors to meet export or domestic content requirements in order to receive "an advantage." This is also consistent with the U.S. model BIT.

Minimum Standard of Treatment

U.S. trade and investment treaties also include provisions guaranteeing foreign investors a "minimum standard of treatment," including "fair and equitable treatment." The vagueness of these provisions opens the door to possible investor-state claims over subsidies, even if the national treatment obligation is not applicable. In one relevant case, a Dutch subsidiary of Japanese bank Nomura charged that the Czech Republic had violated its "fair and equitable treatment" obligation when it did not provide a bank in which it had a stake the same level of financial aid that it provided other privatized banks operating in the country.[15] The firm brought the case under a Netherlands-Czech Republic bilateral investment treaty. An international arbitration tribunal ruled in the bank's favor, ordering the Czech government to pay $236 million in compensation.[16] The Czech Republic, which has been hit by more investor-state cases than any other European country, recently indicated an interest in renegotiating the U.S.-Czech BIT.[17]

IV. Examples of WTO Complaints Related to Public Finance

As of May 2011, WTO member governments have lodged 87 complaints under the SCM Agreement covering a wide range of government actions, including tax incentives, creation of export processing zones, and import licenses. The following examples highlight complaints involving some form of public finance.

A. Aircraft technology

No country has developed a viable aerospace sector without considerable government support. And so it is hardly surprising that the WTO has become a battleground for governments seeking to gain competitive advantage in the aviation market by weakening other governments' supports for their domestic industries. The following are brief summaries of the protracted battles over regional aircraft between rivals Canada and Brazil and over larger aircraft between the United States and Europe. Such cases could become more common as more emerging market countries, including China and Russia, seek to strengthen their aircraft industries.

1. Canada against Brazil over Embraer

The Brazilian government has not yet accepted any free trade agreements or bilateral investment treaties that include investor-state dispute settlement.[18] However, its membership in the WTO has opened the country up to challenges over subsidies. In 1996, Canada filed a complaint against Brazil in what became a five-year fight over alleged use of prohibited export subsidies to regional aircraft manufacturer Embraer.[19] The dispute centered on Brazil's Export Financing Programme (PROEX), a federal program managed by the government-controlled Banco do Brasil. Specifically, Canada targeted an interest rate equalization support program (PROEX Equalization) that covered part of the cost of export credit provided by Brazilian and foreign banks so that it would not be higher than that available in the international market. Under PROEX Equalization, the Banco do Brasil issues Brazilian National Treasury Notes in the name of the bank providing the export credit. These notes may only be redeemed in Brazil in domestic currency at prevailing exchange rates.

In 1999, a panel found that the PROEX equalization payments were indeed export subsidies that violated WTO subsidies rules and needed to be withdrawn.[20] Brazil responded by redefining the criteria for the equalization program, but not to Canada's satisfaction. After another complaint, the WTO ruled again that Brazil's supports to Embraer were inconsistent with global trade rules.[21] In December 2000, the WTO authorized Canada to take countermeasures in the amount of C$344.2 million annually. After another set of modifications, known as PROEX III, the Brazilian government pledged to ensure that equalization supports for regional aviation would not result in net interest rates that were lower than the Commercial Interest Reference Rate (CIRR), published monthly by the OECD. Canada complained again, but this time the WTO panel came down on the side of Brazil, ending the dispute. They noted, however, that the design of PROEX III did not rule out the possibility that future applications could be inconsistent with the SCM Agreement.[22]

2. Brazil against Canada over Bombardier

While the Embraer fight was raging on, Brazil filed its own complaint against Canada and won a 1999 WTO ruling that debt financing provided by the Export Development Corporation's Canada Account for the export of Canadian regional aircraft was inconsistent with the SCM Agreement. In 2001, Brazil filed another complaint against Canada claiming that various Canadian government entities were providing export credits and loan guarantees to the country's regional aircraft industry.[23] Brazil argued that these supports were contingent on export. A WTO panel rejected several of Brazil's claims about specific subsidies, but upheld the claim that the Export Development Corporation's Canada Account provided low-interest financing to Air Wisconsin, Air Nostrum, and Comair to purchase Bombardier aircraft that did indeed constitute prohibited export subsidies. The Panel recommended that Canada withdraw the subsidies within 90 days. After considerable additional wrangling, the dispute was referred to arbitration and in February 2003, Brazil was given the green light to impose trade sanctions on Canada – to the tune of nearly $250 million.

3. United States against European governments over Airbus

In 2004, the United States filed a complaint against European countries over subsidies to Boeing rival Airbus. The dispute focused on more than 300 separate instances of alleged subsidization, over a period of almost 40 years. They fall into five general categories: 1) "Launch Aid" (government loans that are largely repaid through exports); 2) loans from the European Investment Bank; 3) infrastructure and infrastructure-related grants; 4) corporate restructuring measures; and 5) research and technological development funding.[24] The United States argued that seven of the measures were prohibited subsidies under the SCM Agreement and also that the subsidies were having adverse effects on U.S. interests.

In June 2010, the WTO ruled in favor of the United States, concluding that Airbus had received improper subsidies, including $15 billion in loans from European governments at below-market interest rates and several billion dollars in grants, to produce the A380 superjumbo and five other best-selling models.[25] In May

2011, an appellate court partially overturned the earlier ruling. It dismissed the claim that Airbus had received prohibited export subsidies while partially accepting a number of other claims that government supports had had an adverse effect on Boeing. These supports included research and development and infrastructure assistance, such as cash injections from the French government to help pay for leased land in Germany.

The United States is entitled to apply trade sanctions if the European countries do not remove or reform the subsidies to comply with the SCM agreement. According to the *Wall Street Journal*, possible actions could include restructuring loans, changing interest rates and conditions, and cancelling some loan programs.[26] Some analysts predicted that the two parties will come to a negotiated settlement.

4. European Union against United States over Boeing

In 2005, the European Union countered with a complaint against the United States over subsidies to Boeing. They alleged subsidies in ten categories, covering various forms of tax incentives, grants for research and development and worker training. The European Communities estimated that the total amount of the alleged prohibited and actionable subsidies was $19.1 billion between 1989 and 2006.[27]

In March 2011, the WTO ruled in favor of the European Union. The panel rejected a number of the claims, finding that they were legitimate procurement contracts. But the panel determined that the U.S. government had given $5.3 billion in WTO-illegal research and development supports to the aircraft maker for development of the 787 Dreamliner and other jet models that had had adverse effects on the European interests related to Airbus. U.S. officials pointed out that the United States had already remedied about half of the subsidies condemned by the WTO and therefore the panel had recommended the United States withdraw just $2.7 billion in aid to Boeing.[28] They are still considering an appeal.

B. Renewable Energy Technology

With governments increasingly viewing renewable energy technology as a key strategic industry for global competitiveness, it's hardly surprising that the WTO is starting to see complaints over subsidies in this sector.

1. United States against China over wind technology

In December 2010, the United States filed a complaint against China over subsidies, including low-interest loans and export credit guarantees, to enterprises manufacturing wind power equipment in China. Specifically, the Obama administration is charging that subsidies to wind turbine system producers appears to be contingent on the use of domestic over imported components and parts, which would be the kind of "import substitution" policies the SCM Agreement prohibits.[29] The European Union and Japan have since joined in the complaint. The parties are currently in consultations.[30]

2. Japan against Canada

In September 2010, Japan filed a complaint against Canada over policies by the provincial government of Ontario to require renewable energy producers to meet local content requirements in order to qualify for highly subsidized prices. Under Ontario's feed-in tariff program (FIT) the government pays high fixed prices for electricity produced with solar and wind power equipment, but only if the producers use certain levels of locally produced components. A number of green technology manufacturers, including one from Korea, have established operations in Ontario in order to take advantage of the program. Japan is arguing that the policy is a violation of SCM prohibitions on subsidies that are contingent on the use of domestic over imported goods. The parties are currently in consultations.[31]

C. Other Cases or Possible Grounds for Complaints

1. Multi-country complaints against China over loans and other incentives to promote top brands

In 2008 and 2009, the United States, the European Communities, and eight other countries filed complaints against China over that country's "Famous Brands" programs, which aim to promote the production and export of prominent Chinese brands of apparel, agriculture goods, and electronics.[32] The alleged subsidies included R&D funding, special loans, cash grant rewards for exporting, and loan guarantees. The case was settled in late 2009 when China agreed to eliminate the subsidies.[33] The complaining countries charged that these subsidies were prohibited export subsidies under the WTO because they require recipients to meet export goals.

2. Possible complaint against Brazil development bank lending?

In August 2010, the Brazilian newspaper *O Estado de S.Paulo* reported that WTO complaints were possibly in the works against Brazil over the country's national development bank's loans to companies. The article, citing unidentified Brazilian government officials, said that the WTO would be reviewing Brazilian state bank loans.[34]

The complaints likely center on the Program for Sustainability of Investments of the Brazilian Bank for Economic and Social Development (BNDES-PSI), started in July 2009 as part of the government's measures to mitigate the effects of the international financial crisis. As of March 2011, the program had disbursed R$95.6 billion in long-term credit. According to BNDES, "the program, allied to other measures, has enabled Brazilian companies to keep their investment plans, preserving and creating job posts and placing Brazil in a relatively comfortable position compared to other economies, which have felt the effects of the crisis more intensely."[35]

José Guilherme Moreno Caiado, an academic based at Hamburg University, has recently published an analysis of BNDES-PSI credit lines and WTO rules. He concluded that "the concession of credit is conditional upon the export of produced goods, or upon the use of national content, either by a direct clause in this sense or by a general prohibition to import, as well as upon export performance, which are prohibited by the WTO."[36]

Even before the creation of the PSI-BNDES program, in May 2009, the WTO had raised questions about BNDES lending policies.[37] In its regular review of the country's trade policies, which take place every four years, the WTO wrote that BNDES EXIM program provides "preferential export credits linked to domestic content."[38] According to the report, products with a domestic content, in value terms, of at least 60% are automatically eligible for financing. All exporting companies, regardless of the origin of the capital, are eligible to use the program.

V. Conclusion

With changing attitudes about the appropriate role of the state in national economies, we are likely to see more frequent clashes between international trade and investment treaties and government efforts to use public finance for development. Policymakers should make use of existing opportunities for claiming exemptions for sensitive or strategic sectors where there is reason to predict that government supports may conflict with the complex rules of WTO or regional and bilateral trade and investment agreements. However, as the recent financial crisis made clear, it is difficult to foresee what government actions may be deemed necessary in the future. Thus, it is also important that there be a fresh debate over reforms to the global governance of trade and investment to ensure sufficient flexible policy space – in the global North and South – to allow responsible public finance in support of job creation and sustainable development.

Endnotes

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[11] The text reads: ANNEX ON FINANCIAL SERVICES 2 (a)Notwithstanding any other provisions of the agreement, a Member shall not be prevented from taking measures for prudential reasons, including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system. Where such measures do not conform with the provisions of the agreement, they shall not be used as a means of avoiding the Member's commitments or obligations under the agreement. Available at: http://www.wto.org/english/docs_e/legal_e/26-gats_01_e.htm.
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