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The Questionable Case for Subsidies Regulation: A Comparative Perspective

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Government assistance to business enterprise is ubiquitous. Much of what governments do – from highway construction to educational funding to the administration of the courts to direct fiscal outlays to firms – directly or indirectly promotes business activity. At the same time, governments discourage business activity by imposing costs on firms in the form of taxes and regulatory requirements. The net impact of government on business activity in any context thus reflects a complex web of benefits and burdens.

Against this backdrop, numerous policymakers and commentators through the years have decried the potential economic distortions associated with government "subsidies." Various legal systems have confronted the perceived problems associated with subsidies, and a range of legal disciplines on subsidies have evolved.

This paper questions the logic and wisdom of these disciplines. The paper develops the argument with reference to the three sophisticated legal systems that have confronted the problem of subsidies over the longest period of time – the United States Federal system, the GATT/WTO, and the European Union. What emerges from this comparative exercise are two key propositions. First, although the three systems exhibit some similarities, a great deal of divergence exists among them on the substantive and procedural rules respecting subsidies. This absence of legal convergence hints that sound rules for the regulation of subsidies are not easily identified. Second, in each of these systems, the rules that purport to distinguish permissible from impermissible government activity are frequently incoherent. They rely on arbitrary baselines, distinctions that elevate form over substance, and on myopic analysis of government programs that inevitably masks the full effects of government activity on business enterprise. Hence, there is little reason to believe that the rules in any of these systems serve to identify market-distorting subsidies with much accuracy.

Is existing law merely flawed in ways that can be remedied going forward? Or is the problem simply intractable? I tentatively lean toward the latter view. Due to the complexity of the modern economy and the wide panoply of government activity that both encourages and discourages the activities of business enterprise, it is arguably impossible to fashion general principles for the identification, let alone measurement, of market-distorting subsidies. Absent such principles, it is questionable whether the game is worth the candle.

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It does not follow that legal systems should ignore subsidies altogether, particularly in the context of trade agreements. Many changes in government policies have the potential to upset the market access expectations created by trade agreements, and thus to undermine their utility. A sound argument can be made for disciplining *changes* in government policy that have such an effect. A focus on changes in government policy that undermine negotiated market access commitments avoids many of the conceptual problems associated with efforts to define subsidies in the abstract by offering a natural baseline against which to measure the existence and magnitude of policies that become problematic.

Likewise, nothing in the analysis here raises objections to negotiated market access commitments that "bind" specific subsidy programs (the WTO Agreement on Agriculture has that character to a considerable extent). Rather, the worry is that efforts to fashion general rules for the identification and discipline of subsidies, applicable across the board to different industries and sectors, is so fraught with uncertainty and error that nothing useful can be accomplished.

I. Prior Economic Commentary

The existing economic literature portrays subsidies as a mixed bag. Subsidies to import-competing firms provide an alternative to traditional border instruments for purposes of trade protection, and they can thereby undermine market access commitments. Likewise, subsidies to exporting firms can divert business from more efficient competitors, and may even trigger subsidies wars in which exporting nations waste resources competing with each other to confer a competitive advantage on exporters. See Bagwell and Staiger (2002). But subsidies may also ameliorate distortions in domestic and international markets and, indeed, may represent the best policy instrument for addressing distortions to the degree that they operate directly on the distorted margin. Johnson (1965).

Thus, many commentators see a constructive role for subsidies disciplines as long as those disciplines do an adequate job of sorting the good subsidies from the bad. Hufbauer and Erb (1984) put the case for international disciplines on subsidies as follows:

> [U]nbridled and competing national subsidies can undermine world prosperity. Whatever the analytic merits of a purist free trade, turn-the-other-cheek approach, the Great Depression taught the world that protective policies can quickly and destructively spread from nation to nation. Because the concentrated interests of producers command greater political support than the diffuse interests of consumers, national governments find it much easier to emulate the vices of protection than the virtues of free trade. This lesson has prompted the international community to fashion guidelines that distinguish between acceptable and unacceptable national subsidy measures and to codify these guidelines both in bilateral treaties and in multilateral agreements.

Other commentators emphasize the dangers of excessive disciplines on subsidies. Bagwell and Staiger (2006) consider a model in which domestic subsidies are an essential policy instrument for achieving certain domestic objectives. They note that if legal restrictions on subsidies in trade agreements permit trading partners to secure the removal of such subsidies, the incentive to enter trade-liberalizing agreements will be diminished. At bottom, however, their analysis simply highlights the importance of rules that somehow distinguish good subsidies from bad subsidies – the problem that they identify does not arise if the negotiated restrictions on subsidies exempt the measures that are essential to important domestic policy objectives.

The international trade literature further distinguishes between export subsidies and domestic subsidies. The former, which provide a marginal incentive to export rather than sell in the home market, have been criticized on the theory that no obvious non-pecuniary externality seems to justify a stimulus to exports. One difficulty with this argument noted by Bagwell and Staiger (2002), however, is that export subsidies expand trade, and the volume of trade may otherwise be inefficiently small due to trade barriers.

Finally, much of the existing commentary focuses on the unilateral use of countervailing duties to offset the effects of subsidies on imported goods. Subsidized imports have long been regarded as "unfair" in the political arena, and laws authorizing countermeasures date back to the late 1800's. Economists, by contrast, often note that subsidized imports represent an improvement in the terms of trade for the importing nation, and thus confer a national welfare gain. The appropriate response to subsidized imports by the importing nation is thus perhaps a "thank-you note to the embassy" as some have quipped. To be sure, there are limited sets of circumstances in which subsidies might be harmful to the importing nation, as in certain strategic trade models, and countervailing duties might benefit a large importing nation that is not already charging its "optimal tariff." But it is difficult to justify countermeasures against subsidized imports in general if the welfare of the importing nation is the policy maximand. See Sykes (1989). Jackson (1997) accepts that proposition, but argues that countervailing duties may offer a useful deterrent to subsidy practices that reduce global welfare even if importing nations do not benefit from the duties.

The views taken by Jackson and by Hufbauer and Erb rest on a conviction that international subsidies disciplines can do a satisfactory job of distinguishing undesirable from desirable subsidies. The purpose of this paper is to examine that notion carefully.

II. Subsidies Regulation in the United States, the WTO, and the EU: A Quick Overview

The U.S., WTO and EU approaches to subsidies regulation differ dramatically. This section affords an overview of the core rules and procedures in each system.

A. The U.S. Federal System

Article I of the U.S. Constitution assigns to the Congress the power "to regulate commerce with foreign nations" and "among the states." This "commerce clause" is an

affirmative grant of power that plainly permits the Congress to regulate subsidies afforded by state governments. Throughout U.S history, however, Congress has largely declined to interfere with state subsidies.[1]

Affirmative acts of Congress are not the only possible source of constraint. In the mid-1800's, the Supreme Court determined in *The Passenger Cases*[2] and in *Cooley v. Board of Wardens*[3] that certain types of state regulation offend the Congressional commerce power even in the absence of a conflicting act of Congress. The resulting line of cases applying this "dormant commerce clause" doctrine has invalidated a variety of state regulations. Tariffs on interstate commerce, for example, are unquestionably illegal. Other forms of regulation that discriminate against interstate commerce, as by disadvantaging goods imported into a state relative to those produced in the state, or by restricting the exportation of goods produced in the state, have also been invalidated. Lawsuits challenging such measures may be brought in Federal court by disadvantaged competitors, and the relief granted is typically an injunction preventing the enforcement of the challenged measure. See generally Coenen (2004); Regan (1986).

The treatment of "subsidies" has an interesting history. It has long been clear that a discriminatory tax, imposing a greater fiscal burden on goods produced outside a state than on goods produced within it, violates the dormant commerce clause.[4] But suppose that a state initially imposes a non-discriminatory tax on similar in-state and out-of-state goods, and subsequently lowers the tax on in-state goods. Such a policy might be deemed a "subsidy," and indeed the economic effect of the policy can be identical to the effect of direct monetary payments to in-state producers unlinked to any tax. But there is little doubt that such a change in tax policy would create illegal discrimination against in-state commerce. If the discriminatory tax is illegal, therefore, does it follow that direct monetary payments by the state treasury are illegal? The answer is clearly no. By and large, the Supreme Court has declined to interfere with decisions by states to subsidize in-state firms through direct payments. The Court's precedents through the years,[5] along

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[1] Zelinsky (2002) does not a few instances in which Congress has legislated against state taxation, such as with efforts to tax on-line commerce.

[2] 48 U.S. (7 How.) 283 (1849).

[3] 58 U.S. (12 How.) 299 (1851).

[4] See, e.g., Complete Auto Transit v. Brady, 430 U.S. 274 (1977).

[5] See, e.g., New Energy Co. of Indiana v. Limbach, 486 U.S. 269, 278 (1986): "Direct subsidization of domestic industry does not ordinarily run afoul of [the commerce clause]; discriminatory taxation of out of state commerce does."

with the constitutional commentators,[6] indicate that state subsidies that do not resemble tax discrimination are permissible.

To be sure, cases arise that test the line between tax discrimination and subsidization. In *West Lynn Creamery, Inc. v. Healy*,[7] the state of Massachusetts imposed a uniform tax on all milk sold in the state regardless of its source. The proceeds of the tax were then used to provide payments to in-state dairy farmers. The Court determined that the scheme was the equivalent of discriminatory taxation, and held it unconstitutional. But the case is generally read not to condemn subsidies that have no linkage to a tax on the activity that receives the subsidy. See Coenen (1998).

Some ambiguity remains, however, and indeed the Supreme Court remarked in *Camps Newfound/Owatonna, Inc. v. Town of Harrison* that "[w]e have never squarely confronted the constitutionality of subsidies.[8]" Various commentators have argued that the Court should extend the dormant commerce clause doctrine to prohibit state subsidies,[9] and the Sixth Circuit Court of Appeals took up the challenge in *Cuno v. DaimlerChrysler, Inc.*[10] *Cuno* involved, among other things, a franchise tax credit under Ohio law that was enacted to encourage the construction of a new automobile plant in Toledo. A group of taxpayers brought suit to enjoin the tax credit, and the Sixth Circuit held that it discriminated against interstate commerce and thus violated the dormant commerce clause. It reasoned that for a firm to receive the tax credit, it had to locate its operations in Ohio, which discouraged the location of business enterprise in other states.

The Supreme Court invalidated the ruling on appeal, however, in a unanimous decision holding that the individual taxpayers who brought the case had no standing to sue.[11] The Court relied on a number of its prior rulings denying individual taxpayers standing to challenge government expenditures. Pending new developments in the doctrine, therefore, the dormant commerce clause places little constraint on state

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[6] See Tribe (2000) at 1093, 1149, indicating that direct subsidies are apparently constitutional given prior precedents but noting that *West Lynn Creamery* creates some potential for changes in the doctrine.

[7] 512 U.S. 186 (1994).

[8] 520 U.S. 564, 589 (1997).

[9] See Enrich (1996). But see Levmore (1983), who argues that the dormant commerce clause should only condemn state practices that exploit the state's market power, such as taxes on exports or imports over which the state has monopoly or monopsony power.

[10] 386 F. 3d 738 (6th Cir. 2004).

[11] DaimlerChrysler Corp. v. Cuno, 547 U.S. 332 (2006).

subsidies unless they can be characterized as a tax that discriminates against interstate commerce.

B. The WTO System

The original GATT of 1947 had relatively little to say about subsidies.[12] Article XVI established a loose reporting requirement with respect to subsidies that affect imports and exports but was never taken very seriously. Article VI authorized countervailing duties to offset any "bounty or grant," but only if the effect of the subsidization "is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry," It afforded no guidance as to the meaning of the terms "bounty or grant" or "material injury."

Article III(2) did prohibit the imposition of taxes and other internal charges on imports in excess of those imposed on domestic "like products," and further prohibited taxes or internal charges on imports in excess of those applied to "directly competitive or substitutable" domestic products if the differential was imposed "so as to afford protection." Article III(4) extended the non-discrimination obligation to "law, regulations and requirements" affecting the internal sale of like products. This "national treatment" obligation was qualified, however, by an exception for "subsidies" in Article III(8)(b):

> 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 purchases of domestic products.

"Subsidies" to domestic producers thus do not violate the national treatment obligation. Early in the history of GATT, however, it was recognized that new subsidy programs, introduced subsequent to negotiated tariff concessions, might upset the market access expectations created by those negotiations. Accordingly, *new and unanticipated* subsidies to domestic firms in competition with imported goods that have been the subject of a tariff concession, and that impair market access, may be deemed to "nullify or impair" the benefits of tariff concessions in the language of GATT Article XXIII.[13] It is also possible that a pre-existing subsidy program might be the basis for a nonviolation

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[12] On the history of subsidies disciplines in the GATT system see generally Jackson, Davey and Sykes (2008), chapters 7 and 18; Irwin, Mavroidis and Sykes (2008), chapter 2.

[13] See, e.g., GATT, EEC – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins, 37th Supp. BISD 86, adopted on January 25, 1990.

claim, although in the case of pre-existing measures, trade negotiators are rebuttably presumed to have been aware of them.[14] The subsidies are not illegal, but are nevertheless a proper basis for a legal claim known as a "nonviolation" claim, which entitles the claimant to much the same remedy as a practical matter as would a claim involving a violation of GATT.

The 1954-55 GATT review session resulted in some amendments to Article XVI, accepted by only certain industrialized members, which imposed limited restrictions on export subsidies. Further initiatives toward the discipline of subsidies emerged during the Tokyo Round, resulting in the first plurilateral "Subsidies Code." I will not linger on the details of these developments because they have been supplanted by the WTO.

The formation of the WTO in 1995 was accompanied by two new agreements that are both part of the "single undertaking" and are thus binding on all WTO members – the Agreement on Subsidies and Countervailing Measures (SCMs) and the Agreement on Agriculture. Essentially, the former agreement applies to all goods sectors with a temporary and now expired limitation for certain subsidies permitted by the Agreement on Agriculture, while the latter agreement introduces some distinct rules for agriculture.

Unlike GATT, Article 1 of the SCMs Agreement offers a definition of the term "subsidy," which has three elements. First, a subsidy requires a "financial contribution by a government or any public body," or an "income or price support" in the sense of GATT Article XVI. The concept of financial contribution is in turn defined to include direct transfers of funds, situations where "government revenue that is otherwise due is foregone," government provision of goods and services, government "payments to a funding mechanism," or situations where a government entrusts or directs a private body to make these types of contributions. Second, a subsidy exists only if conduct falling into the above categories confers a "benefit." No subsidy arises, for example, if a government sells goods and services for the same price as competing private suppliers. Third, the provisions of the Agreement that allow action to be taken against subsidies apply only if the subsidy is "specific" (the "specificity test"), a concept that will be elaborated further below.

Having defined the concept of subsidy, the SCMs agreement embraced what is popularly known as a "red light/yellow light/green light" approach to subsidies regulation. Two types of subsidies are deemed "prohibited" by Article 3 (the red light category) – export subsidies (except those permitted by the Agreement on Agriculture) and so-called import substitution subsidies, defined as "subsidies contingent, whether solely or as one of several conditions, upon the use of domestic over imported goods." These subsidies are "specific" by definition under Article 2. When a member confers a prohibited subsidy, other members may complain to the dispute resolution process and

[14] See WTO, Japan – Measures Affecting Consumer Photographic Film and Paper, WT/DS44/R, adopted on April 22, 1998.

are entitled to a ruling directing the offending to member to eliminate the subsidy or face the prospect of sanctions.

The yellow light category of subsidies consists of those that are "actionable" before the WTO because of their "adverse effects" as enumerated in Article 5, and that are also subject to countervailing duties under Articles 10-23. Any government measure that fits within the definition of a subsidy and that causes the kinds of harmful effects enumerated by the agreement is potentially within the actionable category.

Importantly, however, the concept of an actionable subsidy is circumscribed by the specificity test, which turns in a murky way on the degree of industrial targeting. In particular, subsidies not encompassed by the prohibited category are specific under Article 2 only if they are "specific to an enterprise or industry or group of enterprises or industries." The concept of a "group" is nowhere defined. Article 2 further indicates that specificity may arise *de jure* or *de facto*. Specificity arises *de jure* when the granting authority or the legislation under which it operates "explicitly limits access to a subsidy to certain enterprises." Again, the breadth of the concept of "certain enterprises" is not specified. By contrast, specificity *de jure* does not arise when a measure is not limited to "certain enterprises," including situations in which eligibility for the subsidy and the amount of the subsidy rest on "objective criteria or conditions." Such criteria or conditions must be "neutral," may not favor "certain enterprises over others," and must be "economic in nature and horizontal in application." The agreement gives the example of a criterion concerning to the "number of employees or size of an enterprise."

Subsidies that appear to be non-specific by the above tests may nevertheless be deemed specific *de facto*. A subsidy may "in fact be specific" when the subsidy program is used by "only a limited number of certain enterprises, " there is "predominant use by certain enterprises," or "disproportionately large amounts of subsidy to certain enterprises."

Finally, geographic targeting may be a basis for a finding of specificity. Article 2.2 provides, somewhat confusingly: "A subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific."

Specificity is necessary for a "subsidy" to be actionable (or subject to countervailing duties), but it is not sufficient. A subsidy must also cause adverse effects. The adverse effects enumerated by Article 5 are three: (i) injury to the domestic industry of another member; (ii) nullification or impairment of benefits relating to tariff concessions under GATT Article II; and (iii) "serious prejudice" to the interests of another member.

The first possibility, injury to the domestic industry of another member, relates closely to the material injury requirement for the imposition of countervailing duties in GATT Article VI. Its inclusion in SCMs Article 5 means that if subsidized goods are causing injury to import-competing firms in another member, the importing member can

choose between the use of countervailing duties (a unilateral remedy) and a complaint to the WTO seeking the removal of an "actionable" subsidy." As a practical matter, the unilateral remedy – which avoids the need to bring a case in the WTO and captures revenue for the treasury to boot – is likely to be the preferred option.

The second possibility, relating to nullification or impairment of benefits associated with tariff concessions, is also familiar from the days of GATT. It essentially does no more than codify the nonviolation doctrine that was well established with respect to new and unanticipated subsidy programs.

The possibility of "serious prejudice" is a more significant development. The term originated in GATT Article XVI, but was not defined. Article 6 of the SCMs Agreement, however, elaborates the concept at length.[15] The key provision is Article 6.3, which details four possible types of serious prejudice: (i) a subsidy may displace or impede exports by one member into the market of the subsidizing member; (ii) the subsidy may displace or impede exports by one member into a third country market (where the member in question competes with the subsidized goods); (iii) the subsidy results in significant "price undercutting" relative to 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; or (iv) the subsidy result in an increase in the world market share in a subsidized "primary product or commodity" relative to a prior three year period. In short, the notion of serious prejudice allows a member to bring a case against a subsidy when the subsidy causes substantial damage to its export opportunities on world markets. It thereby affords a remedy that unilateral countervailing duties cannot achieve, since a member can levy countervailing duties only with respect to imports into its own market. Note also that the treaty text on serious prejudice is written in the present tense – it does not appear to encompass threat of future serious prejudice, and is thus different from the material injury test for countervailing duties, which does allow them in the event of a threat of material injury.

The "green light" category of subsidies was a temporary experiment insulating certain types of subsidies from becoming actionable even if they might otherwise be deemed specific. The three types of subsidies that were protected included certain subsidies for research and development, certain types of assistance to disadvantaged regions, and certain subsidies for compliance with environmental regulations. The details need not detain us, as the green light provisions expired in the year 2000 unless renewed, and thus far the WTO membership has shown no inclination to renew them.

Although the rules respecting subsidies are rather elaborate, as the discussion above indicates, it is important to bear in mind that enforcement is limited. The most common "enforcement" measure by far is a unilateral countervailing duty. WTO (2008) indicates that half a dozen countries reported taking such measures on a provisional or definitive basis over the prior year. The total number of definitive duties or price

[15] Note that Article 6.1 is now expired (see SCMs Article 31).

undertakings (a settlement to avoid a countervailing duty) in effect on June 30, 2008 was reported to be 55. Unilateral countervailing duties, of course, are unlikely to discourage the targeted subsidization practices systematically, as they are not coordinated multilaterally and generally apply to only a fraction of the production that benefits from subsidies. See Sykes (1989).

The alternative enforcement measure is a complaint by a WTO member government to the WTO itself seeking removal of a subsidy program. Since the beginning of the WTO system, however, there have been only on the order of a dozen such complaints, heavily weighted toward alleged export subsidies. A few high profile cases have touched on domestic subsidies, however, including the recent decision in *United States – Upland Cotton* and the ongoing Boeing-Airbus dispute. Only two final rulings to date have invoked the "serious prejudice" concept to condemn a domestic subsidy, the first being *Indonesia – Autos* and the most recent being *Upland Cotton*.

Turning next to the Agreement on Agriculture, it is useful to begin with a bit of history. GATT Article XVI, as amended in the 1954-55 GATT review session, contained a "loophole" for export subsidies on primary products, which include all basic agricultural commodities. Under amended Article XVI, the rule for primary products was that export subsidies should not result in the subsidizing nation obtaining a "more than equitable share" of world export trade in the subsidized product. After some wrangling, this test was ultimately found to be too vague to be enforceable, with the result that agricultural export subsidies were almost completely undisciplined. As noted, GATT had little to say about domestic subsidies either.

During the Uruguay Round, efforts were made to negotiate limits on agricultural subsidies, but major players such as the European Union, the United States and Japan were resistant to dramatic reductions in their farm programs.[16] A decision was made to devise an agreement that could facilitate a gradual reduction in such subsidies over time, by treating them in much the same way as the GATT treats tariffs on goods. Both export subsidies and domestic subsidies became the subject of specific commitments, and nations agreed to limit certain types of domestic and export support programs in accordance with negotiated ceilings. The permissible level of subsidies is scheduled to decline over time, and it is hoped that future negotiations will produce further reductions.

Annex 2 of the Agreement exempts certain types of domestic support programs from the negotiated commitments. Generally speaking, the types of programs that are exempt are those that have relatively less impact on output -- programs that cushion the incomes of farmers, for example, without encouraging them to increase their production.

Article 13 of the Agreement, popularly known as the "peace clause," insulated agricultural subsidies that conform to the Agreement on Agriculture from certain actions

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[16] One the history of the agriculture negotiations, see Barton, Goldstein, Josling and Steinberg (2006).

under the SCMs Agreement and GATT Articles VI and XVI. The peace clause expired at the end of 2003, however, and has not been renewed at this time. Thus, agricultural subsidies that conform to the Agriculture Agreement are nonetheless fully subject to challenge (and to countervailing duties) under GATT and the SCMs agreement. WTO members have largely refrained from bringing such actions during the pendency of the Doha round negotiations, but the future remains quite uncertain.

In sum, the Agreement on Agriculture adds two important innovations to WTO law. First, it shows how subsidy programs can be made subject to negotiated bindings, just like tariffs. Second, through Annex 2, it makes an effort to distinguish between output distorting subsidies and other subsidy programs that may have little effect on output. The latter distinction is not to be found in the SCMs agreement.

C. The European Union

As in the U.S. Federal system and the WTO, the Treaty Establishing the European Community (hereafter EC Treaty) restricts discriminatory taxation of imported and domestically produced goods. Article 90 of the EC Treaty states:

> No Member State shall impose, directly or indirectly, on the products of other Member States any internal taxation of any kind in excess of that imposed directly or indirectly on similar domestic products. Furthermore, no Member State shall impose on the products of other Member States any internal taxation of such a nature as to afford indirect protection to other products.

Roughly speaking, therefore, all three systems have comparable rules for discriminatory taxation of imported products.

In contrast to the WTO, the EC Treaty largely abolishes countervailing duties on internal trade. Article 92 prohibits them unless the EC Commission has approved them for a "limited time". Countervailing duties, of course, are also non-existent in the United States Federal system.

With regard to the rules constraining subsidies, EU law uses the term "state aid." The limitations on state aid bear some significant similarities to WTO rules but, as shall be seen, the disciplines are applied without attention to issues akin to the WTO concepts of injury and serious prejudice, and enforcement is far more aggressive.

Article 87 of the EC Treaty provides:

> 1. Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

> 2. The following shall be compatible with the common market:
> (a) aid having a social character, granted to individual consumers, provided that such aid is granted without discrimination related to the origin of the products concerned;
> (b) aid to make good the damage caused by natural disasters or exceptional occurrences;
> (c) aid granted to the economy of certain areas of the Federal Republic of Germany affected by the division of Germany, in so far as such aid is required in order to compensate for the economic disadvantages caused by that division.
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> 3. The following may be considered to be compatible with the common market:
> (a) aid to promote the economic development of areas where the standard of living is
> abnormally low or where there is serious underemployment;
> (b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
> (c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest;
> (d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;
> (e) such other categories of aid as may be specified by decision of the Council acting by a qualified majority on a proposal from the Commission.

Article 88 goes on to provide for enforcement of these rules by the EC Commission. It gives the Commission the power to order the cessation or modification of existing state aid programs, and provides that its decisions may be appealed directly to the European Court of Justice. It also requires member states to notify the Commission "in sufficient time to enable it to submit its comments, of any plans to grant or alter aid." Thus, all new state aid measures are subject to prior review by the Commission before they can be put into effect.

Article 87 raises a number of interpretive questions. Most fundamentally, what is "state aid?" How does one determine whether aid "distorts or threatens to distort competition?" And how is it determined whether state aid falls within the litany of possible exceptions contained in Article 87(3)? The answers to these questions are to be found, if at all, in the common law jurisprudence of the Commission and the European Court of Justice (ECJ).

State aid requires the use of "state resources," and must be provided to "undertakings," which can be natural or legal persons (corporations) who are engaged in economic activity. The general view of "state resources" is that state aid must have budgetary consequences for the government. Thus, regulatory measures that may advantage a particular enterprise are not state aid. Likewise, certain enterprises may be deemed not to constitute undertakings, such groups promoting cultural matters and

schools. For the most part, however, these requirements do not raise difficult questions. See generally Nicolaides, Kekelekis and Buyskes (2005).

It is well settled that state aid can take the form of virtually any government measure that has consequences for the fisc. These measures include direct transfers, below market loans, tax reductions, the sale of goods, services, or assets by the state at below market prices, the purchase of goods by the state at above market prices, capital injections that are inconsistent with what private investors would do, and the like. Id.; Quigley and Collins (2003). The wide range of measures that may constitute state aid is consistent with the approach of the WTO to the notion of a "financial contribution" under Article 1 of the WTO SCMs Agreement, and also with the range of measures that may be deemed subsidies for purposes of domestic countervailing duty laws. See Jackson, Davey & Sykes (2008).

Another similarity between state aid law and the law of the WTO arises from the principle that Article 87 applies only to "selective" measures and not to measures of general applicability. The requirement of selectivity is plainly akin to the WTO requirement of specificity. But unlike the WTO system, EU law has a fair number of useful precedents regarding the meaning of selectivity. EU law generally interprets the concept of selectivity rather broadly – any limitation on the ability of all undertakings to avail themselves of benefits under the government program in question is a potential basis for a finding of selectivity. Like Article 2 of the SCMs Agreement, however, eligibility for benefits may be restricted by objective criteria that are uniformly applicable. Examples of programs not found to be selective include benefits for all companies that hire workers that have been unemployed for a long time, and reduced social security taxes for all firms that introduce shorter working hours. EU law also allows for findings of *de facto* specificity in cases where government benefits are nominally available on a broad basis but the beneficiaries are in fact limited. See Quigley and Collins (2003).

One obvious difference between EU and WTO rules is the fact that EU rules apply to all state aid, whereas WTO rules apply only to trade in goods (GATS rules on subsidies have not been developed). Accordingly, aid to services industries is covered, as is aid to various investors that may or may not implicate trade in goods.

Another important substantive difference between EU and WTO rules lies in the absence of systematic attention to whether state aid has caused any demonstrable injury or "serious prejudice" to the industries of other member states. Rather, the question is whether the aid "distorts or threatens to distort competition…in so far as it affects trade between Member States," a question that is typically answered before any demonstrable effects of the aid can be observed in the marketplace because of the prior review procedure. The cases suggest that a threat to competition is more or less presumed if the aid program confers a material advantage on the firms that receive it. The main limitation on this presumption is a *de minimis* test, which exempts state aid falling below a particular quantitative threshold. It is also occasionally found that aid does not affect trade between the member states because the beneficiaries do not compete with entities in

other member states, such as firms supplying local transportation services. Another possibility is that state aid may affect only trade with non-member states, although arguments to that effect have generally fared poorly. See Quigley and Collins (2003).

The remarks so far might seem to suggest that measures qualifying as state aid are tightly circumscribed in Europe, to the point that only measures of truly general applicability, or measures below the *de minimis* threshold, should be observed. Yet, it is well known that European governments provide a great deal of assistance to a number of sectors – the Common Agricultural Policy has received much attention, for example, as have the substantial sums provided to Airbus as launch aid. How can these facts be reconciled? The answer, of course, is that the EU rules on state aid are riddled with exceptions.

Article 87, of course, does not limit aid in the form of measures of "general applicability,". Article 36 of the EC Treaty creates a general exemption for agriculture, providing that the common agricultural policy takes precedence over competition rules (including state aid rules). Article 76 establishes a special rule for aid to the transportation sector. The basis for other exceptions is found in Article 87. The automatic exceptions in Article 87(2), for social aid to consumers, natural disaster aid, and aid to areas of Germany adversely affected by the division of Germany, are of modest significance as a basis for sectoral aid. But the discretionary exemptions in Article 87(3) – concerning aid that "may be…compatible with the common market" -- open the door widely for the Commission to approve a wide range of assistance programs. Item (a) authorizes aid to areas with a "low" standard of living or "serious unemployment." Item (b) allows aid to promote an "important project" of common interest or to remedy a "serious disturbance" in the economy. It is often used to justify aid to research and development projects. Item (c) covers assistance to facilitate the development of certain "activities" or "areas" if the assistance does not adversely affect trading conditions to an excessive degree. Item (d) allows aid for cultural and heritage conservation, subject to the same limitation. Finally, item (e) allows any other aid that a qualified majority of the EC Council sees fit to approve. Plainly, almost any manner of aid can be authorized under these broad and vague standards.

The role of the Commission is thus to some degree the reverse of the role of Congress in the U.S. system. Under U.S. law, Congress must affirmatively intervene under the commerce clause to stop state subsidies, a step that is very rarely taken. In Europe, by contrast, the Commission (and occasionally the Council) must generally act to authorize selective "state aid" that exceeds the *de minimis* threshold (outside of agriculture).

The first and third exceptions in Article 87(3) are said to be the most important. Nicolaides, Kekelekis and Buyskes (2005). A considerable volume of regional aid has been authorized for regions in member states with comparatively low per capita incomes under item (a). Item (c) is used in a variety of ways – as a justification for aid to small and medium size enterprises, for example, or for aid to develop capital markets in Eastern Europe. Item (e) is apparently used sparingly, but has been employed to permit aid to

the shipbuilding and coal mining industries. The Commission has also promulgated a number of regulations that in essence "pre-approve" limited amounts of state aid in a variety of situations, including aid for small and medium size enterprises, regional aid and employment and training aid. See the appendices in Nicolaides, Kekelekis and Buyskes (2005).

D. Summary

One recurring principle across the U.S., WTO and EU systems is a prohibition on discriminatory taxation of goods in interstate commerce, even though a discriminatory tax and a subsidy to domestic producers may be economically equivalent in their effects. For government assistance that takes the form of "subsidies" or "state aid," by contrast, the three systems differ dramatically.

The U.S. system is largely laissez-faire – Congress has the power to block state subsidies, but rarely exercises it. Congress is vastly more likely to authorize industry assistance itself than to stand in the way of state measures.

The WTO system has developed an elaborate set of rules, in addition to the nonviolation principle regarding new subsidies and the negotiated bindings of agricultural subsidies. Export subsidies and import substitution subsidies are prohibited; all other "subsidies," defined with reference to a rather vague specificity criterion, are potentially actionable if they injure import-competing firms abroad or foreign exporters. Enforcement, however, is quite limited. Only governments have the capacity to complain to the WTO, and only about a dozen cases have been filed to date. Unilateral countervailing duties are more common, but have only limited ability to discourage subsidization. All of the enforcement actions require the complainant to provide clear evidence of injury to its interests.

The EU system is by far the most restrictive on the surface, although it too allows considerable "state aid." Aside from the exemption for agriculture, state aid is identified by the selectivity principle, which on the surface sounds similar to the specificity principle in the WTO. Precedent interprets the concept of selectivity quite broadly, and also suggests that non *de minimis* aid is more or less presumed to distort competition. State aid can thus be blocked with little evidence of significant injury to competing firms. The Commission is given broad discretion to authorize derogations from this regime, however, and has done so with regularity.

III. Economic Analysis: What Form of Regulation Makes Sense?

The substantial divergence among the three systems in their substantive rules and enforcement measures raises a host of intriguing questions. As a positive matter, why have the three systems evolved in such significantly different ways? As a normative matter, which system, if any, makes the most sense? Can differences across the three legal systems that offer a normative rationale for the observed heterogeneity?

Section A will begin to address these questions by considering the legal distinction between subsidization and tax discrimination, a line that has been quite controversial in the United States although it has received little attention elsewhere. Section B will shift the focus to subsidies, and ask whether across-the-board disciplines on subsidies, as distinguished from more specific measures to secure and protect market access, are essential to the operation of trade agreements. Section C will then turn to the question whether useful general disciplines on subsidies are possible to devise.

A. Tax Discrimination versus Subsidies

Consider first a principle that seems robust across all three legal systems – the strict prohibition on discriminatory taxation of interstate commerce, a prohibition that is not applied to "subsidies." Why should the law contain this distinctive treatment of discriminatory taxation? To frame the issue, imagine a jurisdiction that imposes a tax on the sale of steel products equal to $10.00 per ton, and let the tax be payable to the government by the sellers of steel. Initially, the tax is payable on all sales of steel products, whether they are produced within the jurisdiction or elsewhere. Next suppose that the government lowers the tax on steel produced within the jurisdiction to $5.00 per ton, but continues to impose a $10.00 tax on imported steel. As indicated above, such a policy would clearly violate the law in the United States, the WTO and the EU.

Now imagine a different scenario. Instead of altering the $10.00 per ton tax on all steel products, the taxing jurisdiction announces that it will pay domestic steel producers $5.00 for every ton of steel products that they produce, to be financed out of general revenues. The economic consequences of this policy are identical as a first order approximation to the discriminatory tax system. But as long as the regulating jurisdiction has avoided any appearance of linkage between the tax on steel and the payment to domestic steel producers, the arrangement will likely withstand challenge in the United States. It is also permissible under GATT Article III because of the exception for domestic subsidies in Article III(8)(b). The ultimate fate of the measure in the WTO system is unclear, of course, and it might run afoul of EU state aid rules.[17]

Can there be any policy justification for treating the two scenarios differently under the law? A somewhat naïve response is that discriminatory tax systems have the potential to achieve protectionist objectives while raising revenue at the same time, while subsidies entail an expenditure of government revenue and are thus perhaps self-policing

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[17] It might raise a nonviolation issue within the WTO system if the tariffs imposed by the importing jurisdiction on imported steel products were bound, or it might be actionable upon a showing of serious prejudice. The odds of an exporting nation filling a complaint against such a policy under WTO law, however, are probably quite slim, and the complaining nation would have the burden of showing its injury. In the EU, by contrast, the government payments would seemingly qualify as selective state aid, and would be deemed incompatible with the common market unless they were *de minimis* or fell within some applicable exception to Article 87 in the view of the Commission (or the ECJ).

to a greater degree. The difficulty with this argument, however, is highlighted by the example above -- any revenue-increasing discriminatory tax scheme can be replaced with a revenue-increasing nondiscriminatory tax coupled with a subsidy out of general revenues to domestic producers that has the same revenue consequences and essentially the same effects on interstate competition. It thus seems peculiar to treat the two schemes differently. This point has been made forcefully by U.S. constitutional commentators, most notably Zelinsky (1998, 2002).

Other commentators have responded to the argument that discriminatory taxation and subsidies should be treated identically by challenging the apparent equivalence between tax breaks and direct subsidies. Coenen (1998) argues that direct subsidies are more transparent expenditures of public funds than tax breaks because they appear as line items in budgets. The amount of a subsidy is also easier to calculate than the amount lost through a tax break. Subsidies may also be subject to annual renewal in the appropriations process while tax breaks may not require reauthorization. For all these reasons, Coenen argues, subsidies are subject to greater political scrutiny and less likely to do mischief. Denning (2007) adds that direct subsidies may be subject to a "framing effect" that distinguishes them from tax breaks – taxpayers may be more likely to view direct monetary payments as a cost to them than foregone revenue under a tax system. Zelinsky (2002) generally rejects these distinctions as unpersuasive. Zelinsky notes, among other things, an increasing emphasis in the U.S. appropriations process on tax expenditure analysis, which treats tax breaks and direct subsidies as rough political equivalents. Further, none of the arguments in defense of the distinction between tax discrimination and subsidies refute the proposition tat discriminatory taxation can always be replicated more or less perfectly by a non-discriminatory tax married with a subsidy.

Which view is more compelling? The fact that the U.S., WTO and EU all prohibit discriminatory taxation while treating direct subsidies more leniently perhaps suggests that the distinction has some policy logic. In an effort to rehabilitate the case for treating the two policies differently, consider again the distinction between protectionist devices that raise revenue and protectionist devices that reduce revenue. Assume *arguendo* that the latter devices are less pernicious.[18] One might then ask whether, at the time that the protectionist element of a tax or subsidy scheme is introduced, the net revenue impact on the government is positive or negative. A pure subsidy program, of course, reduces revenue. A discriminatory tax regime or a nondiscriminatory tax regime can increase or reduce revenue, depending on the details. Imagine, then, a legal rule that permits measures that have a substantial net revenue reducing effect, while condemning those programs that enhance revenue or are close to revenue neutral. Such a system, of course, would neither permit nor condemn subsidies and discriminatory taxation all the time, but would place each in broader context and examine their revenue consequences.

[18] Regan (1986) also suggests that the revenue consequences of subsidies should be a consideration relevant to their legality – he emphasizes the dangers posed by subsidies that can alter the competitive balance very cheaply.

If that sort of system holds any appeal, it can be simplified. In particular, consider adding a bright line rule prohibiting discriminatory taxation even when it substantially reduces government revenues relative to the *status quo ante*. A government that wishes to provide the same level of assistance to a domestic industry as it could through a revenue-reducing tax break can simply substitute a direct subsidy. Hence the prohibition on discriminatory taxation does not foreclose any meaningful revenue-reducing policy options. The system just described, of course, looks much like the U.S. Federal system and the original GATT.

But a loophole remains. A clever government that wishes to achieve protection in a revenue-enhancing way might undertake to do so by coupling a non-discriminatory tax increase on all products with a direct subsidy to domestic firms only. Yet, perhaps the government's attempt to proceed in such a fashion will be fairly transparent – the non-discriminatory tax increase will be more or less contemporaneous with the advent of the direct subsidy program. And if the twin aspects of the scheme do not appear linked, perhaps the political advantages of proceeding in this fashion will be lost.

Thus, to address this loophole, perhaps it is enough to add a legal rule that treats a subsidy linked to a non-discriminatory tax increase as the legal equivalent of discriminatory taxation.[19] Arguably, that is precisely what the Supreme Court accomplished in *West Lynn Creamery* when a non-discriminatory tax on all milk sales was enacted and then used to fund a subsidy to Massachusetts dairy farmers.

In sum, the distinction between revenue-enhancing protectionism and revenue-reducing protectionism may well have purchase in justifying the distinctive legal treatment of discriminatory taxation and subsidies. The distinction becomes is convincing, however, if the legal system is also attentive to measures that "game" the rules by blending non-discriminatory taxation with concurrent subsidies. U.S. case law is already sensitized to this issue.

B. Are General Disciplines on Subsidies Necessary?

To assess the need for general disciplines on subsidies, a theory of what objectives are to be served by subsidies regulation is necessary. Three types of objectives might be imagined, each with somewhat different implications.

1. Politically Efficient Market Access (The WTO)

The first possibility is that subsidies disciplines exist for the purpose of enhancing the value of negotiated market access agreements. This perspective draws heavily on the modern theory of trade agreements developed by, for example, Bagwell and Staiger (2002). Within this framework, trade agreements do not arise for the purpose of

[19] Coenen (1998) also argues for attention to the existence of linkage between taxation and subsidization, although he does not emphasize the net revenue issue as a rationale.

achieving "free trade" or first-best efficiency from a conventional welfare standpoint. Rather, the goal is to achieve "political efficiency" as measured by domestic welfare functions that essentially allow for arbitrary preferences over income distribution. Even though traditional efficiency is not the welfare metric, trade agreements are valuable because of international terms of trade externalities that arise when nations set their trade policies noncooperatively. Large nations protect their markets from foreign competition excessively because they ignore the price effects on foreign exporters. Cooperation through trade agreements allows these externalities to be eliminated (at least up to the point where self-enforcement becomes infeasible), but trading nations will still engage in some trade protection (perhaps a lot). Indeed, some industries or sectors may not be subject to any market access commitments.

The primary focus of reciprocal liberalization in trade agreements is usually border instruments. But the parties to market access agreements recognize that certain domestic policy instruments can become substitutes for protectionist border instruments, and the agreements must disable their use for this purpose to the extent reasonably possible lest market access commitments be undermined and the agreements unravel (or never come about in the first instance). Subsidies, in particular, can undermine market access expectations if their existence has not been factored into the negotiations. The logical implication of this problem is a need for legal disciplines on subsidy programs that are unknown to market access negotiators, such as new and unanticipated subsidy programs enacted after the conclusion of negotiations and any pre-existing but non-transparent subsidies.

A legal rule that addresses this issue squarely is the nonviolation doctrine under WTO law, whereby subsidy programs may be held illegal if they benefit import-competing firms whose products are close substitutes for imported goods that are subject to negotiated tariff reductions. The doctrine is actually closely tailored to protecting the expectations of negotiators – as noted earlier, subsidy programs enacted after trade negotiations have been completed are rebuttably presumed to be unanticipated by negotiators and thus a proper basis for a nonviolation claim; programs in existence at the time of the negotiations are rebuttably presumed to have been anticipated.

The nonviolation doctrine alone, however, may not be enough. It is possible that important market access barriers are initially the product of domestic instruments, and that the mere elimination of border instruments does not enhance market access to the desired degree. In such instances, it may be necessary for the domestic instruments themselves to become a subject of market access negotiations. The implications of this problem can also be seen in the WTO system in the Agreement on Agriculture, which embodies negotiated commitments to reduce domestic agricultural support programs.

Are any additional rules on subsidies necessary? If the sole objective of an agreement is to achieve negotiated improvements in market access, and to protect the expectations of access created by agreements against erosion by domestic measures that become a protectionist substitute for border instruments, the answer might seem to be "no." The combination of the nonviolation doctrine with the opportunity to negotiate

specific commitments to reduce particular subsidies that impair market access addresses all of the immediately apparent concerns.

Janow and Staiger (2003) and Bagwell and Staiger (2006) make these points, and further raise the possibility that additional rules on subsidies are actually undesirable. Suppose that a subsidy is a valuable policy instrument for some purpose other than trade protection, and that no other available policy instrument is a good substitute. Suppose further that such a subsidy is in place at the time of trade negotiations, and that its continued presence does not impair market access expectations because negotiators were aware of the subsidy and its effects. If trading partners can nevertheless secure removal of the subsidy, they can in effect expand their market access opportunistically, while damaging the ability of importing nations to pursue non-protectionist objectives. As a result, trading nations may become more reluctant to enter trade agreements in the first place. On this basis, Janow and Staiger and Bagwell and Staiger suggest that the additional disciplines contained in the WTO SCMs Agreement may be counterproductive.

But a puzzle arises. If negotiated market access is the only objective of a trade agreement, why do trade agreements contain any legal disciplines that apply across the board, irrespective of whether market access commitments have been undertaken on the products in question? Why, for example, does GATT Article III prohibit discriminatory taxation and regulations whether or not the tariffs on the imported goods in question have been bound (the subject of concessions)? Why does GATT Article XI prohibit quantitative restrictions across the board, whether or not the items in question are subject to tariff bindings?

To be sure, with respect to the products on which commitments are to be undertaken, it is beneficial to channel protection into as few policy instruments as possible (ideally one), and to have that instrument be fairly transparent (such as a tariff). Market access negotiations are cheaper and easier to enforce if the number of protectionist instruments that must be constrained is limited and the instruments have easily observable effects on trade, which is the essential logic of the "tariffication" effort under the Agreement on Agriculture. Bagwell and Sykes (2004).

Perhaps this logic can be extended. Even for products that are not subject to market access commitments initially, it may be useful to make protection more transparent by channeling all of it into tariffs. Such a policy may reduce unnecessary transaction costs of trade for all nations, and facilitate future market access negotiations.

I am agnostic on the question whether these considerations can explain the presence of across the board disciplines such as Article III of the original GATT. If they do offer a sufficient justification, however, it must nevertheless be balanced against the need to avoid undue constraints on domestic instruments that have other useful purposes besides protection. The initial response of GATT was to leave subsidies largely unfettered, presumably because subsidies can serve a variety of non-protectionist purposes.

By this account, the subsequent evolution of GATT subsidies rules, with the Tokyo Round Subsidies Code and now the WTO SCMs Agreement, should be driven in substantial part by increasing optimism on the part of the negotiators about their ability to distinguish useful subsidies from protectionist subsidies, and thus to avoid the problems highlighted by Janow, Bagwell and Staiger. Section C below will examine the soundness of WTO rules through this lens.

2. Free Trade (The United States and the EU)

A different perspective on the role of subsidies regulation arises if the goal of inter-jurisdictional cooperation is the attainment of free trade, and not merely enhanced market access. This assumption is quite implausible with respect to the WTO, which has never had the objective of eliminating all trade barriers, much less all government policies that might be deemed inefficient. But it is more plausible with reference to the United States and EU. Both systems purport to prohibit completely all internal barriers to trade such as tariffs and quotas, and apply this prohibition across the board to all goods and services markets. The same logic seems to justify a prohibition on all protectionist domestic instruments as well. See Regan (1986).

Although the rationale for general disciplines on subsidies is different under the assumption that free trade is the objective, its implications for appropriate legal rules is much the same. The challenge for the legal system is to identify subsidies that are protectionist, and to discipline those subsidies while leaving governments free to pursue other legitimate policy objectives. General subsidies disciplines become suspect if they are poorly suited to this task.

3. Competitive Subsidization

A third possible objective of subsidies disciplines is suggested by the work of Bagwell and Staiger (2002) on export subsidies. Imagine multiple nations exporting the same product, and suppose that their governments are persuaded by their exporters to engage in export subsidization. When such nations act noncooperatively, they will fail to take account of the fact that their export subsidies divert sales from foreign competitors. Because of this negative externality, a tendency will arise for exporting nations to engage in excessive export subsidization from their collective perspective.

Plausibly, this problem of "competitive subsidization" generalizes to other settings. Governments may grant domestic subsidies as well without taking account of their negative implications for foreign producers of competing goods, leading to a noncooperative equilibrium involving excessive subsidization from the subsidizing governments' perspective.

These observations suggest a possible role for restrictions on subsidies that is conceptually distinct from that implied by the discussion of politically efficient market access agreements or free trade agreements. Even if governments have no interest in

market access agreements, much less a desire for completely free trade, they might wish to cooperate to reduce competitive subsidization. The possibility arises that subsidies disciplines may be understood or justified by their ability to abate this class of problems. The rules might then be aimed not so much at subsidies that undermine negotiated market access commitments, or at protectionist subsidies in general, but at subsidies in contexts where pressures for competitive subsidization are particularly problematic.

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In sum, if across the board disciplines on subsidies are useful at all – a proposition that is questionable in the case of the WTO – they should do a reasonably accurate job of identifying and disciplining protectionist subsidies while allowing other forms of subsidies to survive. In addition, there *may* be a constructive role for disciplines aimed not at protectionism but at competitive subsidization. The next section will examine the WTO and EU legal systems in an effort to determine whether and to what extent they perform these tasks successfully (recalling that the United States essentially ignores internal subsidies).

C. Is It Possible to Devise General Disciplines that are Useful?

As shall be seen, many features of existing law are questionable judged by the standards developed above. The capacity of the rules to identify subsidization at all, much less to distinguish protectionist from constructive subsidies, is much in doubt. Restraints on competitive subsidization are also of questionable utility.

1. Gross versus Net Subsidization

Before one can determine whether a subsidy is objectionable or not, it is first necessary to determine that a subsidy exists. Under WTO and EU law, this task is accomplished by identifying individual government measures that might constitute "subsidies" or "state aid," and then examining those measures individually in relation to the legal definitions of those terms.

During the course of this process, the investigating authorities systematically ignore virtually all of the other government measures that affect the competitive position of the industry in question. No account is taken of the income, payroll, excise and other taxes paid by firms. No heed is given to all the regulatory burdens that may be imposed by employment and discrimination laws, workplace safety rules, environmental regulations, and so on. No account is taken of how general infrastructure, such as road building and government-owned utilities, may have affected the costs of firms (save for the case where a government utility is itself alleged to confer a subsidy). No attention is paid to how the educational system may have aided or disadvantaged an industry. Plainly, these and other government measures affect the competitive position of firms vis-à-vis their foreign competitors, perhaps profoundly.

Because the analytical process is myopic, focused only on the details of the

particular program being evaluated,[20] a finding that a "subsidy" or "state aid" is present does not establish that the government has done anything *net* to afford the industry a competitive advantage. It is entirely possible that the balance of benefits and burdens associated with government measures as a whole may actually impair the competitive position of the industry relative to foreign competitors (whose position is of course affected by the balance of benefits and burdens associated with their own government's actions). Programs that appear to confer "subsidies" therefore may actually offset other disadvantages and serve as useful corrective measures. This observation is nothing more than an application of the familiar theory of the second best, which implies, *inter alia*, that an action which would distort resource allocation in an otherwise first-best setting may well be constructive in the presence of other offsetting distortions.

It is no surprise that the law proceeds in this fashion. Investigating authorities could not possibly engage in a full accounting of the effects of government on firms and industries. The task would be so massive and subject to data limitations that there could be little hope of getting it right or even of completing it within a reasonable time frame.

Because practicable legal rules for identifying or measuring net subsidization are impossible to devise, therefore, existing rules on subsidies can at best identify and measure gross subsidization. The utility of any system of disciplines that ignores the myriad of potentially offsetting government measures is questionable.

2. Benchmark Problems

Assume *arguendo* that a focus only on gross subsidization can somehow be defended. How is gross subsidization to be identified? The answer inevitably involves some sort of counterfactual benchmark against which government measures can be assessed to determine whether they confer an advantage.

a. The Adequacy of Market Benchmarks

The benchmark often employed by the law is a market benchmark. This benchmark is used to determine whether a subsidy exists under both WTO and EU law for measures that fit into two of the three categories of "financial contributions" enumerated in SCMs Article 1 – direct transfers of funds by governments, and government sales of goods and services. If the government simply writes a check to a firm and receives nothing in return, for example, the transfer of funds is treated as a pure subsidy because private actors do not write such checks. If the government makes a loan to a firm at 6% per annum, the question is whether the rate on the government loan is

[20] U.S. countervailing duty law provides an instructive illustration. Under §771, the only offsets allowed in the calculation of "net countervailable subsidy" are application fees paid to obtain the subsidy, the lost time value of money if receipt of the subsidy is deferred, and any export taxes imposed specifically to offset the subsidy (in settlement of a countervailing duty action). See 19 U.S.C. §1677(6).

lower than the rate that the firm could have obtained from a private lender. If the government sells oil to a firm, the question is whether the government price of oil is below the fair market value of oil, and so on.

How satisfactory are market benchmarks? In economic models of competitive markets, any government-induced departure from competitive equilibrium may be labeled a distortion in the absence of offsetting non-pecuniary externalities. The market benchmark thus appears a natural one in many instances. But how well do actual markets track the assumptions of neoclassical competitive models?[21]

One difficulty has already been noted -- taxes and regulations affect markets in a myriad of ways, some of which may cause distortions. For the same reason that gross subsidization fails to capture the effects of governments on the competitive position of firms, it is often questionable whether markets offer an accurate efficiency benchmark.

Imperfect competition is also common. In imperfectly competitive markets, prices tend to exceed marginal costs, and output is then too low from an efficiency standpoint. Output expanding subsidies are then potentially desirable. Likewise, price benchmarks set by imperfectly competitive markets may be too high from an efficiency standpoint.

Non-pecuniary externalities, both positive and negative, are also important, whether associated with carbon emissions, with intellectual property spillovers, with the fact that certain activities of firms impose costs on governments, and so on. Despite their potential importance as a source of distortion to market benchmarks, these issues too are generally ignored.

In the few cases where the law does consider the possibility that market benchmarks are distorted, the results are not terribly satisfactory. For example, consider the long-running softwood lumber dispute between the United States and Canada, in which the United States alleged that Canadian provinces provided subsidies to lumber producers through their pricing of timber harvesting rights ("stumpage"). Canada responded by arguing that provincial stumpage prices were comparable to the prices of charged in Canada by private landowners. The United States then argued that the private sale prices were distorted by the enormous volume of crown timber sold in competition with private timber. The United States thus relied on "cross border comparisons" between timber prices in the United States and timber prices on crown lands to assess the existence and magnitude of subsidization. These comparisons resulted in a finding that Canada confers a considerable subsidy, and thus a hefty countervailing duty.

Cross border comparisons are highly problematic. Logging conditions (roads, terrain) may be vastly different across the border, significantly affecting the fair value of standing timer. Environmental regulations may differ. The tree species mix and the

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[21] See also Zheng (2008).

market value of the wood may differ. Transport costs to end markets may differ. Appropriate adjustments for all these considerations are extremely difficult to make, and are subject to manipulation in ways that can favor a domestic interest group.

Canada thus challenged the use of cross border comparisons in the WTO. The Appellate Body ultimately ruled against Canada on this issue, however, accepting the U.S. position that the large volume of government sales distorted Canadian prices, but ultimately offering no guidance on whether the U.S. alternative was acceptable. [22] The dispute was settled before the matter could be further litigated.

The problem is not limited to standing timber. Often when governments are involved in providing goods or services, such as natural resources, electricity, transportation services, postal services, and telecommunications services, the government will be a major market player or even the sole market participant. The same benchmark problem then arises as in the softwood dispute, and the range of options for resolving it can prove equally unappealing.

b. Market Benchmarks Unavailable

In addition to the problem that market benchmarks may themselves be distorted, important cases arise in which market benchmarks simply do not exist. The absence of any market benchmark is an especially acute problem for cases involving the second type of financial contribution under SCMs Article 1 – revenue foregone by the government. Suppose, for example, that a U.S. subsidiary does business in Europe. Imagine two possible tax regimes concerning the tax liability of the U.S. subsidiary. Under the first regime, the U.S. government presumes that the overseas activities of the firm will be taxed by the government of the jurisdiction(s) in which it operates, and income attributable to the overseas activity of the firm is thus untaxed by the United States (assume that some sort of arm's-length allocation rule does an adequate job of dealing with any internal transfer prices). Under the second regime, the U.S. government wishes to capture for itself some portion of the overseas income of U.S. subsidiaries, and enacts a law providing that a percentage of their overseas income each year shall be deemed repatriated and taxed to the parent company. But exporters successfully lobby the government to exempt some of the income earned on export sales transactions (as distinguished from, say, investment income or sales transactions not involving goods produced in the United States) on the grounds that to tax those transactions would unduly impair competitiveness. Thus, income earned on export sales transactions by U.S. subsidiaries is effectively taxed at a lower rate than other sources of income for the same subsidiaries.

Which regime, if either, should be deemed a subsidy? Because the second regime imposes some tax liability while the first imposes none, one might be tempted to say that

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[22] United States – Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada. WT/DS257/AB/R, adopted January 19, 2004.

the second regime does more to "subsidize" U.S. firms than the second. The second regime, however, is actually a stylized and simplified description of the facts in *United States – Tax Treatment for Foreign Sales Corporations*,[23] part of a longstanding dispute going back to the 1970's under GATT. In this iteration of the dispute process, the WTO Appellate Body determined that the second regime conferred a prohibited export subsidy by reducing the taxation of export sales transactions relative to the taxation of other foreign subsidiary income, thus creating a situation in which "government revenue that is otherwise due is foregone" in the language of SCMs Article 1. Along the way, the Appellate Body also made clear that United States was under no obligation to tax the foreign income of U.S. subsidiaries at all, and could have chosen not to do so without running afoul of the SCMs Agreement. Thus, the first regime, even though more generous to U.S. subsidiaries, would not have been deemed a subsidy.

The case illustrates a more general and fundamental problem with the notion of a tax subsidy. When one firm pays less tax than another (or some activities of a firm pay less tax than other activities, as in the FSC case), is the firm that pays a lower tax "subsidized," or is the firm that pays the higher tax simply "taxed" at a higher rate? In other words, which tax rate applies as the counterfactual benchmark? Indeed, why not consider some third tax rate as the most likely counterfactual? The FSC case suggests that WTO law, at least, will systematically look to the higher rate as the benchmark, and find a subsidy on that basis.

This approach perhaps seems plausible in some circumstances. Consider an economy of 100 firms engaged in various activities. Assume that 99 are subject to a 25% income tax rate, while one of them is exempt from tax. Perhaps the narrow exemption causes a substantial reallocation of resources toward the untaxed activity to a degree that might be perceived to cause a serious distortion.

But now reverse the facts, and suppose that 99 firms are taxed at a lower rate, and only one at the higher rate. Is there a "subsidy" to the 99 firms? Or suppose that a state government that ordinarily taxes corporate income is seeking to attract new business investment in competition with other states that have no corporate income tax. The state thus offers certain potential new investors a 20-year exemption from its ordinary corporate tax. Is it sensible to say that the state that offers a time limited exemption is conferring a "subsidy," while the states that offer an apparently perpetual tax exemption are not?

This class of problems has no obvious solution. It is unrealistic to ask the legal process to divine what tax authorities would have done in a world in which they had been forced *ab initio* to eschew any differences in tax treatment. But to assume that a higher tax rate elsewhere in the tax system necessarily provides the right counterfactual for identifying, let alone measuring, the existence of a "subsidy" is a seemingly arbitrary alternative. This difficulty, of course, is *in addition* to the issue noted earlier – whether

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[23] WT/DS108/AB/R, adopted on March 20, 2000.

observed tax differences might be justified to offset other government burdens, an issue that the legal system also ignores.

Tax subsidy cases are not the only ones without market benchmarks. In *British Steel Corp. v. United States,*[24] the British government had contributed equity to the British Steel Corporation, which was wholly owned by the government. No market valuation for the company was available. The United States treated the entire equity infusion as subsidy on the grounds that the company was not "equityworthy" and thus a private investor would not invest in it, a test still enshrined in U.S. law.[25] The equityworthiness determination was made on the basis of an examination of the balance sheet and a finding that British Steel was constantly losing money. British Steel argued, in response, that the equity infusion was necessary to finance projects with positive present value. If that assertion were correct, of course, the equity infusion would be rational on the part of a private investor even if the company was otherwise losing money – a positive present value investment by definition would reduce future net losses. The United States refused to consider the argument seriously, however, noting, among other things, how difficult it would have been to evaluate its factual accuracy.

c. Other Benchmark Problems

Another class of benchmark problems arises under SCMs Article 1 for a class of cases involving government activity that does not fit neatly into any of the enumerated types of financial contributions. A good illustration is to be found in *United States – Measures Treating Export Restraints as Subsidies*,[26] yet another dispute report in the long-running U.S.-Canada softwood lumber battle. Canada restricted or prohibited the exportation of logs harvested on crown lands. The United States had statutes and regulations in place that would treat such export restrictions, which of course have the effect of depressing the price of logs in Canada and making them cheaper for independent sawmills, as countervailable subsidies. Canada brought a challenge to U.S. law "as such" (before the law was actually applied), and the dispute panel held that export restrictions could not be treated as conferring a subsidy because they did not involve an expenditure of funds by the government. Likewise, they did not qualify as sales of goods by the government at below market prices, since private loggers sold the logs and the government did not command the loggers to reduce their prices.

The U.S. position on the matter made considerable sense from an economic standpoint. From the perspective of the mills producing lumber, the economic effects of log export restrictions are potentially identical to the effects of the government selling logs at below market prices, or to the effects of direct subsidies private loggers. Either of

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[24] 632 F. Supp. 59 (CIT 1986).

[25] See 19 U.S.C. §351.507.

[26] WT/DS/194R, adopted on August 23, 2001.

those measures would clearly fit within the definition of subsidy under WTO law (and state aid under EU law).

Janow and Staiger (2003) defend the decision in the case with an argument derived from Lerner symmetry. They note that an export restriction on one good will tend to diminish imports generally (because of balanced trade) and will also tend to stimulate other exports somewhat (think of a currency depreciation due to the export restriction that makes all other exports a bit cheaper). Hence, they argue, "an export tax on a single export good is conceptually equivalent to (i.e., 'exactly like') an alternative program in which an export subsidy of the same magnitude is placed on every other export good and an import tariff of the same magnitude is placed on each imported good.[27]" They state that this equivalence holds for export restrictions on input products as well. They then suggest that the subsidy component of this equivalent package should not be actionable or countervailable because it is not specific.[28]

Their argument is a clever one, but perhaps unpersuasive. From a legal standpoint, a package of import tariffs and export subsidies would likely violate numerous tariff bindings, and recall that all export subsidies are deemed specific under WTO law. From an economic standpoint, their argument does not refute the proposition that an export restriction on an input product makes it available to domestic downstream firms at a lower price, and enables those firms to expand at the expense of foreign competitors.

The panel decision is nonetheless understandable in light of the treaty text, and an alternative rule that allowed export restrictions on input products to be treated as actionable subsidies would raise potentially daunting problems of quantification. But more importantly, consider the logical implications of the U.S. position. All manner of government regulatory policies have price effects on the inputs that are used by domestic firms to produce final products. Should any government regulation that arguably lowers input prices be treated as a subsidy? As noted earlier, subsidies disciplines generally ignore the effects of regulatory policies on the costs of firms, perhaps because it would be

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[27] Id. at 229.

[28] One might also defend the decision by arguing that the United States should have pursued a different remedy against the log export restrictions. A prohibition on exports may be viewed as an export quota of zero, which violates GATT Article XI unless it falls within an exception. Given that the log export restrictions were apparently enacted for the benefit of Canadian sawmills, it is difficult to see how any exception in Article XI or XX would have protected them.

One difficulty with this approach to the issue, however, is that WTO law does not prohibit export taxes. Canada could thus have responded to the U.S. complaint under Article XI with a prohibitive export tax and accomplished the same thing.

wholly impractical to do anything else. But if it is acceptable to ignore the effects of regulatory policies, why bother with "subsidies" either?

One final benchmark problem can arise in relation to the legal requirement in both WTO and EU law that a subsidy must provide a benefit to the recipient. Consider the issue that arose in *United States – Imposition of Countervailing Duties on Certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom*.[29] The producer of the goods in question was a British steel company that had gone through a privatization process. Its manufacturing facilities had been constructed with government funding, and the government subsequently sold the facilities through an equity offering on a public stock exchange. The shares were seemingly sold for fair market value in arm's-length transactions. Nevertheless, the United States treated the prior government ownership as conferring a subsidy over the life of the assets that was allocable to production after the privatization sale was complete, and applied countervailing duties.

The WTO Appellate Body ruled that no subsidy existed because the owners of the steel firm had not benefited from any government assistance. In effect, the sale of assets to private buyers at fair market value was deemed to have cleansed the firm of any earlier subsidization.

This principle is also problematic from an economic standpoint.[30] To see why, imagine that a government builds a new steel plant at a time when the steel market is horribly depressed. Assume that no private investor would have built a new plant under these circumstances. The government then auctions off the factory for fair market value, which is far below the cost of building it. The buyers then put the plant into operation because the price of steel is high enough to cover the marginal costs of steel production. The rule set out above would then hold that the resulting steel firm was not subsidized, even though its productive capacity (and the downward pressure on prices from its production) would not at exist at all but for the government's uneconomical initial investment.

The problem could be addressed by changing the legal rule to provide that the construction of uneconomical productive capacity creates a subsidy that can survive privatization under appropriate circumstances. The benchmark question would no longer be whether the buyers in a privatization sale paid fair market value, but whether the capacity that they purchased was the result of uneconomical government investments. The problem, of course, is that such questions are not easy to answer. The wisdom of investments must surely be evaluated from an *ex ante* perspective, and the information necessary to assess the financial soundness of government decisions perhaps many years earlier may not be available. Moreover, even if an investment was uneconomical at the

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[29] WT/DS138/AB/R, adopted on June 7, 2000.

[30] See also Grossman and Mavroidis (2003).

time, market conditions may have changed later to justify it. The task of identifying the subsidy is thus a difficult one, and the conceptual challenges of quantifying it seem even more daunting.

3. Identifying Protectionism

Even if a focus on gross rather than net subsidization is defensible, and even if an acceptable benchmark for identifying and quantifying (if necessary) gross subsidization is available, an important question remains – is the subsidy one that ought to be condemned? Following the discussion in Section B, this question seemingly comes down primarily to the question whether the subsidy is protectionist or not. Thus, consider the legal rules that are used to identify unacceptable government subsidies, and how well they map to the goal of identifying protection.

a. The Specificity/Selectivity Test

Government spending in developed countries often exceeds 50% of GDP. In the United States, the percentage is approximately 40%. Much of this spending has little impact on the competitive position of firms, and seemingly raises no issues of subsidization. But a great deal of government spending does affect the costs of firms engaged in commerce. Basic expenditures on public education and road construction, for example, can have profound effects on costs. Those types of expenditures can be excluded from the ambit of "subsidies" on the grounds that firms receive no direct financial contribution, and indeed WTO and EU law both take that view. But many government programs do make financial contributions to firms, and of course many tax policies also have a direct financial effect. Unless all such measures are to be deemed worrisome subsidies, the financial contribution requirement alone is an inadequate filter.

The additional test under existing law, as noted earlier, focuses on industrial targeting. WTO law (specificity) and EU law (selectivity) inquire whether the financial benefits are limited to "certain enterprises" either in law or in fact. Both also provide that programs that are limited by certain purportedly "neutral" criteria are acceptable, such as programs limited to small firms.

How well do the concepts of specificity and selectivity perform as markers for protectionist policy? In my view, the answer is "poorly."

To be sure, government measures of truly general application cannot protect any particular industry. In simple economic models, an effort to subsidize all industrial activity uniformly would presumably have no real effects at all, and would wash out following some combination of price and exchange rate adjustments.

But the effects of government measures are never so uniform,[31] and the specificity

[31] Trebilcock and Fishbein (2007), p. 22, suggest that "[a]lmost every action a government takes will favor some sectors of the economy over others."

test has been applied in practice to insulate measures that likely have protectionist effect or intent. Likewise, even if measures are specific or selective, they may well be justifiable on non-protectionist grounds.

A few examples will make the point, beginning with cases in which the specificity test has been interpreted in ways that preclude scrutiny of arguably suspect policies. Under WTO law, in particular, terms such as "certain enterprises" and "group of enterprises or industries" are undefined. They can thus be applied broadly or narrowly in ways that reflect political considerations rather than economic principle. The United States has long held the view, for example, never challenged under GATT or the WTO, that government subsidy programs applicable to the agricultural sector as a whole are not specific.[32] Agricultural subsidy programs that cover a large number of products with more or less uniform benefits are insulated from scrutiny under this interpretation, even though such programs could well have the intent and effect of protecting domestic farmers.

As another example of how the test can be manipulated, the United States initially took the position in the softwood dispute with Canada that any subsidies in the price of standing timber were not specific – they afforded benefits to more that just "certain enterprises," including the lumber industry, the pulp and paper industry, the furniture industry, and others. Not long after, when domestic pressures for import protection intensified, the United States reversed itself, arguing that most of the benefits of timber subsidies went to the lumber and pulp and paper industries, and that those industries represented only a single "group.[33]"

EU law largely avoids this problem by construing the notion of "selectivity" quite broadly. But that policy creates another problem – it sweeps in a vast range of government measures that exhibit some degree of targeting, creating pressure for exemptions. The resulting exemptions are sometimes questionable to say the least if the underlying objective is to ferret out economic protection.

Recall the general exemption under EU law for the common agricultural policy. Instead of taking the position that broad agricultural subsidies are non-specific, like the United States, the EU simply exempts its agricultural programs altogether from state aid disciplines. Many readers will no doubt find it difficult to imagine that the common agricultural policy has no protectionist elements.

Recall as well the authority under Article 87 of the EC Treaty for state aid to regions facing economic difficulty. This authority is the basis for substantial programs to

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[32] See 19 C.F.R. §351.502(d).

[33] See Certain Softwood Lumber Products from Canada, U.S.-Canada Free Trade Agreement Binational Panel No. USA-92-1904-01, December 17, 1993.

encourage business investment in areas with low per capita GDP or high unemployment. Yet, there may be good economic reasons why certain geographic areas have lower per capita GDP or higher unemployment. Perhaps the population is less educated, perhaps natural resources are limited, or perhaps transportation costs are especially high. Programs to create new business or to prop up existing ones in these areas are arguably no different from an efficiency standpoint from programs that seek to protect businesses from foreign competition.

To be sure, not all targeted subsidies are worrisome. As noted earlier, Johnson (1965) argues that in the presence of market distortions, corrective policies that operate directly on the distorted margin are typically the most efficient policy instruments. Subsidies may well fit the bill. Output or investment subsidies may thus be the best response, for example, when firms generate positive externalities, a situation often thought to arise in technologically progressive industries. Employment subsidies may be the best response to labor market imperfections that produce inefficiently high unemployment, and so forth. Depending on the circumstances, such subsidies may well be limited to only a small group of firms and thus appear specific.

The task of crafting exceptions for "efficient" subsidies, however, is enormously difficult. The WTO seemingly made an attempt with the "green light" categories of subsidies, covering certain research and development, regional assistance, and environmental compliance programs. As noted, the green light approach expired in 2000 and has not been renewed.

The lack of support for renewal of the green light system is perhaps understandable. The green light categories were themselves subject to question. Although research and development programs may well yield positive externalities that justify subsidization, for example, nothing in the rules for that category made any principled effort to identify cases likely to be associated with large positive externalities, and it is difficult to imagine any practicable set of rules that could. Moreover, money is fungible. In practice, it is impossible to prevent a government from providing an "R&D subsidy" in cases where the research would have gone forward anyway, and the additional government money is in fact diverted to other purposes. The environmental category was also clearly problematic. Subsidies for environmental compliance may be precisely the wrong policy from an efficiency standpoint; a tax on environmental damage in accordance with the polluter pays principle may be the proper response to such harms. Finally, I have already commented on the efficiency implications of aid to disadvantaged regions.

To make matters worse, exceptions for "efficient" subsidies may fall well short of what is needed, even if they could be crafted. Most observers would concur that income distribution is also a matter of legitimate government concern. But once the door is opened to considerations of income distribution, how does one distinguish an undesirable "protectionist" subsidy from an acceptable subsidy aimed at distributional equity? Is a subsidy to preserve family farms protectionist, or is it a legitimate expression of democratic preferences for preserving a certain way of life? Even if aid to disadvantaged

regions is questionable on efficiency grounds, might it not be justified by income distribution concerns[34]?

In sum, the specificity and selectivity tests do not provide a satisfactory basis for distinguishing good subsidies from bad subsidies. They are readily manipulable on their face. If such manipulation is substantially foreclosed by a broad interpretation of the targeting criterion as in the EU, the resulting political pressures for exemptions lead to results that are surely questionable from an efficiency standpoint. Efforts to craft rule-based efficiency exceptions have shown little promise. And if distribution-based exemptions are allowed, nothing much of an intelligible test is left. One way or another, therefore, the specificity and selectivity tests simply beget a political process in which the ultimate determination as to what constitutes an illegal subsidy bears little relation to the economic concept of protection.

b. The Marginal Cost Problem and Injury

If general legal rules for the identification of protectionist subsidies are too difficult to fashion, perhaps a more limited safe harbor can be created for subsidies that do not harm foreign competitors. As other commentators have noted, subsidies cannot harm competitors unless they affect output. Goetz, Granet and Schwartz (1986). Subsidies that lower marginal costs will tend to increase output. Subsidies that induce investment in capacity that would not otherwise be created also increase output, including subsidies that directly lower the costs of investment as well as other subsidies that simply increase industry profitability and attract entry.

Some commentators have proposed that the law insulate from scrutiny all subsidies that do not increase output. Diamond (1990). These proposals have had little discernible impact on existing legal rules with the exception of Annex 2 of the WTO Agriculture Agreement. Annex 2 exempts certain government programs from the negotiated ceilings on domestic support payments if they satisfy the "fundamental requirement that they have no, or at most minimal, trade-distorting effects or effects on production." Examples in Annex 2 include government extension, inspection and infrastructure services; domestic food aid; payments for disaster relief; income support payments that are not linked to the type or volume of production; and structural adjustment assistance for producer or resource retirement.

The difficulty with efforts to carve out a safe harbor for subsidies that do not affect output is the weakness of the premise behind such efforts – virtually all subsidies have the potential to affect output. The programs enumerated in Annex 2 of the Agriculture Agreement, for example, increase the profitability of agricultural production, *ceteris paribus*, and thus may be expected to attract more capital to agriculture. Indeed, even a government payment to *reduce* output can attract investment for the purpose of collecting the subsidy, leading to increased output in advance of the subsidy (if it is

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[34] Schwartz and Harper (1972) make a similar point.

anticipated) or subsequent to it (if it may be expected to recur). The exemptions in Annex 2, therefore, may be more a reflection of political expediency than of sound economic principles.

The alternative to general rules that exempt "non-distorting" subsidies from scrutiny is case-by-case adjudication focused on the same issue. In theory, the effect of subsidies on competitors might be considered as part of the "material injury" or "serious prejudice" inquiry under WTO law, for example, or as a necessary element of the proof required for a successful nonviolation case. But the difficulty is much the same – virtually all subsidy programs have the potential to affect output, and it is often unknowable as a practical matter to what extent subsidy programs have in fact affected output. It is thus unsurprising that the analysis of injury by investigating authorities generally fails to establish a clear causal linkage between subsidy programs and injury, but instead simply assumes that subsidies stimulate foreign sales. See Jackson, Davey and Sykes (2008); Sykes (1996).

Finally, it bears emphasis that a safe harbor for subsidies that do not affect output is at best a highly imperfect corrective for the weaknesses of existing subsidies disciplines. It does not address the failings of a focus on gross subsidization, and it is no more than a highly imperfect cut at the distinction between protectionist and non-protectionist subsidies.

4. Prohibited Subsidies

If existing disciplines do a poor job at identifying undesirable subsidies in general, is it at least possible to defend the category of "prohibited subsidies" under WTO law? Sadly, the answer may be no.

a, Export Subsidies

Although it is difficult to imagine a role for export subsidies in an otherwise "first-best" world, considerations of the second-best again come into play. As noted earlier, if trade barriers cause the volume of trade to be inefficiently small, export subsidies can enhance welfare by expanding the volume of trade. Bagwell and Staiger (2002). Imperfect competition is another possible reason why trade volumes (and overall industry output) may be too small, suggesting a further scenario in which export subsidies *may* help to offset another distortion.

Existing restrictions on export subsidies in the WTO, therefore, need not enhance overall welfare. The possibility arises that they are instead simply a response to competitive subsidization and the loss of rents that exporters suffer as a consequence. Bagwell and Staiger (2002). It is understandable that exporters should wish to stop this flow of rents to customers by ending the competitive pressures to subsidize, but less clear that any net gain arises once the welfare of importing nations is taken into account.

To be sure, export subsidies are not the ideal responses to distortions associated

with trade barriers and imperfect competition. First, and rather trivially, the magnitude of export subsidization may exceed the amount that is useful to offset any pre-existing distortions. Second, export subsidies may introduce problems of trade diversion, as importers switch from lower cost unsubsidized exporters to higher cost subsidized exporters. The attendant welfare costs must be factored into the calculus in assessing the overall effects of export subsidies.

Finally, export subsidization may pose some threat to negotiated market access agreements. An importing nation that makes a tariff concession, for example, may be fearful that the remaining level of protection will be overcome by future export subsidies, so that the desired local prices for import-competing goods cannot be maintained. This fear may cause a reluctance to make tariff commitments in the first instance. Likewise, a nation that secures a market access commitment from another country may fear that the commitment will be undermined by subsidized exports from a third country, thus placing it in the awkward position of having to match the subsidy or give up the market access that it hoped to achieve.

Thus, export subsidies are assuredly a mixed bag from a welfare standpoint. An across the board prohibition on them seems difficult to defend, however, unless one is prepared to assume (a) that export subsidies are on average welfare-reducing; and (b) tailored rules to sort the good from the bad are too difficult to devise. Although assumption (b) is plausible, the empirical basis for (a) is not evident.

b. Import Substitution Subsidies.

Recall that GATT Article III(8)(b) exempts "the payment of subsidies exclusively to domestic producers" from the national treatment obligation. Accordingly, a GATT panel held in *Italian Discrimination Against Imported Agricultural Machinery*[35] that a low interest loan program available to purchasers of certain Italian-made farm machinery was a violation of Article III. A closely related principle was later enshrined in the WTO SCMs Agreement, which places import substitution subsidies – "subsidies contingent…upon the use of domestic over imported goods" – into the category of prohibited subsidies.

The blanket prohibition on import substitution subsidies seems odd. Imagine a subsidy to a domestic purchaser of an Italian tractor equal to 500 Euros, a subsidy that is clearly illegal. Now imagine instead a subsidy to the Italian tractor manufacturer of 500 Euros per tractor sold. If the manufacturer does not export (or if the subsidy to the manufacturer is limited to units sold domestically), the economic effects of the two subsidies are identical. The producer subsidy shifts the supply curve inward, while the purchaser subsidy shifts the demand curve outward by a comparable amount. The effect on the equilibrium number of sales by the manufacturer, and thus the effect on foreign manufacturers seeking to sell tractors in Italy, will be the same. It thus seems peculiar for

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[35] 7th Supp. BISD 60 (1959), adopted October 23, 1958.

the law to condemn the purchaser subsidy but potentially to allow the producer subsidy.

Janow and Staiger (2003) defend the distinction by suggesting that it plugs a loophole in WTO law. They posit that a government could otherwise escape the WTO disciplines on producer subsidies by structuring them as purchaser subsidies. The difficulty with this argument is that a purchaser subsidy can only disadvantage foreign firms by causing purchasers to divert their purchases from imported goods to domestically produced goods. But that problem is addressed by the nonviolation doctrine already, and by the principle that all subsidy programs causing serious prejudice are actionable (whether the subsidy is paid to producers or purchasers). Thus, there is no apparent loophole that requires plugging. By placing import substitution subsidies in the prohibited category, the WTO treats them more harshly than economically equivalent producer subsidies that are merely actionable.

One might argue, however, despite the oddity of this rule, that it is perhaps little more than a "trap for the unwary" as lawyers often say. A government that is aware of the rule need simply structure its subsidy programs as payments to producers and the problem will evaporate. But this argument overlooks the fact that the transaction costs of the two types of subsidies may not be the same. If the purchaser subsidy happens to be cheaper administratively, why foreclose it?

Conclusion

This paper raises serious questions about the utility of general subsidies disciplines in the WTO that go beyond the nonviolation doctrine and the opportunity for market-by-market commitments, as well as questions about the basic approach to state aid regulation in the EU. For the reasons given, the ability of rules of general applicability to identify and measure subsidization in any meaningful sense, let alone to determine whether it is socially desirable or undesirable, is much in doubt. The laissez-faire approach to subsidies in the U.S. Federal system, therefore, may have much to commend it given the weaknesses of the available alternatives.

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