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STUDIES

WHAT SHAPES THE LAW?

REFLECTIONS ON THE
HISTORY, LAW, POLITICS
AND ECONOMICS OF
INTERNATIONAL AND
EUROPEAN SUBSIDY
DISCIPLINES

Edited by:

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UNIVERSITY OF
BIRMINGHAM

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Abstract

This book puts together several contributions that, from various time, system and disciplinary perspectives, address the same questions – what has shaped subsidy laws? Which actors mould subsidy and State aid law and what forces are at work? The book includes reports from former or current negotiators, officials, practitioners and scholars, that focus on various attempts to regulate subsidies at the national, European and international levels. Prominence is given to the actual practice, and to the account given by the key actors, operating in the field since the 1970s. Various disciplines are interrogated – from history to law, from political science to economics. What comes out is a fascinating account that provides a goldmine of insights and leads for further enquiry in a topical and under-researched area.

Keywords

Subsidy; state aid; history; history of law; international trade; competition; political economy; EU; WTO.

Foreword

Julio Lacarte Muró¹

Since the end of World War II, trade has been conducted under the provisions of General Agreement on Tariffs and Trade (GATT) and, since 1995, under the provisions of the World Trade Organization (WTO). This has been a drastic departure from the past, when the nearest thing to some sort of universal and disjointed order existed with the treaties signed by the United States under the Trade Agreements Act and the preferential systems with the colonies of a number of European countries, mainly Great Britain, France and the Netherlands.

The end of colonialism driven by the United Nations meant that a great number of countries, mainly in Africa and Asia, became independent and gradually became contracting parties of GATT and subsequently of the WTO, ensuring the universality of the system.

Both the GATT and WTO provisions on subsidies became the framework of rules that countries would comply with. In other words, for the first time there existed a common set of obligations that determined what countries could and could not do in the area of subsidies.

Together with their many other provisions, the GATT and the WTO have had two basic pillars to sustain them: the most-favoured nation (MFN) clause and national treatment. The MFN clause is intended to ensure a level field of competition among all countries and subsidies – quite obviously – create an exception to this rule.

It is therefore not surprising that during the Uruguay Round which led to the creation of the WTO, negotiations on subsidies were among the most hard-fought of all the many areas in which country interests were involved.

Indeed, they took place almost to the last day of the Round in a smoke-filled room where participants defended with great tenacity their respective points of view. The final texts were the result of grudging agreements which were reached with enormous difficulty.

The Doha Round has opened the way for a revision of many WTO provisions and while one cannot foresee when or how the negotiations will conclude, we know that the area of subsidies has been the subject of discussion and of the tabling of a wide range of proposals, many of them in contradiction to each other. They cover the Agreement on Implementation of Article VI of GATT 1994 (the Anti-Dumping Agreement), fisheries subsidies, and countervailing duties, and in essence they answer to positions that are very similar to those that were advanced during the Uruguay Round by different countries. This being so, past disagreements have been revived and no doubt will continue to bedevil the negotiating process.

There is expectation that an agreement on the elimination or reduction of export subsidies on agricultural goods will be reached at the Ministerial Conference that will take place in Nairobi in December 2015. If this takes place, one – if not all – of the bones of contention will have been settled to a substantial degree. This is an area to which exporters, who consider themselves competitive and who have suffered from the policies of those countries that have been granting support to their producers, attach great importance. For the moment, we must await the outcome of the Nairobi Ministerial Conference.

It is inevitable that negotiations on such delicate issues that touch on important national interests that are not be exempt from disagreements and – sometimes – acrimony. This is this project comes in, throwing light on past experiences and present issues, and contributing at the highest professional level to a better understanding of the negotiations presently taking place.

¹ Former Chairman of the World Trade Organization's Appellate Body.

Julio Lacarte Muró

Certainly this project merits strong support for it sets out objectively and fully the multiple sides of a question that is due to exercise the world trading community now and in the future. This electronic book is a significant step for the in-depth analysis of subsidies in all their aspects and, because it brings together the views of some of the most outstanding world experts on the matter, merits the most thorough reading and reflection.

I congratulate the University of Birmingham and the European University Institute for what I consider to be a really worthwhile contribution to international economic relations.

Montevideo
October 2015

Foreword

Sir Nicholas Forwood QC²

This is in several respects a unique work. International trade law makes particular demands of its practitioners, not least of those called on to apply it, whether as panel or Appellate Body members, arbitrators or judges, as I all too fully appreciate from my fifteen years at the Court of Justice of the EU. And within the broader body of international trade law, the rules relating to subsidies and state aids have a special place, due in no small measure to the large differences in economic philosophy of the state parties to the SCM Agreement, and the consequent difficulties in identifying a suitable reference framework for the interpretation and application of the Agreement. The difficulties raised by the interpretation and application of EU State aid law are also of course well-known, at least to European practitioners and scholars.

It was therefore a commendable initiative for Luca Rubini to bring together in May 2015, in Birmingham, an impressive assembly of the leading thinkers in the field. Tracing the development of anti-subsidy rules and their application from the GATT, through the Tokyo and Uruguay rounds, as well as EU State aid rules from their beginning in post-war Europe, the brief but information-rich e-papers resulting from that event, which comprise this work, offer a unique insight into the reasons why the WTO subsidy and EU State aid laws are what they are, warts and all, as well as providing invaluable material to guide practitioners, judges and others in its application.

The papers should also be compulsory reading for all trade negotiators, whether negotiating multilaterally or bi-laterally, and still more for their political constituents. All tribunals, judicial or conventional, face special challenges when legislative compromise results in ambiguous texts, but where the ambiguity is deliberate, reflecting compromises of wording but not of principle, the task is acute. If this collection also advances – as it should – the cause of greater clarity in current and future international trade negotiations, it will be doubly worthwhile.

Brick Court Chambers
London
January 2016

² Formerly Judge of the General Court, Court of Justice of the European Union.

Introduction

I am writing these few words of introduction with huge trepidation. It is the first time one book collects such a number of essays on the history of subsidy and State aid laws written by such a group of distinguished contributors.

This e-book finds its origin in a two-day workshop organized in Birmingham in May 2015, under the aegis of the University of Birmingham and the Global Governance Programme (GGP) of the European University Institute, and with the kind sponsorship of two leading international law firms (Sidley Austin and Van Bael and Bellis). The speakers – former or current negotiators, diplomats, officials, practitioners and scholars – convened in beautiful Edgbaston with one specific set of instructions: to present a brief input statement trying to address the following questions.

Which actors mould subsidy and State aid law and what forces are at work? More specifically: How are the drafting, interpretation and application of the rules actually affected by these actors and these forces? What was the purpose or rationale of the rules that the law creators had in mind? Is this purpose duly reflected in subsequent administrative and judicial decisions? If not, why? Can an evolution of the initial purpose be identified? If so, why?

This book collects the extremely rich set of written input statements presented in Birmingham. These have been slightly amended after the workshop, to polish points and address remarks raised in the discussion. But - to keep the freshness and distinctiveness of the individual inputs - this polishing was limited. Thus, if it is impossible to reproduce the richness of the debate that took place in two rainy days in the English Midlands, this collection of short essays certainly gives a good idea of the level and breadth of the discussion.

Since the focus of the analysis was set in the past, this brainstorming exercise was clearly geared into getting a better understanding of the justification, origin and evolution of laws that have been topical, unclear and controversial since the very beginning. And remain very much so to this day. The insights from the past thus inevitably led to generate good analysis to understand the present and predict the future. From another perspective, this workshop represented a good example where academic analysis meets more policy-oriented thinking.¹ No theoretical framework was imposed to the discussion, thus giving room to an approach that can largely be described as inductive.² Centre-stage was given to the key actors, kindly questioned by key scholars from various disciplines – law, history, political science, economics.

What comes out from these essays is a goldmine of critical thinking on the law, economics and policy of state subsidization, from the late 19th century up to ... the future!

It is difficult to summarize in few lines the extremely rich content of these essays. Only few impressions can do the trick. One is the recurrence of some themes – if not even cycles – in the governance and regulation of subsidies. Many of the issues and narratives, interests and positions that animated the debate in the 19th century, also went through the 20th century. To be sure, the current prominence – or better: attention – gained by Global Value Chains raises new issues. Equally, the new geo-political composition at both the global and European levels requires new efforts of imagination. But, contribution after contribution, one has the impression that there is a lot that comes up again and

¹ In this respect, the Birmingham workshop is ideally linked with current initiatives that have the goal of discussing new governance and regulatory structures for subsidies. See, e.g., the work of the Global Economics group of the GGP, headed by Bernard Hoekman and Petros Mavroidis, and, more specifically, the E-15 Initiative ‘Rethinking International Subsidy Disciplines’, organized by the ICTSD and the World Economic Forum and headed by Gary Horlick.

² We have been guided by what Anthony D’Amato has masterly expressed in the following statement: ‘[the inductive approach] puts emphasis where it belongs – on the actual practice of states, rather than on the metaphysical speculations of publicists. It is not excessively, or even primarily, concerned with the notion of induction *per se*, and therefore criticism on this particular aspect of the inductive approach is, although relevant, rather academic’. A. D’Amato, ‘The Inductive Approach Revisited’ (1966) *Indian Journal of International Law*, 509-514, at pp. 510-511.

again, thus making the historical investigation a promising path to follow. Many papers offer a truly unique insight into the negotiations of the 1970s, 1980s and 1990s – highlighting the general approach, techniques, and expectations of some of the key players. This emerged vividly in Birmingham in the presentations of the two panels dedicated to the Tokyo Round and the Uruguay Round and in the often lively discussions that followed. The importance of international efforts in regulating subsidies is posited but is also challenged by some, highlighting how discipline often comes from the bottom, i.e. from domestic forces. The exposition of the EU model of State aid control and its history presents a good opportunity to contrast the European way with the international attempts to control subsidies.

This publication breaks new ground in the field of subsidy laws and policy. There have been important conferences on this topical area since the late 1970s (Georgetown in 1979)³ and early 1980s (Estoril in 1981,⁴ Bruges in 1989,⁵ Georgetown again in 1989).⁶ But – to the best of my knowledge – no single event (possibly with the exception of the workshop organized by Claus-Dieter Ehlermann in 1999 at the European University Institute)⁷ can match it, in terms of importance and breadth. And, even symbolically, an important connection was kept with all these events, since many of the key participants in the Birmingham workshop did participate or indeed organize those seminal events.

Two glosses.

First, I believe this e-book has a lot to offer also to those working beyond the subsidy field. Subsidies are a prime and vivid example of a complex scenario where decision-making is characterised by conflicts of ideas and interests and in which various actors operate at various levels. Their regulation is highly representative of increasingly common policy-making dilemmas that are becoming more intense as markets continue to globalize and the world becomes more interdependent. This means that subsidies naturally are a prime case-study for investigation, especially in what is a context of significant lack of research.

Secondly, the purpose of the exercise was to generate a discussion as free as possible. Not only was the conference held under the Chatham House Rule, but the ‘terms of reference’ indicated above were simply given as a *canovaccio* thus leaving the participants free to improvise on it, and contribute to the debate with new directions or perspectives. Ultimately, the workshop and this e-book represent the starting point of an ambitious research project that the editor is about to begin and that will involve a systematic review of the ‘shaping’ of subsidy and State aid regulation since their beginning. Two young brilliant researchers⁸ will accompany the editor in this venture.

Before concluding, I have to remember two people that contributed to the workshop and the e-book in different ways and, unfortunately, passed away while this publication was being prepared. John Greenwald, who was one of the main forces in the Birmingham discussion, always providing sparks and wit to it, left us only few weeks after the workshop. Julio Lacarte-Muró, the last standing negotiator of the GATT 1947, could not come all way from Montevideo, Uruguay, to Birmingham, but nevertheless kindly accepted to write a brief foreword to this e-book, and passed away just few

³ The proceedings of the ‘Symposium on Multilateral Trade Agreements’ were published in Volumes 11 (1979) and 12 (1980) of *Law and Policy in International Business*.

⁴ D. Wallace, FJ. Wallace, VZ. Krikorian (eds), *Interface Three: Legal Treatment of Domestic Subsidies* (Washington DC: International Law Institute, 1994).

⁵ J Bourgeois (ed), *Subsidies in International Trade* (Bruges: College of Europe, Kluwer, 1991).

⁶ Symposium on Countervailing Duty Law, proceedings published in Volume 21 (1990) of *Law and Policy in International Business*.

⁷ CD Ehlermann and M. Everson, *European Competition Law Annual 1999: Selected Issues in the Field of State Aids* (Oxford: Hart Publishing, 2001).

⁸ Juan-Jorge Piernas-López, from the University of Murcia, and Mona Pinchis, from King’s College London.

Introduction

months before it went into press.⁹ This e-book is dedicated to both. I want to finally thank Claus-Dieter Ehlermann, Jacques Bourgeois and Sir Francis Jacobs for participating in the discussion. Last, Jennifer Hawkins has to be much commended for having helped me with her meticulous and efficient editing of the thirty contributions.

⁹ He was really cherishing at the idea of a 'second' visit to Birmingham, the first having taken place few years ago, to play tennis in a diplomats' tournament in Edgbaston.

Biographies

Luca Rubini is Reader in International Economic Law, at Birmingham Law School. His interest lies in the regulation of the State intervention in the economy, particularly subsidies. He is the author of the first theoretical analysis of the definition of subsidy in the WTO and EU, *The Definition of Subsidy and State Aid – WTO Law and EC Law in Comparative Perspective* (Oxford University Press, 2009). He has been Robert Schuman Senior Research Fellow (2012-13) at the Global Governance Programme of the European University Institute.

Jennifer Hawkins is a trade lawyer and law graduate of University College Dublin, University of Aix-Marseille and Melbourne University. She currently works in the Trade practice of PricewaterhouseCoopers in Dublin. She previously worked in various international trade roles in Geneva, including in firms and interning at the WTO's Appellate Body Secretariat. In 2010-11, Jennifer was Professor John Jackson's research and editorial assistant on the Journal of International Economic Law.

Philippe De Baere has been a partner in Van Bael & Bellis' Brussels office since 1992. His practice focuses on EU and WTO trade law as well as EU customs law and export controls. He has been involved in most major EU anti-dumping, anti-circumvention and anti-subsidy proceedings since 1990. In the field of international trade law, Philippe has assisted WTO Members in several landmark WTO dispute settlement proceedings. He regularly lectures on EC Trade Law at the University Carlos III in Madrid and the Catholic University of Leuven (KUL).

Jose-Luis Buendia-Sierra obtained his degree in Law and his PhD at the University of Zaragoza, Spain. He also holds a Master in European Legal Studies from the College of Europe, Bruges. Since 2005 Jose Luis Buendia is Partner at the law firm Garrigues, Brussels. Previously, he spent fourteen years as a European Commission official (Legal Service, Directorate-Generals of Competition and Internal Market and Cabinets). Since 2009, he has been a visiting lecturer on State aid at King's College London. Previously, he has been a visiting lecturer at Vrije Universiteit Brussel and at Universidad de Zaragoza.

Eduardo Chikusa, economist and Diplomat, he has presided over the Committee on Subsidies and Countervailing Measures of the WTO and worked as deputy chief of the Trade Defense and Safeguard Division in the Ministry of External Relations in Brazil. Since 2013, he has been the delegate in charge of Rules in the Permanent Mission of Brazil to the WTO.

Michelle Cini is Professor of European Politics at the University of Bristol, where she has been based since 1991. She has been Editor-in-Chief (with Amy Verdun) of JCMS: Journal of Common Market Studies, since July 2010 and has held a number of visiting positions, including at the EUI (Jean Monnet Fellow) 1999-2000, New York and Columbia Universities (1999), Nanjing University, China (2008), and Harvard University (2014). She has published extensively in the field of European Union politics. She has a particular interest in EU policy-making, organisational reform and executive politics, EU competition and state aid policy, and public ethics.

Terry Collins-Williams retired from the Public Service of Canada after a career of more than thirty years in the field of international trade and economic relations. He participated as a principal negotiator in many of the key trade negotiations in which Canada was involved over the last thirty years, including the Uruguay and Doha Rounds of multilateral trade negotiations and the North American Free Trade Agreement. He also served abroad in economic and trade positions at the Canadian Embassies in Washington and Tokyo. During the period 2000-2005 Terry was Minister and Deputy Permanent Representative of Canada to the World Trade Organization in Geneva. Since retiring from the Government, Terry has been teaching trade policy and trade negotiations skills at universities in Canada, and internationally in Kazakhstan, Kyrgyz Republic, Malaysia, Barbados and

Cuba. He has participated in a number of research studies and written papers including those on subsidies discipline and anti-dumping.

Dominic Coppens is an associate with Sidley Austin LLP's Brussels office and a member of the Firm's WTO litigation practice. He is also an Associate Fellow of the Leuven Centre for Global Governance Studies at the University of Leuven (Belgium). Dominic authored the book "WTO Disciplines on Subsidies and Countervailing Measures: Balancing Policy Space and Legal Constraints" (Cambridge University Press, 2014, 646 pp.).

William J. Davey is the Guy Raymond Jones Chair Emeritus at the College of Law. From 1995-99, he served as the director of the Legal Affairs Division of the World Trade Organization. He has served on several WTO dispute settlement panels, including subsidy-related cases involving Brazil, Canada, the European Union and South Korea. In 2007, the University of Berne conferred an honorary doctor of laws "for his fundamental work in the development and evolution of the World Trade Organization's dispute settlement system." In 2004, he received the University of Illinois' Distinguished Faculty Award for International Achievement. Professor Davey has written many articles and book chapters on various international trade law issues and is the author, inter alia, of *Legal Problems of International Economic Relations* (sixth edition 2013, with Jackson & Sykes) and *Non-discrimination in the World Trade Organization: The Rules and Exceptions* (2012).

Gerard Depayre is a consultant in international trade in Geneva, former EU official and negotiator for the SCM Agreement and for the accession of China to the WTO.

Joseph Michael Finger has worked on international issues at the United Nations Conference on Trade and Development (Geneva), the US Treasury Department and the World Bank. Dr. Finger held the chair of Vernon F. Taylor Distinguished Professor of Economics, Trinity University, San Antonio, in 2004 and 2005, and has taught at the China Foreign Affairs University, the University of Berne, the Stockholm School of Economics, the Univ. of Adelaide, the Univ. of N. Carolina and Duke University. He is author or coauthor of some 170 articles and nine books,.

James Flett works in the WTO Team of the European Commission Legal Service. He has twenty-five years' experience in international trade law. He frequently represents the European Union before the WTO. Mr. Flett graduated from the LSE, and has a Master's degree in European law from the College of Europe, Bruges. He is a qualified solicitor. Before joining the Commission Legal Service Mr. Flett spent several years working for international law firms in London and Brussels, with a particular emphasis on international trade law. He is a frequent speaker at conferences and universities and has published widely on WTO law.

John D. Greenwald was a partner of Cassidy, Levy, Kent, in the Washington DC office. He had a general international practice, with particular emphasis on international trade matters including antidumping and countervailing duty investigations. Early in his legal career, after a year in private practice, in 1974 Mr. Greenwald became an attorney in the Office of the Special Representative for Trade Negotiations and was Deputy General Counsel when the office became the Office of U.S. Trade Representative ("USTR"). At USTR, he was responsible for negotiating international agreements on antidumping and subsidies/countervailing measures in the Tokyo Round of Trade Negotiations. After the Tokyo Round concluded in 1979, in 1980 he became the first head of the Import Administration of the Department of Commerce, where he was responsible for the administration of the US antidumping and countervailing duty laws. Prior to law school, Mr. Greenwald served two years as a Peace Corps Volunteer in Rio Grande do Norte, Brazil.

Malcolm Harbour OBE was Conservative MEP for the West Midlands from 1999-2014, and Chairman of the Internal Market and Consumer Protection Committee 2009-2014. He joined the Council of Birmingham University in 2014. He is Senior Adviser to the European Policy Centre, and the policy consultants Cabinet DN. In 2015, he gave the Birmingham European Law School Annual

Lecture. From 1967 to 1999, he worked in the motor industry as an engineer, a senior commercial executive, a consultant and a researcher.

Bernard Hoekman is Professor and Director, Global Economics at the Robert Schuman Centre for Advanced Studies, European University Institute in Florence, Italy. A CEPR Research Fellow, he is a graduate of the Erasmus University Rotterdam and obtained his Ph.D. in economics from the University of Michigan. His most recent publications are *The Global Trade Slowdown: A New Normal?* (CEPR, 2015) and *The World Trade Organization: Law, Economics and Politics* (with Petros Mavroidis), Routledge Global Institutions Series, Second Edition, 2016.

Gary Horlick has represented leading US and global companies, and more than 20 countries in international trade negotiations and disputes, and has chaired WTO and Mercosur dispute panels. He served as International Trade Counsel of the U.S. Senate Finance Committee (1981); head of Import Administration of the U.S. Department of Commerce (1981-1983) where he was responsible for all U.S. antidumping and countervailing duty cases, Foreign Trade Zones, and Statutory Import Programs; and teaches at Yale Law School, Georgetown Law Center, and the University of Berne's World Trade Institute. He graduated from Dartmouth College, Cambridge University, and Yale Law School. He served as the first Chairman of the WTO's Permanent Group of Experts on subsidies.

Anthony Howe is Professor at the University of East Anglia and specialises in the history of nineteenth and early twentieth-century Britain. His books include *Free Trade and Liberal England, 1846-1946* (Oxford, 1998) and, with Simon Morgan, he has edited *Rethinking Nineteenth-Century Liberalism: Richard Cobden Bicentenary Essays* (Ashgate, 2006). With the support of an AHRC resource enhancement grant, he recently edited four volumes the letters of the leading British radical Richard Cobden (1804-1865).

Gary Clyde Hufbauer has been the Reginald Jones Senior Fellow at the Peterson Institute for International Economics since 1992. He was on leave as the Maurice R. Greenberg Chair and Director of Studies at the Council on Foreign Relations (1996-98), and he formerly held positions as Marcus Wallenberg Professor of International Finance Diplomacy at Georgetown University (1985-92), deputy director of the International Law Institute at Georgetown University (1979-81); deputy assistant secretary for international trade and investment policy of the US Treasury (1977-79); and director of the international tax staff at the Treasury (1974-76). He holds an A.B from Harvard College, a Ph.D. in economics from King College at Cambridge University, and a J.D. from Georgetown University Law Center. He has written extensively on international trade, investment, and tax issues.

Douglas A. Irwin is the John Sloan Dickey Third Century Professor in the Social Sciences in the Department of Economics at Dartmouth College. He is author of books such as *Free Trade under Fire* (4th edition, 2015), *Trade Policy Disaster: Lessons from the 1930s* (2012), *Peddling Protectionism: Smoot-Hawley and the Great Depression* (2011), and *Against the Tide: An Intellectual History of Free Trade* (1996), and many articles on trade policy in books and professional journals.

Mark Koulen is a Senior Counsellor in the Trade Policies Review Division in the Secretariat of the World Trade Organization (WTO) in Geneva. Koulen has held a variety of positions in the GATT and WTO Secretariats including in the context of Uruguay Round negotiations on anti-dumping and on subsidies and countervailing measures, post- Uruguay Round discussions on trade and investment, and dispute settlement proceedings in the area of trade remedies. He holds a Master's degree (cum laude) in international law and international relations and a postgraduate degree in European Community law from the University of Amsterdam, the Netherlands.

Petros C. Mavroidis studied law and economics in Thessaloniki, Brussels and Berkeley and holds a Dr iuris from the University of Heidelberg. He is Edwin B. Parker professor of Law at Columbia Law School, New York and now on leave at EUI. He also teaches at the University of Neuchatel, Switzerland. He has been the American Law Institute (ALI) chief reporter for the project on

'Principles of International Trade Law: the WTO' that was completed in 2012. His most recent publication is *The Regulation of International Trade: the WTO Agreements on Trade in Goods* (Vols. 1 and 2) MIT Press, 2016.

Massimo Merola is partner in charge of BonelliErede Brussels Office and scientific director of the firm's European Law and Antitrust group, where he oversees a broad EU, Competition and Regulatory law practice, with special focus on State aid. Since 1993 he has been professor of State aid and public undertakings at the College of Europe, Bruges, and is currently President of the Global Competition Law Centre (GCLC) of the College. As a renowned practitioner and scholar, Massimo is a regular speaker at European conferences and seminars on Competition and State aid and the author of more than fifty scientific publications.

Hugo Paemen was the spokesman of the Belgian Foreign Ministry and held positions at the Belgian Embassies in Paris and Washington (Economic Minister). He became 'chef de cabinet' of the Vice-President of the European Commission Viscount Davignon (1978-85) and the spokesman of the Commission headed by Jacques Delors (1985-87). From 1987 until 1995 he was Deputy Director-General for External Relations at the European Commission responsible for trade, and, in that capacity, he was the chief European negotiator during the Uruguay Round. He was Head of the European Commission's Washington Delegation from 1995 to 1999. He authored "From the GATT to the WTO: the European Community in the Uruguay Round", and has contributed to several publications relating to current diplomatic and trade issues.

Elisabetta Righini is counsel at Latham & Watkins' Brussels office. Her practice centers on international and European law, with a particular focus on State aid. Previously, she worked at the European Commission, as a senior member of the Cabinet of former Competition Commissioner and Vice-President, Joaquín Almunia. Ms. Righini has extensive experience as a litigator, having served for 10 years as a member of the Legal Service at the European Commission where she appeared in over 100 cases before the European Court of Justice and before the World Trade Organization. Ms Righini studied law at the University of Florence and the University of London. She is a visiting professor at the Centre of European law of Kings College London's Dickson Poon School of Law.

Koen Van de Castele is Head of Unit State Aid Policy and Case support, DG Competition, European Commission, Brussels. He holds an LL.M. from the University of Michigan Law School (1995-1996), a diploma of advanced European Legal Studies from the College of Europe (1991-1992) and a law degree from K.U. Leuven, Belgium (1986-1991).

Vincent Verouden is a Director at E.CA Economics in Brussels/Berlin. His consulting activities span the fields of antitrust, merger control and state aid control. Until October 2014, he worked at DG Competition of the European Commission, most recently (2012-2014) as Deputy Chief Economist. At the Commission, Vincent worked on many individual state aid cases as well as on the development of policy, in particular the Commission's State Aid Action Plan for the reform of state aid control in Europe (2005) and the State Aid Modernisation programme (2012-2014).

Peter John Williams was a member of the GATT Secretariat from 1961 to 1991. Director of Division and Secretary of the Trade Negotiations Committee in the Tokyo and the Uruguay Rounds, as well as chairman of several technical negotiating groups. Next, member of the Permanent Delegation of the European Commission in Geneva, dealing mainly with accessions to the WTO. Thereafter, representative of the Pacific Islands Forum Secretariat to the WTO and adviser to the Governments of Samoa, Tonga and Vanuatu on their accession. Author of the 2008 WTO Handbook on Accession to the organization.

Jan Woznowski was Director of the Rules Division (1992-2008) which covered, inter alia, all issues relating to subsidies and countervailing measures and the dispute settlement in this area. He joined the GATT Secretariat in 1975. During his career at the GATT/WTO he performed, inter alia, the following functions. During the Tokyo Round he was Secretary of several Negotiating Groups or

Biographies

Subgroups, in particular the NSG on Subsidies and Countervailing Measures. In the Uruguay Round he was Secretary of the Negotiating Group on Subsidies and Countervailing Measures and NG on Trade in Civil Aircraft. Since the Min Meeting 1990, he was Coordinator for Rules Negotiations (subsidies and countervail, anti-dumping, safeguards, TRIMS). In GATT Secretariat, he was Secretary of the Committee on Subsidies and Countervailing Measures, Committee on AD, Aircraft Committee.

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Abbreviations

AD	Antidumping
CAP	Common Agricultural Policy
Commission	European Commission
CSCM	Committee on Subsidies and Countervailing Measures
CVD	Countervailing duty
DG	Directorate-General
DG COMP	Directorate-General for Competition
DISC	Domestic International Sales Corporation
DSM	Dispute Settlement Mechanism
DSU	Dispute Settlement Understanding
EC	European Community (or European Communities)
ECJ	European Court of Justice
ECSC	European Coal and Steel Community
EEC	European Economic Community
EEC Treaty	Treaty Establishing the EEC
ERT	European Roundtable of Industrialists
EU	European Union
FDI	Foreign direct investment
FSC	Foreign Sales Corporation
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GBER	General Block Exemption
GTA	Global Trade Alert
ITO	International Trade Organization
LASA	Lesser Amounts of State Aid
LET	Less Effects on Trade
MEP	Member of the European Parliament
MFN	Most-favoured nation
MNC	Multinational corporation
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
OEEC	Organisation for European Economic Co-operation
S&D	Special and differential
SCM Agreement	Agreement on Subsidies and Countervailing Measures
SCT	Supply chain trade
SGEI	Service of General Economic Interest
SOE	State owned enterprise
SAAP	State Aid Action Plan
SAM	State Aid Modernisation
TBT Agreement	Agreement on Technical Barriers to Trade
TiSA	Trade in Services Agreement
TFEU	Treaty on the Functioning of the European Union
TNC	Trade Negotiations Committee
TPP	Trans-Pacific Partnership
TRIMs Agreement	Agreement on Trade-Related Investment Measures
TTIP	Transatlantic Trade and Investment Partnership
UNCTAD	United Nations Conference on Trade and Development
US	United States
USTR	United States Trade Representative
VC	Value chain
Vienna Convention	Vienna Convention on the Law of Treaties
WTO	World Trade Organization
WTO Agreement	Agreement Establishing the World Trade Organization

To John D. Greenwald (1945-2015) and Julio Lacarte-Muró (1918-2016)

Part I – The Foundations of the Enquiry

Law, History, Economics and Politics: Enquiring the Forces Shaping Subsidy and State Aid Control

Subsidies, Bounties, and Free Trade: Issues and Perspectives, 1880-1940

Anthony Howe¹

This essay sets out to introduce the longer-term historical forces shaping subsidy and state aid laws in Britain and continental Europe. While many of the essays in this e-book are concerned with a later period, this essay focuses on an earlier period that nevertheless influenced the nature and contours of later policy and debate.²

Oddly perhaps the first factor which strikes one from a British perspective is the need to conceal the very existence of such subsidies and state aid laws. For not only were they “hidden” in their indirect economic consequences but they were also, where possible, deliberately concealed linguistically. This is well-illustrated by a cartoon published in *Punch* in 1926 in which members of the British Cabinet were depicted in a reference library completing a “soft-word puzzle” and seeking out synonyms for the word subsidy - Stanley Baldwin, the Prime Minister, asking “[c]an anybody think of another word for subsidy?”³ This was in the context of the political need to subsidise wages in the coal industry at a period of economic collapse and labour crisis. Not only were wage subsidies seen as reminiscent of the (pre-Victorian) Old Poor Law but the notion of subsidy was equated more notoriously in the public mind with the Corn Laws which had subsidised British agriculture before 1846. The shadow of the so-called Hungry Forties had been powerfully evoked in Edwardian Britain and had also contributed to Baldwin’s losing the 1923 election. Of course, by the 1920s, economists had distinguished between protection in general and subsidies in particular: the one partially restricting the market to the home producer, raising prices and limiting output, the second imposing no restrictions on the home market, lowering the cost of production, increasing demand and output, with quite different administrative and practical effects.⁴ Nevertheless, politically subsidies remained anathema in Britain in a way that they did not in France or Germany, an interesting example perhaps of British exceptionalism. Even in the 1930s in the context of shipping, virtually all government advisers and enquiries pointed to the undesirability of subsidies, although at the end of the day they were resorted to. The shadow of the historical debate on protection also lives on; even today, economists sometimes link the Common Agricultural Policy (CAP) back to the Corn Laws of the 1840s.⁵

Political distaste for subsidies was directly linked back to the classical political economy which had dominated debate in the so-called Free Trade Nation. Palgrave’s famous *Dictionary of Political Economy* in the 1890s had no entry for “subsidy” although quite a full and not unsympathetic one by Edgeworth on bounties, accepting their speculative benefits “are not inconsistent with firm adherence to the practical principle of free trade”.⁶ Authoritative economists such as Smith, Ricardo, and McCulloch were cited as opposed to all subsidies, and in the heyday of laissez-faire, the conventional

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² See too in this e-book, D. Irwin, ‘Historical Notes on Subsidies and the Trading System’.

³ B. Supple, *The History of the British Coal Industry, Volume 4, 1913-1946: The Political Economy of Decline* (Oxford, 1987), p. 239. See Appendix 1.

⁴ R. Meeker, *History of the Shipping Subsidies* (New York, 1905), pp. 172-82; see too L. Rubini, *The Definition of Subsidy and State Aid: WTO and EC law in Comparative Perspective* (Oxford, 2009). For deprecation of but resort to subsidies in shipbuilding in the 1930s, see L. Johnman & H. Murphy, *British Shipbuilding and the State Since 1918* (Exeter, 2002), pp. 46-54.

⁵ C. Bliss, ‘The Corn Laws and the CAP’, in G. Cook ed. *The Politics and Economics of International Trade* (2 vols. London, 1998), Vol. ii, pp. 148-65.

⁶ ‘Bounties, Abstract Theory of’ in R.H. I. Palgrave, *Dictionary of Political Economy* (3 vols. London, 1894-99, i. (reprinted 1919), pp. 172-3.

wisdom was that of George Baden Powell, that “State Aid should only be invoked or utilised for the sole purpose of disestablishing State Interference”.⁷ Hence the dominance of the language of political economy narrowed the scope and likelihood of the state resorting to aid in any form.⁸

Even so exceptions emerged, almost unnoticed by the public. The first and in many ways the main exception in Britain, continental Europe, and America was through subventions to shipping companies for postal services. By 1900 Britain spent over £759,000 in this way.⁹ While this proved uncontroversial for much of the nineteenth century, as a form of general governmental support for universal or imperial communications, by the 1890s it had engendered an interesting but little studied policy debate. On the one hand, against the background of what seemed to be the slowing down of the British economy and the growth of foreign competition, the case for state aid became more positively made, especially on the grounds that foreign states were undermining British shipping, by subsidising its competitors, even allowing them to buy up British shipping lines. In this context the civil servant Giffen, for long the doyen of economic orthodoxy and opponent of bounties, admitted that the state owed “something to individuals whose living is threatened by the action of powerful governments”; more particularly, foreign shipping subsidies were seen as justifying retaliation, in a way that foreign tariffs were not, as a “hostile attack on a vital industry of the country in time of peace carried on directly or indirectly, not by ordinary competitors but by foreign governments”.¹⁰ This also of course revived Adam Smith’s famous strategic justification of the Navigation Laws, dropped by the orthodox in the 1840s but now again revived as the case was again made that Britain’s naval supremacy was bound up with its maritime strength, and indirectly with the shipping subsidies.¹¹ However, neither argument was fully accepted – the economic case for shipping subsidies beyond postal contracts met only a limited response against the case that any state aid would sap private initiative and further limit shipbuilding; some opposed postal subventions too as deterring competition in shipping. Nevertheless, in 1903, the Cunard Insurance Act assisted the building of the giant steam turbine driven passenger liners, *Aquitania* and *Mauritania*. The strategic case for subsidies was also hardly convincing during the burgeoning age of the Dreadnought; subsidies, it was held, produced few vessels of potential value in wartime. Even the Admiralty held in 1902 that payments to steamship companies were “worse than wasted” from a defence point of view.¹²

The debate over shipping subsidies also drew more attention to the state subsidies given to railway companies abroad but the far more prominent issue was that of state support for European agriculture, above all, the bounties for the growth of sugar beet.¹³ By the later 19th century European agriculture had hugely benefited from such subsidies, creating what was seen in free trade Britain as prosperous bounty-fed industries in France, Germany, Austria, and Russia. In many ways it was the sugar bounties which were the real equivalent to the later CAP. Such bounties were defended by some on infant-industry grounds but in Britain they appeared wholly inadmissible in theory. Yet they inspired an intense policy debate as to the proper national response to such bounties.¹⁴ On the one hand,

⁷ *State Aid and State Interference* (London, 1882), cited in D. C. M. Platt, *Finance, Trade, and Politics. British Foreign Policy, 1815-1914* (Oxford, 1968), xxxiv-xxxv.

⁸ A. Howe, ‘Popular Political Economy’ in D. Craig & J. Thompson eds. *Languages of Politics in Nineteenth-Century Britain* (2013), pp. 118-41.

⁹ Meeker, above n 4, p. 38.

¹⁰ Platt, above n 7, pp. 103-4.

¹¹ For later nineteenth-century revaluations of Smith, see M-W. Palen, ‘Adam Smith as an Advocate of Empire, c. 1870-1932’, *Historical Journal* 57 (March 2014), 179-198; for state support for the shipbuilding industry, see S. Pollard & P. Robertson, *The British Shipbuilding Industry, 1870-1914* (Cambridge, Mass. & London, 1979), pp. 222-6.

¹² Meeker, above n 4, p. 20. See too Platt, above n 7, pp. 103-4; Select Committee on Steamship Subsidies, *Parliamentary Papers*, 1900, VIII (300) & 1902, IX (385); S. Walpole, *Shipping Subsidies* (Cobden Club, London, 1902).

¹³ R.W. Beachey, *The British West Indies Sugar Industry in the Late 19th Century* (Oxford, 1957).

¹⁴ A. Howe, *Free Trade and Liberal England, 1846-1946* (Oxford, 1997), pp. 204-13.

dogmatic free traders, including Giffen cited above, saw no reason for any action, for foreign bounties provided cheap sugar which had contributed to the free breakfast table, the growing confectionery trades, and in general benefited the British consumer at the expense of the foreign taxpayer. Others argued that the proper response lay in countervailing duties, that the state should restore a level playing field, and that this in particular would help the West Indian cane sugar industry, the main casualty of the influx of bounty-fed European sugar. Nevertheless, this seemingly “free trade” argument was also seen to conceal the case for a broader resort to state aid, that it was a stalking-horse for protection and that retaliatory and other tariffs would follow. Countervailing duties therefore were rejected; interestingly too this debate now foregrounded the consumers’ interest in free imports ahead of the “right” of the producer to free exchange.¹⁵

In the early twentieth century, however, an international sugar convention was agreed, in some ways a genuine forerunner to the GATT as an enlightened instrument of international economic policy, designed to create a level playing field by prohibiting the introduction of bounty-fed sugar. It also set up what may be seen as an exemplary permanent commission, to meet at Brussels, with authority to decide whether countries did offer bounties and to authorise suitable penal action.¹⁶ Nevertheless, Britain’s adherence to the convention of 1902 proved short-lived. Its supporters came largely from the ranks of those who soon turned to wider schemes for government intervention by way of tariffs, and the Convention had been widely criticised on those very grounds as a stalking-horse for full-blown protection, threatening the working classes with higher prices, undermining employment in new industries, offering gains to sectional interests, and subordinating the British parliament to an illegitimate, unelected, constitutional authority in Brussels which, as the young Winston Churchill claimed, threatened British sovereignty; all of course arguments which would be heard in later years. Not surprisingly therefore the Liberal government elected in 1906, and re-elected twice in 1910, came under pressure to withdraw from the Convention which Britain did in 1912.¹⁷ It may also be noted that the Russian government initially declined to join on the grounds that its state support for sugar was not a subsidy but it did join in 1907.¹⁸

Before 1914 therefore Europe had been embroiled in trade policy debates in several new ways irrespective of the wider debate between free trade and tariff protection, although for some economists all forms of protection remained anathema as did indirect forms of subsidy.¹⁹ In this way, a wide range of what Keynes would call “serpents” had already invaded the pre-1914 paradise of laissez-faire.²⁰ The First World War magnified the number and scale of such serpents, with the widespread resort to controls and regulation. The issue for the future was therefore the degree to which wartime necessity would become peacetime normalcy, whether emergency controls would be disbanded or regularised. In fact, a number of forces determined that they should remain in place. By 1927, a preparatory paper for the World Economic Conference concluded that the forces behind the resort to direct and indirect subsidies were the result of the “economic consequences of the great war, the decline in world trade, the diminishing consumption which manifested itself in many countries, the great number of the unemployed, all these circumstances have led to an increase in direct Government subsidies to production or exportation”.²¹ In the aftermath of war, the key forces which determined the future scope

¹⁵ For a recent overview, M. Fakhri, *Sugar and the Making of International Trade Law* (Cambridge, 2014), pp. 21-67.

¹⁶ F. S. L. Lyons, *Internationalism in Europe, 1815-1914* (Leyden, 1963), pp. 103-10; G. A. Pigman, ‘Hegemony and Trade Liberalization Policy: Britain and the Brussels Sugar Convention of 1902’, *Review of International Studies* 23 (1997), 185-210.

¹⁷ Howe, above n 14, pp. 208-12, 225, 277; F. Trentmann, *Free Trade Nation* (Oxford, 2008), pp. 154-61.

¹⁸ Fakhri, above n 15, p. 27.

¹⁹ A. Howe & M. Duckenfield eds. *Battles over Free Trade: Vol. 3 The Challenge of Economic Nationalism, 1879-1939* (London, 2008).

²⁰ J. M. Keynes, *Economic Consequences of the Peace* (London, 1919), p. 10.

²¹ Documents of the International Economic Conference, 1927, L.N. 11.1927. 35 Direct and Indirect Subsidies, p.10.

of state aid were two-fold. Firstly, the number of states in Europe had been transformed by the peace settlement – the term “state” now meant, not empire as before 1914, but nation state as embodied in the doctrine of national self-determination. Hence we find among the new subsidies those for sugar in Latvia and the Irish Free State, for viticulture and silkworm cultivation in the kingdom of the Serbs, Croats and Slovenes. Secondly, both new and old states faced a huge array of economic and political problems which increased the demand from interest groups and political associations for new interventions, even in the Free Trade Nation. Here after the First World War a series of infractions of free trade proliferated but without the principle itself being rejected until 1931.²² These took many forms, for example, the Trade Facilities Act of 1920 provided subsidised interest rates for shipbuilding firms;²³ as we have already seen subsidies in support of wages were notoriously resorted to in the coal mining industry, the occasion for the cartoon mentioned above. However, most paradoxically of all, in 1924 Britain’s first Labour government actually introduced subsidies for sugar beet production which led to a thriving industry in East Anglia, helping agriculture, employment, and the political prospects of Labour in a rural area. Oddly, in other respects, the Labour government adhered, some would say perversely, to orthodox Cobdenite economic policies.²⁴ In this context, subsidies were primarily national political instruments, and any theoretical justification fell far short of practice.

But here too the force of theory eventually caught up with that of practice. For in 1931 free trade was finally abandoned in Britain, a policy shift in some ways legitimated by the evidence given to the MacMillan committee, including Keynes’s famous defence of a revenue tariff. When he presented that case (a revenue tariff), in an addendum he also argued that this should be balanced by an equal subsidy on all exports; this he believed would be difficult operationally given the commercial treaties Britain adhered to but that it should prove possible to provide “sundry indirect advantages to the export industries”.²⁵ Fearing a general tariff might, as free traders claimed, damage exports, he therefore stressed the need to find “ways of giving equivalent advantages to the export industries” as the most practical plan of action, given the obstacles to direct subsidies.²⁶ This was an inelegant solution and not surprisingly when Keynes came ten years later to produce his Clearing Union Scheme he was now firmly committed to the principle of “no export subsidies, direct or indirect”.²⁷ Although Keynes elsewhere disparaged a return to nineteenth-century iron-clad formulae, I think on this particular point he ended up not too far from them.

Finally, by 1940, the force of international regulation itself was far more potent than it had been in 1919, although in some ways the Convention of 1902 set a precedent for international economic co-operation as did the successful regulation of industries such as shipping during the War. Here, although the League of Nations proved unable to “steer the world economy”, its economic activities are now receiving their due amount of historical attention.²⁸ In some ways it embodied institutionally the free trade tradition previously represented by Britain; as such it sought primarily to act as a brake on rising tariffs but as we have seen above some of its attention was given to direct and indirect subsidies. Its later *World Economic Surveys* usefully detailed the widespread resort to subsidies whether in Britain, Switzerland, or Japan, especially in order to bolster agricultural sectors of the

²² See, *inter alia*, F. Capie, *Depression and Protection: Britain Between the Wars* (London, 1983).

²³ L. Johnman and H. Murphy, ‘Subsidy and Treasury: the Trade Facilities Act and the UK Shipbuilding Industry in the 1920s’, *Contemporary British History* 22/1 (2008), 89-110.

²⁴ Trentmann, above n 17, pp. 309-11.

²⁵ *The Collected Writings of John Maynard Keynes*, Vol. xx *Activities, 1929-1931* ed. D. Moggridge (Cambridge, 1981), pp. 296.

²⁶ *Ibid.* Vol. xx *Activities, 1929-1931* ed. D. Moggridge (Cambridge, 1981), pp. 296, 298, 499.

²⁷ *Ibid.* Vol. xxv. *Activities, 1940-1944* ed. D. Moggridge (Cambridge, 1980), p. 51. Keynes accepted the case for domestic subsidies and later thought they might be needed for air travel and shipping (p. 167). In discussion of commercial policy, Keynes also identified subsidies as the ‘real menace of the future’, *ibid.* Vol. xxvi. *Activities, 1941-1946*, p. 318.

²⁸ P. Clavin, *Steering the World Economy: the League of Nations, 1920-1946* (Oxford, 2013).

economy; thus that of 1934-5 (the 4th) highlighted Britain and Switzerland as examples “merely to illustrate the burden that has been imposed on the taxpayers of a great many countries”, but also noting the wider effects of subsidies, that “the policy of Government regulation and subsidies leads to shifts of production among these industries involving the demand for new subsidies”.²⁹ The League’s economists also pointed out their wider deleterious effects, with subsidies increasing the budgetary difficulties of governments, and creating a vicious circle – “subsidies create budgetary strain which precludes interest reductions and thereby causes fresh subsidies to be demanded.”³⁰ The League found no solutions but it had developed an increasingly sophisticated knowledge of the political economy of subsidies, which in turn helped stiffen the resolve to avoid them in the new world economic order envisaged in economic planning for peace.³¹

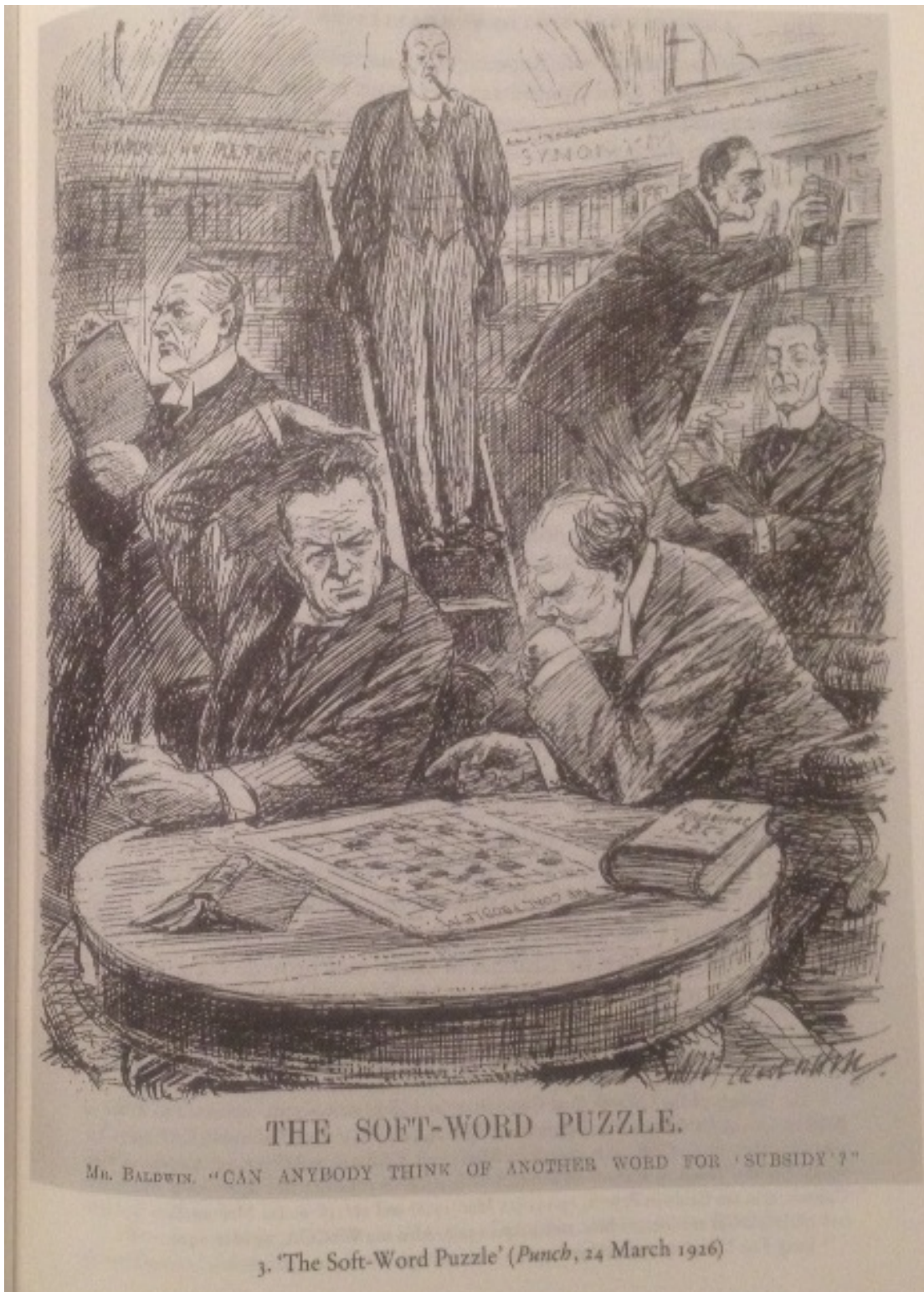
Other essays will take up the theme of wartime and post-war policy but this short introduction has sought to illustrate the variety of forces of economic theory and popular economic memory, the competing interests of consumers and producers, the requirements of naval defence strategy and of political expediency, the demands of the nation state against the possibilities of international regulation, all of which provide a few more clues to answering that “soft-word puzzle” which so perplexed twentieth-century statesmen.

²⁹ *World Economic Survey Fourth Year 1934-35* (League of Nations, Geneva), p. 85.

³⁰ *Ibid.*, p. 262.

³¹ *Commercial Policies in the Interwar Period: International Proposals and National Policies* (League of Nations, Geneva, 1942).

Appendix 1. The Soft Word Puzzle, *Punch*, 24th March 1926.



Historical Notes on Subsidies and the Trading System

Douglas Irwin¹

The use of export subsidies as a trade instrument dates back to the mercantilist period of the 17th and 18th centuries. If the goal of mercantilism was to promote exports and restrict imports, trade barriers could accomplish the latter but not the former, hence the selective use of subsidies for particular industries. Adam Smith discusses (and criticises) “export bounties” in the *Wealth of Nations*, but many subsidies at the time were tax rebates rather than explicit state expenditures. Subsidies are expensive for governments, which is why (historically) they have not been used as much as import restrictions.

When did subsidies first become a concern for trade policy? One can look to the advent of countervailing duties to see when governments first became concerned enough to offset foreign export subsidies in a country’s domestic market.

The first countervailing duty law was enacted by the United States, but only for the case of sugar (for reasons to be discussed shortly). Belgium enacted the first general Countervailing Duty (CVD) law in 1892, and the United States rewrote its CVD law in the 1897 Dingley tariff and made it potentially applicable to all imports. Other countries soon followed (India in 1899, Switzerland in 1902, France and Japan in 1910, and so forth). Each of these countries had their own CVD law with distinct provisions and applied it unilaterally. However, there is no indication that these statutes were heavily used prior to World War II.

The one sector in which international discussion of subsidies was key is sugar. In 1864, the United Kingdom, France, the Netherlands, and Belgium agreed to an international sugar convention regulating the use of subsidies for domestic sugar production and export. This was expanded in 1902 to an international convention on sugar. The extensive use of countries paying export bounties on sugar led countries to impose CVDs on imported, subsidised sugar. Interestingly, the idea of free trade was so well ingrained in the United Kingdom that there was a great deal of opposition to the idea of CVDs, which were viewed as inconsistent with free trade and harmful to consumers. However, the harm to the Birmingham sugar industry led Joseph Chamberlain and others to push the British government to do something about subsidised sugar imports.

The use of subsidies more generally (not just export subsidies) became more of an issue after World War I, as subsidies were employed during the war. The World Economic Conference (1927), sponsored by the League of Nations, investigated the rise in trade barriers during the war, but also looked into “indirect means of protecting national trade” through subsidies. As it concluded:

The fact that subsidies are in certain circumstances held to interfere less with the liberty of trading than Customs tariffs does not make it any the less necessary to lay stress on the hidden dangers inherent in this means of encouraging production and exportation. The greater the number of countries which have recourse to this practice, the more difficult will it be for other countries to refrain from following their example. Thus the attempt to restore foreign trade to normal conditions meets with a real obstacle in the shape of subsidies.²

At the League’s World Economic Conference in 1933, an early attempt was made to distinguish between “good” and “bad” subsidies in subsidy regulation. Germany made the distinction between “natural” and “artificial and unnatural” measures (one only has domestic effects, the other creates an advantage at the expense of foreign competitor), although the US delegate was sceptical that this distinction could be sustained. Similarly, the French delegation took the view that

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² League of Nations, Report and Proceedings of the World Economic Conference held at Geneva, May 4th to 23rd, 1927, Doc C.356.M.129, December 1927, 44.

a distinction must be drawn between bounties and subsidies for production on the one hand and bounties and subsidies for export on the other. The former might be justified by the need of obviating the dangerous social consequences which the disappearance or stoppage of particular industries or undertakings might bring about. In so far as they affected the national economy only, they could not properly form the subject of international agreements.³

Further discussions on the role of subsidies in the trading system occurred after World War II in preparation for the GATT/International Trade Organization (ITO) conference. In the preparatory negotiations, the United States wanted to permit production subsidies and prohibit export subsidies. Australia, Brazil, and other primary commodity exporters said that one cannot easily draw a line between the two, and that the form of support would not matter if it affected the world market.⁴

In the final negotiations, Article XVI of the GATT required that contracting parties notify the GATT Secretariat about domestic subsidies that might affect exports and that countries should “avoid” the use of export subsidies. And, of course, Article VI allowed countries to countervail direct or indirect production or export subsidies.

The GATT’s recognition of subsidies and permission to use countervailing measures did not mean that the issue was an important one in international trade. In 1958, the GATT Secretariat reported that only the United States had separate antidumping and countervailing duty laws, and only the United States and Belgium made any noticeable use of countervailing duties. And as Robert Baldwin has noted: “From the time that the early Antidumping (AD) and CVD laws were passed to the end of the Kennedy Round in 1967, unfair trade was not a major trade issue in the United States or in the GATT.”⁵ Between 1954 and 1965, 88 CVD petitions were initiated but only 2 CVD orders issued. Between 1966 and 1979, 129 CVD petitions initiated, but only 21 CVD orders. The lack of use of CVDs may reflect the infrequent use of subsidies or the fact that the Treasury Department was responsible for the administration of the law.

In any event, subsidies became a more important issue in the early 1970s when countries began to support production capacity and exports in light of the onset of stagflation. At that point, countervailing duties began to receive serious GATT attention with the negotiation of the 1979 Tokyo Round Subsidies and Countervailing Duty Code.

³ See League of Nations, Monetary and Economic Conference: Reports Approved by the Conference on July 27th 1933, and Resolutions Adopted by the Bureau and the Executive Committee, Doc C.435.M.220., 17 July 1933, 34.

⁴ *Preparatory Committee of the International Conference on Trade and Employment*, UN ESCOR, 2nd Comm, 6th mtg, UN Doc E/PC/T/C.II/37, 1 November 1946, 7–8.

⁵ RE. Baldwin, “Imposing Multilateral Discipline on Administered Protection” in AO. Krueger (ed.), *The WTO as an International Organization* (Chicago, 1998).

The Regulation of Subsidies in the GATT/WTO

Petros C. Mavroidis¹

The main point of this essay is as follows: In the beginning, there was a mild acknowledgement that domestic subsidies might be pursuing all sorts of interests; tax became a big issue (and remains unresolved); efforts concentrated on countervailing duties (CVDs) without defining the term “subsidy” and, now that we have a subsidy, it is a mess

Regulation of subsidies in GATT/WTO underwent a series of changes over the years: the natural outcome of changing views over their usefulness, the identity of participants, the link to farm trade, the general economic situation, and the overall evolution of the international trade regime (which we can also cite among the many explanatory variables).

I think that, before we go any further, it is important to keep in mind the definitional shortcomings of the term “subsidy” that Sykes has pointed to in various publications. The trading regime understood early on that subsidies can lead to concession erosion and that something should be done to address this concern, but also realised that defining what it was supposed to regulate (e.g. “subsidies”) was in and of itself a formidable task. The current definition, the first in the history of the trading regime, is full of holes and loopholes, and panels and the Appellate Body are still struggling with key elements of the definition, like “specificity”.

Usefulness: From early on, there was acknowledgement that subsidies are not all that bad, since some schemes could be promoting social preferences that might be under-supplied in a no-subsidy world. Both Jackson², as well as Irwin, Mavroidis and Sykes³ provide evidence to this effect. Some economists (Bagwell and Staiger)⁴ have gone so far as to state that, in light of the fact that subsidies – even when they do not promote a social preference – expand and do not restrict trade, it makes no sense to outlaw them while treating duties (an instrument that undeniably restricts trade) with impunity.

This question was debated during the Tokyo Round, when the original “traffic light”-approach had been first proposed, but which did not see the light of day. Article 8 of the current Agreement on Subsidies and Countervailing Measures (SCM Agreement) goes some way towards accepting that some schemes should be “immunised” against potential challenges. It is by now defunct in light of the lack of support to retain it beyond the originally agreed five years.

Identity of Participants: The difference (in terms of participation) between the original negotiation, the Tokyo Round, and the Uruguay Round is developing countries. They do not represent a unified block: net importers are quite happy to pay the subsidised rather than world price, whereas exporters would rather face no “subsidised competition”.

But perceptions regarding subsidies have changed even within the same trading nation. From Keynes’ preference for short-term adjustments, and Franklin D. Roosevelt’s New Deal, we moved on to Thatcher and Reaganomics, only to see similar policies cede the ground to massive subsidisation following the financial crisis of 2007/8.

Link to Farm Trade: The link to farm trade has been present from Day One, with the provision on subsidies for primary products. It became a big issue when CAP subsidies emerged as the most important item in the European Union (EU) budget in the 1970s and early 1980s. The United States

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² J.H. Jackson, *World Trade and the Law of GATT* (Indianapolis, 1969).

³ D. Irwin, PC Mavroidis, A.O. Sykes, *The Genesis of the GATT* (Cambridge, 2008).

⁴ K. Bagwell and R.W. Staiger, *The Economics of the World Trading System* (Cambridge, Mass. and London, 2002).

(US) changed its attitude around that time: originally, it avoided questioning the consistency of European integration with the GATT, what Finger has called the “original sin”. It went so far as to avoid questioning even blatantly anti-GATT CAP instruments for fear of upstaging the overall integration process, since no-one wanted to untangle the European process for fear of returning to the pre-World War II period. However, in the 1970s and 1980s, the US challenged the consistency of various CAP mechanisms with the GATT rules.

It won Pyrrhic victories since many of these reports were not implemented. Eventually, the EU agreed to negotiate its farm policy and the Agreement on Agriculture was eventually signed during the Uruguay Round.

General Economic Situation: The membership has shown remarkable restraint when challenging subsidies. The best example comes from post-2008 practice. Both the EU and the US (as well as others) have subsidised heavily in order to address the consequences of the financial crisis. Some of the schemes are hard to challenge in light of the existing rules, but many are stonewall subsidies by today’s legal definition.

And yet, no one has taken legal action against similar schemes, realising probably that the schemes were addressing extraordinary circumstances and were not meant to confer benefits to specific recipients.

Evolution of the Trade Regime: It is probably worth reflecting on (some of) the major steps that brought about the Tokyo and Uruguay round agreements, since a lot of things happened since 1948 that might help explain the current shape.

- 1948, GATT: Subsidies are negotiated in GATT, but the original discipline imposed is “benign” (at least compared to what has followed ever since). Note though that the bifurcation between domestic and export subsidies had already been agreed in 1946 at the London conference⁵ (and has been kept alive). The negotiating record is not conclusive on the reasons supporting this distinction, but it does suggest that, whereas social preferences could be advanced when domestic subsidies were being granted, the only/main reason for granting export subsidies was the wish to confer advantage to domestic producers.
- 1955, Review Session: The link between subsidies and tax policies was clearly stated here. It was agreed that tax schemes exempting exported goods from the obligation to pay taxes would not be considered “subsidy”. A series of initiatives that followed were around this theme:
 - 1960, Working Party on Subsidies: This initiative condoned the “origin” principle for direct subsidies, and the “destination” principle for indirect subsidies. The problem was that the US was providing mainly direct subsidies, whereas the EU was providing indirect subsidies for the most part.
 - 1971, Working Party on Border Tax Adjustments: The quintessential elements of the 1960 Working Party were not altered. There was some agreement on what kind of schemes could be adjusted, but nothing beyond that. The US was unhappy with the fact that EU exports could benefit from low taxation in tax havens (export markets), whereas US exports could not. Unavoidably, absence of agreement led to disputes: First the DISC (Domestic International Sales Corporations), and then the FSC (Foreign Sales Corporation) litigation, with sub-optimal results (and a rather formalistic understanding of “income foregone” by panels and the Appellate Body).

⁵ I.e., the UN Conference on Trade and Employment.

- 1979, Tokyo Round: Greenwald, Hufbauer and others have provided us with enough food for thought.⁶ One issue that we could debate a bit more is whether attempts were made to resolve DISC-type disputes at the negotiating table.
- 1995, Uruguay Round: We have some great papers on this score,⁷ but would be keen to explore a bit more the relationship between the Tokyo Round agreement and the two subsidies agreements signed during the Uruguay Round (i.e., the SCM Agreement and the Agreement on Agriculture).

⁶ See in this e-book, J. Greenwald, 'Negotiating Subsidies in the GATT/WTO: The Tokyo Round', G. Hufbauer, 'What Shapes Subsidy Disciplines in the GATT and WTO?', J. Woznowski, 'The Shape of Things: Few Thoughts on Negotiating Rules on Subsidies in the GATT and WTO', G. Depayre, 'Negotiating Subsidies in the GATT/WTO: The Tokyo Round and the Uruguay Round', P. Williams, 'Some Factors that Led to the Conclusion of the Tokyo and Uruguay Rounds'.

⁷ See J. Woznowski, 'The Shape of Things: Few Thoughts on Negotiating Rules on Subsidies in the GATT and WTO', G. Depayre, 'Negotiating Subsidies in the GATT/WTO: The Tokyo Round and the Uruguay Round', T. Collins-Williams, 'A Negotiator's Perspective on Enhancing Subsidies' Disciplines', P. Paemen, 'Forces that (may) have Shaped Subsidy Regulation', P. Williams, 'Some Factors that Led to the Conclusion of the Tokyo and Uruguay Rounds'.

EU State Aid Policy – The Origins and Early Years

Michelle Cini¹

Focusing on the origins and early development of the EU's state aid regime provides a background to the study of the current policy, helping to explain the form it takes today. With this historical perspective in mind, this essay comprises a call – not uncommon from those keen to inject a policy/political perspective into the study of subsidy policy – for a greater understanding of the broader context in which the policy sits. Particular attention is directed towards “the spirit of the times” in which the policy was first developed and during which the state aid laws were drafted. For the EU, the context is the early years of the European integration process, as well as the dominant elite positions of the time on state intervention. EU state aid policy was designed to contribute to the creation of a common or single market, which is increasingly viewed as the core component of the wider project of European unification. Market integration may involve questions of economics and law, but the political setting and the role of ideas also need also to be acknowledged when considering the forces shaping EU state aid policy.

State aid policy also needs to be understood in the context of a liberalisation agenda which since the 1970s has increasingly viewed subsidy as “a bad thing”. There is tension here, however, as subsidy policy may also be an instrument of industrial policy (albeit combined with other instruments of a more “positive” kind). Even if the EU's state aid policy, when prioritised, was largely negative in that it focused on reducing the amount of aid granted, policies – albeit modest – that granted EU-level aid to encourage regional development and social integration, including under the framework of the Common Agricultural Policy (CAP), were reliant not only on EU subsidies, but also on the taking of a more lenient approach under certain circumstances to national subsidies. These tensions which also exist in domestic contexts expressed themselves in practical terms as inter-departmental coordination problems within the European Commission.

It is conventional when discussing the EU's state aid policy to view it as a rather anomalous dimension of the European-level competition policy. This says a great deal about the origins of and rationale for the EU policy, at least in its early incarnation; but it also leads to some confusion as to the relationship between state aid policy and the more interventionist or regulatory policies pursued by the EU. Competition lawyers do not always want to address state aid, as they see it as beyond their “anti-trust” remit, and as such, the policy – at least in the EU – sometimes ends up floating in a rather detached way from other EU policies. While not wanting to exaggerate this point, the study and practice of state aid policy tend to be rather specialised fields of interest, which sometimes do not engage as much as they should with the broader contextual policy environment in which they are situated. It is important to recognise, therefore, that the study of state aid policy can be enhanced where researchers consider the wider political or policy context.

During the early 1960s, European competition policy was synonymous with restrictive practices policy. State aid policy tended to be a rather marginalised in this initial period, even though the treaty provisions that would later be “activated” were already in place. Interestingly, the administrative culture of the key actor, DG IV (now Directorate-General (DG) Competition) embodied a strong pro-consumer ethos at this time, providing evidence of a public interest dimension to the policy. However, this did not spill over into the state aid domain to the same extent as it did in other branches of European Community (EC) competition policy; and in any case, consumer relations was transferred out of the DG in 1967.

It was not until the completion of the customs union in 1968 that supranational level subsidy control came into its own. Before this period the policy was rather anomalous. With the establishment

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of the Common External Tariff and with the removal of intra-EC quotas and tariffs at the end of the 1960s, it was reasonable for EU actors to focus attention on non-tariff barriers, including government subsidies used to (unfairly) advantage domestic industry.

It was at this point that the question of a European industrial policy was raised for the first time. There was no specific treaty base for such a policy and there were few initial tools at the EC institutions' (Commission's) disposal, though this was not necessarily much of a barrier to policy formulation. By the mid-1960s, the West Europeans were becoming concerned about the extent to which foreign direct investment into the region and a wave of US takeovers reflected the weakness of European industry, whilst also contributing to its further weakening. That said, there was little general support for the creation of a European industrial strategy, even though calls advocating such a move were more frequently heard at this time, and various memoranda were published on industrial concentration (1965), industrial policy (1970) and science and technology policy (1970), which seemed to point in that direction. Ultimately this led in 1972 to a *Communiqué* issued at the end of the Paris Summit calling for the establishment of a single industrial base within the Community. Yet as Dennis Swann reported a decade later, "[t]he beginning of 1974 represented a high point in the willingness of the Community to contemplate positive action in the broad field of industrial 'policy'"². When it came to translating this into a concrete and coherent policy, however, the results were limited. The post-1973 recession led to some heated debates on this issue and it is not surprising therefore that few state aid procedures were initiated at this time and few negative decisions taken.

It was not until the period after the initiation of the single market project, in fact from the latter years of the 1980s, that the Commission sought to prioritise state aid policy. The speed with which state aid appeared on the EC agenda was remarkable. It was facilitated by what is often termed the "neo-liberal" turn, highlighting the importance of the role of ideas in driving the prioritisation of state aid control. More concretely, state aid control was to become an important element of the EC's single market agenda, with the latter serving as a "window of opportunity" for actors keen to address the weakness that characterised the EC's subsidy control. An important element in this story, one not unconnected to the previous points, is the growing status of DG IV (Competition).

In terms of "operationalising" state aid policy, the constraint that had prevented the full enforcement of the policy prior to the late 1980s had not been a legislative one, as the instruments necessary for effective enforcement already existed with the EC treaty. Weak application up to this point had meant that the policy was almost non-existent. A new direction came with the appointments of first Peter Sutherland, and then Leon Brittan as responsible Commissioners, and followed from a review of national subsidies led by DG IV which began in 1985. Brittan's policy review of 1989 was of particular importance as a turning point for the policy. The first set of results was put to good use, and it was decided to focus on the scrutiny of all existing aid. The new state aid policy was to acknowledge and attempt to rectify the errors and inaction of the past.

Within political science, since the late 1980s, students of European integration have increasingly turned to new institutionalist perspectives for a better understanding of policy initiation and policy change at the supranational level. Historical institutionalism and a more recent variant, discursive institutionalism, may offer insights into the origins and development of state aid/subsidy policy by highlighting such features as "critical junctures", the embeddedness of rules within institutions, the potential and limits of incremental change, with a focus on both the exogenous and endogenous drivers of change, and the role of ideas and language in shaping and amending policy. Whilst insights from these approaches are not the only way of examining the core question posed by this project (see for example the seminal framework originally developed by John Kingdon as an alternative³), there is scope here for supplementing the empirical analysis which must frame the core of the research project

² D. Swann, *Competition and Industrial Policy in the European Community* (London, 1983), p. 141.

³ See, J.W. Kingdon, *Agendas, Alternative and Public Policies* (New York, (1995).

with theoretical lessons learnt from the study of other policy areas. Some authors have already taken steps in this direction (for example Lavdas and Menindrou,⁴ Smith,⁵ and more recently Zahariades).⁶ The project may be inspired by these and other studies.

⁴ K. Lavdas and M. Menindrou, 'Competition Policy and Institutional Politics in the European Community: State Aid Control and Small Business Promotion', *European Journal of Political Research* 28/2 (1995), 171–201.

⁵ M.P. Smith, 'Autonomy by the Rules: The European Commission and the Development of State Aid Policy', *Journal of Common Market Studies* 36/1 (1998), 55–78; M. Smith, 'How Adaptable is the European Commission? The Case of State Aid Regulation', *Journal of Public Policy* 21/3 (2001), 219–38.

⁶ N. Zahariades, 'Discretion by the rules: European State Aid Policy and the 1999 Procedural Regulation', *Journal of European Public Policy* 17/7 (2010), 954–70.

Subsidies, Spillovers and the Trading System

Bernard Hoekman¹

The negative spillover effects of subsidisation by a country on other countries have long been a matter of concern for governments. International disciplines have been difficult to agree however. Only in the case of deep economic integration arrangements has it proved possible. The main example is of course the European Union: the countries that signed the Treaty of Rome forming the European Economic Community (EEC) included specific disciplines on so-called “state aids” – subsidies. One motivation for this was the worry that governments would not be able to undo the effects of complete removal of border barriers to trade. The GATT 1947 was a shallow integration agreement and did not include disciplines on the use of subsidies; its national treatment rules did not apply to subsidies. It was only over time that gradually disciplines were negotiated on subsidies in the GATT, initially through a Code that applied only to signatories, and later through the SCM Agreement that was incorporated into the WTO and that complemented specific disciplines applicable to agriculture. One can see some parallelism between the gradual expansion in subsidy rules in the GATT/WTO with the much earlier incorporation of subsidy disciplines in the EEC, in that an increasing focus on subsidies in the multilateral forum is associated with the steep decline over time in tariffs and the elimination of quotas.

A Widely Used Instrument

Subsidies are widely used by all governments, although richer nations tend to use them more intensively than poorer ones, reflecting basic budget (tax-raising) constraints. From a rule-making or trading system perspective a key question is whether a given subsidy has a significant negative impact on foreign countries (welfare). Determining this is complex and has become more complicated in recent decades as a result of the rise of international production networks. In a value chain world, one country’s subsidies may benefit another country’s firms, workers and communities. Negative spillovers can and will occur, but their incidence is more difficult to determine, making the political economy of rule-making efforts more complex than in a world where production is mostly national.

Data on subsidies are notoriously patchy and incomplete. One very useful recent source of new data on subsidies and other policy instrument that may have an impact on trade is the Global Trade Alert (GTA).² This is informative regarding the relative intensity of the use of subsidies. The GTA includes some 22,582 measures at the time of writing. Tariffs and temporary barriers to trade such as antidumping (trade remedies in trade law speak) account for 65 percent of all measures reported. Sector-specific subsidies taken together account for 14.3 percent of all measures imposed since 2008 (for a total of 3,224 measures). Almost one-third (29 percent) of the subsidies target exports. Subsidies are used more intensively for services, accounting for about one-third of all trade-related measures pertaining to services. Measures targeting investment account for another third.

Many of the policies of a subsidy nature maintained by governments come under the heading of industrial policy. Thinking about the rationale for industrial policy interventions has moved from a traditional approach based largely on product market interventions (production subsidies, state ownership, tariff protection) to market failure-correcting taxes and subsidies focusing mainly on factor markets (e.g., research and development, training, credit and locational investment subsidies) to an emphasis on growth-enhancing sectoral interventions that aim at internalising knowledge spillovers and that are designed in a way that they promote/support competition so as to reduce the potential for

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² <http://www.globaltradealert.org/>.

rent-seeking and capture. While the motivations for and thinking about the design of subsidy programmes has changed substantially in the last two decades, WTO rules have not changed in some 30 years: the SCM Agreement reflects a negotiation and associated deliberations that occurred in the 1980s.

Changing Incentives to Use Subsidies

The shift in recent decades towards ever greater fragmentation of production and the organisation of commerce in value chains (VCs) has changed the incentives to use traditional trade policies. VCs differ from the standard context analysed in the older trade and development literature and that is embodied in WTO rules as it involves not countries or industries, but centres around international networks of firms. Instead of value added being mostly national, in a VC world the value of a final product is generated in many countries. Thus, interventions that expand the ability of a firm in a country to provide a greater share of total inputs may have both positive local spillover effects and (assuming a government does so effectively and enhances the competitiveness of the VC as a whole), give rise to positive as well as negative cross-border spillovers. The direction and size of spillover effects will depend on linkages *within* and *across* chains, both competing VCs and non-competing VCs that may use the same type of inputs or that are buyers of what a VC produces.

There is nothing new about VCs as regards the potential benefits of cooperation on rules of the game. But such cooperation is likely to be harder to design given that the distributional and efficiency effects are more difficult to determine *ex ante*. One reason is the greater scope that may be needed for targeted interventions to address coordination failures that impede FDI/SCT (foreign direct investment/supply chain trade) investments. A consequence of the centrality of FDI and more generally investment for VCs/SCT-related policy interventions is that discrimination may be less of an issue than for trade policy. Investors will operate plants that generate local employment, independent of nationality of ownership. The spillovers that may arise are therefore somewhat different from the mercantilist motivation for many WTO rules: a concern about effects of policy on exporters. If the issue is investment incentives, effects are not (only) on exporters but on locations for investment, i.e., the potential problem is investment diversion. Non-discriminatory investment policies may be distorting by attracting investment to less efficient locations. Investment subsidies may lead to higher employment and higher wages/innovation but at the cost of other locations. Negative spillovers are particularly likely to be created by FDI incentives and other subsidies aiming to expand SCT competitiveness and increase investment and employment.³

Some Implications

One implication for rule-making is that this must go beyond subsidies in the sense of a fiscal transfer as defined in the SCM Agreement. Given the complexity of determining the distributional effects of VC/SCT interventions, which will centre in part on identifying the counterfactual (what would have happened in the absence of a policy mix that led to an investment going to A?), the challenge is not just to agree on rules *ex ante* but to define what constitutes an undesirable spillover and to assess whether alleged actions have generated such spillovers.

If FDI policy is an important aspect of VC/SCT-related policies an issue from a WTO perspective is that incentives to attract investment are not covered by WTO rules. The focus of WTO subsidy rules

³ Subsidies may be a second best device for governments to overcome constraints that impede investment that they cannot affect. An example of such a constraint is trade policy. A local government cannot affect a nation's trade policy, but this may be very important from a SCT perspective. In a VC world what matters is access to inputs and getting processed/final products into export markets duty free. Investment incentives are a potential instrument that a local government can use to offset specific locational or operating disadvantages but that may not be sufficient. See, in this e-book, the comments by G. Hufbauer, 'What Shapes Subsidy Disciplines in the GATT & WTO?'

is on whether interventions are export subsidies or cause adverse effects for exporters in third markets or for domestic import-competing producers. But if the main goal and effect of SCT promoting policies is to attract FDI the issue becomes one of investment diversion. This is not regulated by the WTO. It is very much an open question whether countries will be able to agree that rules are needed here. In the WTO working group on investment that was created in the late 1990s following the WTO ministerial meeting in Singapore, major OECD (Organisation for Economic Co-operation and Development) governments were not willing to discuss investment incentive programs, removing much of the potential rationale for a multilateral agreement. In a VC context it may be even less likely that there is appetite to agree to disciplines, given that a high import content of any given VC means investment subsidies will benefit some foreign interests as well as local ones. While there may well be investment diversion, documenting this is not straightforward given the overall distorted operating environment in many countries that reduces investment below what it should be in many lower-income countries.

The SCM Agreement is premised on trade involving products that are mostly produced in one country and sold to another, where national industries are mostly vertically integrated and most value added is (assumed to be) generated from domestic factors of production. This is less the case for VC-based SCT. As a result it is both less clear who benefits from a “subsidy” and it becomes necessary to consider a broader set of policies and whether these as a whole generate negative spillovers. In any such an assessment the first order of business is to identify and define the spillovers that are of concern. In the GATT it is all about a domestic industry: as long as a sufficiently large share of the industry is in agreement that they are being injured by a foreign subsidy action can be initiated. It has always been recognised that imposing countervailing measures on imports will be detrimental to consumers and downstream users. But in a VC framework countervailing measures may have no effect for the firms that bring the case. VCs do not operate as spot markets – there are complex relationships between the links in the chain/nodes in the network to ensure reliability of supply, quality, interconnection, etc. Domestic input suppliers that are not part of a VC that imports parts/components therefore may not benefit from countervailing duties on imported inputs that are used by a VC. The end result may be that the relevant lead firm simply eats the cost if it is not too high or else moves production elsewhere.

Matters are complicated further by the fact that SCT-subsidies will be embedded in products – i.e., the effect for the end product is indirect and depends on the value share of the subsidised activity in the total. Thus, to measure effect of interventions an analysis is needed of the sources of value added/profits, as opposed to the size of the subsidy *per se*. Given that a VC comprises a range of firms in different countries, does it make sense to allow a firm (set of firms) that are not part of given VC take action that is aimed at inducing a lead firm to source from them as opposed to the preferred suppliers – but where the action simply makes the end product(s) less competitive on world markets – assuming the lead firm stays and does not pack up and leave? From an FDI attraction perspective permitting firms to launch countervailing duty actions is likely to run counter to investment promotion objectives and have detrimental impacts on the reputation of a country as a platform for VC-based activity.

Conclusion

The rise of VC/SCT trade makes policy- and rule-making more complex than in a world where trade does not involve vertical specialisation and extensive unbundling of production activities across many countries/locations. The interdependencies and linkages between the various activities that are part and parcel of the unbundling of the production process across many countries requires a re-thinking of the case (need) for government intervention to address market failures and facilitate the operation of VCs. Many such policies are “horizontal” and involve the investment climate, property rights, contract enforcement, skills, infrastructure, connectivity etc. But specific interventions may be needed as well, e.g., targeting coordination failures and weak or missing links in a (potential) VC. Investment

incentives of a fiscal nature may be efficient from the perspective of attracting firms and generating employment in extensive margin activities but at the same time generate negative spillovers on other countries.

Arguably the focus of the WTO when it comes to subsidisation is too narrow. For example, the effects of differential regulatory policies are not considered; investment subsidies are not covered; and there is no focus on behaviour by companies that may have results that are equivalent to a subsidy. A first step is re-considering whether existing subsidy disciplines are fit for purpose and identifying where there are gaps that result in significant trade (investment) distortions. Necessary inputs into – and a possible output – of any process of re-consideration of the *status quo* rules is a concerted effort to determine how existing SCM Agreement and other WTO disciplines impact on SCT opportunities and the efficiency of global value chains. That in turn will require much more attention to documenting what policies governments currently are using to influence the pattern of production and trade. The situation in this regard is not good. While introducing his 2014 report *Overview of Developments in the International Trading Environment*, WTO Director-General noted the following:

Just 37% of Members responded to the request to submit information on their new trade measures....[E]ven when Members participate in this information-gathering process, they often do not provide information on certain types of measures – especially on the so-called behind-the-border measures, including general economic support....With respect to the Agreement on Agriculture, ... compliance with notification obligations in the areas of domestic support and export subsidies generally remains below 50%. In the case of the [SCM] Agreement, ... the percentage of Members that do not submit notifications on subsidies has risen from 27% in 1995 to 44% in 2013. Regarding state-trading enterprises, the percentage of Members that do not make any notification has increased from 37% in 1995 to 66% in 2012.

The limited willingness of WTO Members to abide by notification requirements illustrates both the challenges that confront attempts to consider the need for new rules of the game in the WTO towards policies with subsidy-like effects, and the importance of mobilising more resources to document and map out the use of different policy instruments by governments so as to permit the needed assessment of their effects and the need for – and design of – potential new rules.

The WTO and the Making of National Subsidy Policy

J. Michael Finger¹

In this essay I offer a suggestion for expanding the scope and “analytical framework” of this project. In doing so I will in two ways display my age. First, my suggestion to expand the “analytical framework” draws on two analysts from the past, Bela Balassa and Bob Hudec. Second, I will talk about country studies; these made up a lot of the World Bank’s trade work in the 1970s and 1980s.

I begin with two points, taken from two of my intellectual heroes, that are (in my view) relevant to any study of international economic policies but not often taken into account. I then suggest how these points might be included in this project. This discussion draws on an analysis of Latin American trade policy reform, which I undertook recently with several colleagues.

Voices from the Past

Bela Balassa, in his path-breaking study of trade policy in developing countries, observed that “the existing system of protection in many developing countries can be described as the historical result of actions taken at different times and for different reasons. These actions have been in response to the particular circumstances of the situation, and have often been conditioned by the demands of special interest groups.”²

Starting from such an observation, “reform” is not a matter of substituting one textbook strategy for another – e.g., export-oriented development replaces an import substitution strategy. To presume that what is in place is a coherent strategy is to give away a major part of the case against it. As Bela pointed out, policies in place often have no overall purpose or logic. Achieving coherence – meaning simply, discipline with respect to any overall strategy – is perhaps a greater challenge than choosing one strategy over another. The history of Argentina’s trade policies shows that Prebisch’s “dependencia” theory came after Juan Peron’s economic “policies” were in place, not before.³ *Academic scribblers draw more from madmen in authority than vice versa.*

This concern adds a significant dimension of “governance” to the examination of policy reform.⁴

The second point I draw from Robert E. Hudec. In much of his work Hudec framed the GATT/WTO agreements as commitment by participants to apply only approved methods of trade control, and to subject these controls to a long-term process of discipline through reciprocal

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² B. Balassa, *The Structure of Protection in Developing Countries* (London and Baltimore, 1971), xv.

³ Marcelo Regúnaga and Agustín Tejada Rodríguez (2015) examine Argentina’s agricultural policies against their own import substitution premises and find them lacking. See, M. Regúnaga and A. Tejada Rodríguez, ‘Argentina’s Agricultural Trade Policy and Sustainable Development’, *International Centre for Trade and Sustainable Development, Issue Paper No. 55* (2015). In the 2013 WTO Trade Policy Review of Argentina, part of the Argentine government’s “defense” of its trade policies (which they proudly labeled “import substitution”) as supportive of the WTO system was that Argentina’s share of global imports was increasing. See, World Trade Organization, WT/TPR/M/277/Add.1, *Trade Policy Review Argentina: Record of the Meeting Addendum*, 19 July 2013.

⁴ A lesson from developing country experience may be that developing country (and developed country) governance cannot avoid corruption/capture of import substitution policy instruments. Free trade – as textbook economics – might be inferior, but it avoids this governance problem. This interpretation speaks against the value of “policy space” – which Balassa might interpret as freedom to create the sort of mess he found prevalent in the 1970s, when he began his work. Winston Churchill might assert that free trade is the worst trade policy, except for the others that have been tried.

negotiations.⁵ In the language of mathematical programming, Hudec's view might be thought of as the logical "dual" to the more familiar view of the GATT/WTO system as a process of negotiating trade disciplines.

As I will note below, how the GATT/WTO system supported the domestic politics of eliminating the plethora of restrictions that Latin American countries had accumulated was an important part of trade reform there. Approaching the GATT/WTO system from this perspective – examining the extent to which national trade policies/politics has been shaped by/to GATT/WTO standards – may help to explain why the GATT/WTO system is a success relative to its stated objectives even though the negotiation of further international agreements is proving difficult.⁶

The Scope of the Project

Dr. Rubini's précis describes as follows the proposed scope of this project:

The aim of the research project is to explore the forces that have shaped subsidy regulation in the 20th and early 21st centuries. This will enable a full understanding of the origin and development of treaty and legal language, of judicial and administrative decisions and the reasons/formulas they employ. ... Although the main focus will be on the *GATT/WTO and EU systems*, attention will also be paid to other experiments, like the *Brussels Sugar Convention*, as well as to the discussions within the *League of Nations*.⁷ [emphasis added]

I read this as saying that the project will be about international negotiations and their inputs. The précis thus places the work within the contemporary mode of thought that Bagwell and Staiger label "the political economy of trade reform." One of its key premises of this approach, they point out, is that:

Most trade-policy decisions that governments face today arise in the context of a variety of international commitments that must be considered; hence, the study of commercial policy in international trade has in effect become the study of trade agreements, in which the GATT/WTO plays a central role.⁸

Lessons from recent Latin American experience

Regarding the Latin American liberalisation experiences my colleagues and I have studied,⁹ the Bagwell-Staiger statement about trade policy decisions is both descriptively incorrect and analytically

⁵ See, e.g., R.E. Hudec, *Developing Countries in the GATT Legal System* (New York, 2011 reissue), p. 119-120. Kennedy and Southwick (2002) provide a bibliography of Hudec's work. See, D. L. M. Kennedy and J.D. Southwick, *The Political Economy of International Trade Law: Essays in Honor of Robert E. Hudec* (Cambridge, 2002).

⁶ See, e.g., R. Wolfe, 'First Diagnose, Then Treat: What Ails the Doha Round?', *World Trade Review* 14 (2015) 1, 7-28.

⁷ I revert in this footnote to my early training in anthropology and sociology. In such mode of thought, Dr. Rubini's proposal appears to be influenced by familiarity with how the United States and the Europeans make trade policy and with the receptivity of funding agencies to studies of international negotiations. Harry Johnson divided economists into three categories: (1) those who write theory papers; (2) those who write policy papers; and (3) those who administer policy, i.e., work for the government. To these three we should add a fourth: those who staff funding agencies – to whose perceptions in the end we all succumb.

⁸ K. Bagwell and R.W. Staiger, 'The World Trade Organization: Theory and Practice', *Annual Reviews of Economics* 2 (2010), 223-256. Thinking in the same frame of mind as the previous footnote, a social explanation for this presumption might include the attractiveness/romance of studying international negotiations and the availability of Nash-Dixit bargaining models. Peter Bauer (another voice from the past) sometimes reminded development economists that "The poor are a gold mine!" Today he might say, "The WTO is a gold mine!"

⁹ Finger and Nogués (2006) covered Argentina, Brazil, Chile, Colombia, Costa Rica, Mexico and Peru. See, J.M. Finger and J. Nogués, *Safeguards and Antidumping in Latin America Trade Liberalization* (Washington, DC, 2006). In a follow-up study, Baracat et al. (2015) covered Peru and Argentina. See, E.A. Baracat, J.M. Finger, R.L. Thorne, and J. Nogués, 'Trade Reform and Institution Building: Peru and Argentina under the WTO', *World Trade Review* (forthcoming 2015).

misleading. With Mexico's NAFTA (North American Free Trade Agreement) bargaining being the possible exception, Latin American trade policy reform has been in large part unilateral. Liberalisation was not fashioned through the process of reciprocal bargaining; indeed the bound rates these countries attached to the Uruguay Round agreements were ceiling bindings, two to four times higher than the MFN rates then applied.

The application by Latin American governments of GATT/WTO rules on antidumping and other trade remedies has likewise been unilateral. These governments were not bargaining over the content of these rules. When the reforms were put in place all except Mexico were GATT contracting parties and hence had already accepted (and sometimes ignored) the international law obligations of those rules. They were using the rules – as they existed – as part of the national politics of closing down the plethora of *ad hoc* mechanisms that had accumulated and to restructure domestic policy-making institutions to ensure that the philosophies and interests that supported the ongoing reforms would have a voice in the management of pressures for protection that might arise in the future.¹⁰

The Peru case brought out how reform leaders used international negotiations (bilateral negotiations with the US more than WTO negotiations) and the Asian example to create among Peruvians a positive vision of Peru in the global economy and to transform the domestic politics of trade.¹¹

Within this environment Peruvian reform leaders drew on WTO standards to eliminate the muddle of policies they inherited and to bring rule-of-law – meaning simply a positive list approach to what the government can do – into policy governance.

For Peruvian reformers the challenges are to keep policy decisions within the formalised (and WTO-consistent) framework and to avoid corruption of that framework. As of this writing, Peru has imposed few new restrictions, all of them through their formalised framework (according to Global Trade Alert data). None has been challenged as WTO-inconsistent (according to WTO dispute settlement data).¹²

The GATT/WTO obligations on which Peruvian reform was built have not prevented Argentina's return to an import substitution regime. This reversion has been primarily through a return to "off-the-books" restrictions applied through processes not sanctioned by the GATT/WTO system – and having no formal existence in Argentine law.¹³

¹⁰ More generally, several Latin American governments attempted to move governance away from *cortoplacismo* toward a greater degree of *previsibilidad*; stability of expectations about the rules of the game and about agreed procedures for changing these. (See, A.F. Lowenthal, 'Disaggregating Latin America: Diverse Trajectories, Emerging Clusters and their Implications', *Brookings Institution, Brookings Research and Commentary* (2011), available at http://www.brookings.edu/papers/2011/1101_latin_america_lowenthal.aspx, accessed Apr. 14 2015.) Among regional leaders, Alejandro Foxley, Chile's former Minister of Economy and Minister of Foreign Affairs explains such a vision in his address to the Conference "Gobernabilidad y Desarrollo 2009" (Asunción, Paraguay, 2009), available at <http://www.hacienda.gov.py/web-hacienda/pub003.pdf>.

¹¹ The Asian example served more as a vehicle for communicating to the public what reform leaders wanted to do (and what its results would be) than as a template for what to do.

¹² Baracat et al., above n 9, provide details. The most recent report of the WTO Director-General report on trade restrictions (i.e., the 2015 report) lists no new restrictions by Peru. However, Peru has listed two terminations of antidumping measures, the elimination of import clearance duties originally imposed in 2004 and the elimination of import tariffs on 1,089 tariff lines. See, World Trade Organization, *Report to the Trade Policy Review Body from the Director-General on Trade-Related Developments*, 3 July 2015.

¹³ The informality of Argentine practices and procedures has complicated the WTO judicial process. Part of Argentina's response to legal challenge has been that there is no evidence in Argentine law or regulation that the practices in question

One of the principal conclusions from the Latin American studies is that trade policy is at its core a national decision. National practice, we concluded, applies discipline, while WTO rules are only one of the forces that shape national practice. To think simply of WTO rules as specifying what a Member can and cannot do overlooks a good deal of what makes the WTO system work.

The other (overlapping) conclusion concerns the domestic institutionalisation of GATT/WTO principles of trade control. For a country to use the modern value-chain economy as a vehicle for development, WTO rules and other policy disciplines must have operational content in national institutions. Recourse, say, to overcharge of a customs duty through the exporting country's rights under WTO tariff bindings would take years, and thus would be of no commercial value either to the exporting company or to the importing company. Likewise for misuse of other trade controls – those the GATT/WTO system allows and those it does not.

Suggestion: Include Country Studies

My suggestion is to expand the project beyond an analysis of inputs into international agreements to include “country studies” that would:

- Focus on national decisions to grant or remove subsidies rather than on international negotiations/agreements.
- Pay attention to the integration of GATT/WTO principles/processes into national decision processes – attention to such “deep” application of GATT/WTO principles as well as to broad application to non-border as well as to border measures.

To think simply of the WTO as a negotiation to determine what a Member can and cannot do overlooks a good deal of what makes the WTO system work. Similarly, to think of the WTO system as the creation of “global governance” rather than as international cooperation in support of better national governance is a presumptuous (or perhaps only unthoughtful) extension of the EU model to the rest of the world.

Beyond understanding what contributes to effective use of or discipline on subsidies, more attention to national practice might provide a basis for a more positive evaluation of the WTO system. Robert Wolfe recently pointed out that the Doha Round being dead does not mean that the WTO is dead. After all, Wolfe reminded, the 1995 Agreement Establishing the World Trade Organization specifies its first function as facilitating the application and furthering the objectives of the WTO agreements.¹⁴

(Contd.) _____

even exist. Baracat et al., above n 9, analyse these as the output of the “informal sector of government”, the WTO Panel and Appellate Body reports on the Argentina cases label them “unwritten measures”.

¹⁴ See, above n 6, 22.

Part II – The Real World

Negotiating Subsidies in the GATT/WTO: The Tokyo Round, the Uruguay Round, and the Doha Round

Some Factors that Led to the Conclusion of the Tokyo and Uruguay Rounds

Peter Williams¹

This essay examines some of the factors that led to the conclusion of the Tokyo and Uruguay Rounds, both of which produced agreements dealing with subsidies. Results of the Tokyo Round included agreements on subsidies and countervailing duties and commodity agreements on dairy and bovine meat. Results of the Uruguay Round included the agriculture agreement, a further agreement on subsidies and countervailing duties, and the General Agreement on Trade in Services.

The main point of this essay is that these agreements on subsidies would not have been possible outside a major negotiating round dealing with a wider range of subjects: subsidies, especially export subsidies, are best dealt with multilaterally. Each GATT round was more ambitious and complex than the one before.² When both the Tokyo and Uruguay Rounds ended many commentators said never again but they were followed by the Doha Round. The reason for the organisation of major Rounds is of course the need to conduct them “with a view to ensuring benefits to all participants and ... an overall balance in the outcome of the negotiations”³, the results of which are to be applied on a most-favoured-nation basis. The reasons behind this insistence on reciprocity are by now well understood. It is true that GATT/WTO has produced a number of agreements outside major negotiating rounds but these have been agreements on infrastructure sectors that all countries have an interest in making more efficient: information technology, basic telecommunications, financial services and, more recently, trade facilitation.

Successive GATT rounds after 1947 produced agreements because they were founded on principles and practices that had been tested by time in earlier negotiations on bilateral trade agreements. Participants were convinced that they could all benefit from the results (many would have said that the negotiations were not zero sum games) and had a pragmatic willingness to compromise when necessary, to accept the benefits that were available, and to try again another day. Only in the Uruguay Round did the conditions exist for major participants to go for broke.⁴

Sufficient driving force is needed if major negotiating rounds are to be launched and brought to a successful conclusion. Powerful motives and objectives are necessary. The main motive for proposing the Kennedy Round was the formation of the European Economic Community and the European Free Trade Area and the need to reduce the relative disadvantage that these created for outside suppliers. Preparations for the Tokyo Round were begun when several large economies were simultaneously undergoing a recession and were motivated by a desire to take positive action to head off protectionist pressures and to tackle not only tariffs but also the unfinished business of non-tariff measures and agriculture. Preparations for the Uruguay Round were begun to deal with unfinished business including agriculture and to meet the challenges of a rapidly changing world.

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² The Tokyo Round lasted for 12 years. Preparations began in November 1967. The Round itself was inaugurated at a ministerial meeting held in Tokyo in September 1973 and was concluded in November 1979. The Tokyo Declaration was four pages long, 99 countries participated in the negotiations and the Round produced agreements on 12 different subjects. The preparations for the Uruguay Round started in 1981 and the implementation of the Round's results was agreed at the end of 1994, more than 13 years later. The Punta Del Este Declaration ran to 10 pages, 123 countries participated, and agreements were reached on 29 subjects supplemented by 24 decisions, declarations and understandings. The Declaration that launched the Doha Round in 2001 is also 10 pages long but is supplemented by 18 pages of related declarations and a set of procedures relating to export subsidies of some developing countries. There are now 161 Members of the WTO.

³ This is the wording of the Doha Declaration, paragraph 49.

⁴ A gambling term: risking everything to reap substantial reward.

These negotiations relied heavily on the leadership of the United States of America and it is commonly said that the success of the GATT in the early days was the result of the exercise of hegemonic power. In the days of the cold war it had a political interest in strengthening the “free world” as well as an economic interest in trade stabilisation and liberalisation. The United States considered itself the leader of the free world and that it had a responsibility to take the initiative. In the early days the GATT was the essence of the United States’ trade policy: when another government asked for a bilateral trade agreement it was told to join the GATT. It maintained this leadership role in the Tokyo Round despite the deterioration of its balance of payments: after abandoning of the gold standard and imposing a 10 per cent import surcharge in 1972, the United States administration adopted an outward-looking strategy. In the Uruguay Round, the United States once more provided the leadership but President Reagan’s tough new trade policy, adopted in response to the five-fold increase in the United States’ trade deficit from 1981 to 1985, was based not only on a multilateral initiative and on regional and bilateral action but also on unilateral action, including greater use of Section 301 authority.

To say that the United States has provided leadership is of course not to say that it could dictate the course and the result of GATT Rounds. It always worked with core steering groups of other governments that took basic decisions before negotiations on specific issues were widened to other interested governments. At the beginning it worked very closely with the United Kingdom: in the Tokyo Round with the European Economic Community and Japan: in the Uruguay Round with other members of the Quad, which included Canada as well as the EU and Japan. However, in the final stages of this Round bilateral negotiations between the United Nations and European Communities were crucial to the success of the Round.

It was never going to be possible for a parliament of all the participants to bring the negotiations to a successful conclusion but reliance on steering groups posed a problem for other countries and it was necessary to find ways to resolve the tension between the need for efficiency and the need for equity. In the Uruguay Round, countries with similar interests formed coalitions to increase their bargaining power. The Cairns Group of agricultural exporters is one main example of this. Developing countries particularly resented the use of small steering groups. In earlier GATT Rounds they were rule takers rather than rule makers, reaping some benefits, in accordance with the most-favoured-nation clause, from the generalisation of tariff reductions exchanged between developed countries. The establishment of the United Nations Conference on Trade and Development (UNCTAD) in 1964 coincided with the opening of the Kennedy Round. At that time, and during the Tokyo Round, the developing countries in the Group of 77 pinned their hopes on the UNCTAD, commodity agreements and the generalised system of preferences, rather than on their participation in the GATT. However, the main developing country delegations did participate actively in the negotiations, did exercise some influence on their outcome and did derive some benefits.

The Tokyo Round ended with agreement and produced some useful results but was a disappointment in several respects. Developed participants’ tariffs on industrial products were reduced by about one third and were to some extent harmonised. The non-tariff codes improved disciplines in the areas covered. However, participation in the codes was voluntary. Agriculture remained very largely outside the disciplines of the GATT and some observers considered that the negotiation of a dairy products cartel was a retreat from basic GATT principles. Developing countries made a relatively small contribution to the objectives of the Round. Some observers drew the conclusion that in future the developed countries should not only bargain amongst themselves to reduce their levels of protection because they would then be left with little power to bargain with developing countries, especially the more advanced among them.

When the Uruguay Round began in 1985 it was clear that developing countries needed to be more effectively involved in the negotiations. Faith in the UNCTAD and the UN’s New International Economic Order had been shaken by the limited benefits that most of them drew from the generalised system of preferences, the failure of the Cancun summit hosted in 1981 by President Lopez Portillo

ending attempts to negotiate global economic agreements between North and South, and the difficulty of organising and managing commodity agreements, four of which collapsed or were suspended in the 1980s (sugar, tin, coffee and cocoa). It was also clear that each developing country had its own interests.

Some developing countries had improved their standards of living enormously by adopting export-oriented development policies. On the other hand, in August 1982 Mexico's announcement that it could no longer service its debt had triggered a Latin American debt crisis. This was followed by criticism of developing countries with overvalued exchange rates and import restrictions, and led to loans to these countries being made conditional on reforms, including unilateral tariff reductions, and to what became known (in 1989) as the Washington Consensus. Hard-line developing countries continued to demand redress for past injustices, standstill and rollback, in addition to preferential treatment and less than full reciprocity.

It was necessary for the agenda of the Uruguay Round to be broad enough to promise benefits to all these various participants. When the conference inaugurating the Round opened in Punta del Este it was faced with two competing drafts, one in the name of a group of 48 developed and developing countries and another by a group of 20 hardline countries. It was a tribute to the GATT approach and the quality of many of the negotiators that the conference was able to reach agreement on a declaration containing an agenda for the negotiations that straddled issues as diverse as the insistence of the hard-liners on standstill and rollback of measures inconsistent with the GATT and developed countries' insistence that negotiations must take place on trade in services and trade-related intellectual property where their comparative advantage increasingly lay.

The Punta Del Este agenda held out the promise of substantial benefits for the full range of participants. Only the hard problems were left. These included: agricultural restrictions and distortions; restrictions on textiles and clothing; grey area measures; anti-dumping duties; subsidies and countervailing measures; trade-related investment measures; trade-related aspects of intellectual property rights; trade in services; dispute settlement rules and procedures. GATT Rounds were largely driven by impersonal forces but the results achieved are a tribute to a large number of people. Nothing would have happened without individuals to do the work. So many people were involved that it is invidious to single out individuals.⁵

To find a balance of benefits at a high level the trick is first to get ambitious offers and draft agreements on the table. It is relatively easy to find a balance of benefits at a low level, but if offers start to be withdrawn the risk is that nothing is left. In the Uruguay Round the prospective benefits of the negotiations were big enough and widespread enough to persuade participants to maintain their initial offers and then to take the decisions necessary to bring the negotiations to a successful conclusion.

In the end the conditions were right. The collapse of the import substitution policies, the New International Economic Order, the central planning model and the Soviet Union created a honeymoon period for free markets. The benefits of the Round were clear. The Uruguay Round resulted in an agreement that was more far-reaching than imagined when the negotiations opened.

The outcome of the negotiations was even more ambitious in some important respects than had been expected at the outset. The final agreements were bound together in a new organisation with much more effective dispute settlement provisions. The rule-makers obtained significant benefits in areas of interest to them. The rule-takers obtained incidental benefits and joined the WTO because they did not want to remain outside in the cold.

⁵ For a list of 106 people that "played a leading role in creating the WTO", see C. VanGrasstek, *The History and Future of the World Trade Organization* (Geneva, 2013), Annex 1: Biographical Appendix. See also, e.g., the index to E.H. Preeg, *Traders in a Brave New World: The Uruguay Round and the Future of the International Trading System* (Chicago, 1995).

To end on a different note. Keynes wrote: “Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.”⁶ From this point of view, at the top of my list of individuals that influenced the GATT Rounds would be David Ricardo, closely followed by Richard Cobden, who lost his faith in a free trade utopia and, with Michel Chevalier, concluded the reciprocal Anglo-French Trade Agreement of 1860. GATT Rounds also owed a lot to Senator Reed Smoot and Representative Willis C. Hawley whose 1930 Tariff led President Franklin D. Roosevelt and his Secretary of State Cordell Hull to champion the Reciprocal Trade Agreements Act of 1934 that led to the United States’ bilateral agreements of the 1930s and 1940s. The General Agreement was largely a multilateralisation of these.

⁶ J.M. Keynes, *The General Theory of Employment Interest and Money* (Cambridge, 1936), p. 383.

Negotiating Subsidies in the GATT/WTO: The Tokyo Round

John D. Greenwald¹

The Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade (the Subsidies Code) was one of the more difficult negotiating exercises in the Tokyo Round. Although subsidies and countervailing measures were on the negotiating agenda from the beginning, there was no progress until very late in the negotiations. The challenge was to bridge fundamental differences between the United States, on the one hand and, on the other, the European Union.

The United States was insistent on meaningful multilateral discipline over the use of subsidies. The European Union, along with most of the other participants in the negotiations, was unenthusiastic about subsidies discipline, but insistent that the Tokyo Round result in a change to US countervailing duty law that would require a finding of material injury as a precondition to the imposition of countervailing duties. These differences meant that any negotiated agreement had to be modest — and the Subsidies Code negotiators have much to be modest about.

For those interested in the details of what happened in the Tokyo Round SCM negotiations and why (at least from a US negotiator's perspective), Dick Rivers and I wrote an account of the negotiating challenges in a 1979 article published in *Law and Policy in International Business*, Vol. 11, at pages 1447-1495.² The essence of what we said is:

The subsidy/countervailing measures negotiations were difficult because the United States would not agree to include an injury test in its countervailing duty law without improved discipline over subsidies while the EU and most other countries had very little interest in GATT discipline over their use of subsidies.

The first several years of negotiations failed to develop a framework that would permit serious negotiation. The Treasury Department, which led the US negotiating team at that time, would spend untold hours developing and vetting within the US government elaborate draft agreements, notably a “green light, yellow light, red light” approach, which were presented to, and promptly rejected by, other delegations.

Serious negotiations began only after a Washington-based USTR (United States Trade Representative) team assumed the negotiating lead for the United States, and US and EU negotiators then agreed to build an agreement from the bottom up on the basis of the existing rules of Articles VI, XVI and XXIII of the GATT. This was by design an incrementalist approach that would at best introduce modest new disciplines over the use of subsidies and countervailing measures.

On subsidies, the Tokyo Round agreement strengthened the prohibition on the use of export subsidies by developed countries (including by means of a more elaborate “illustrative list” of export subsidies). However, subsidies on “certain primary products” were excluded from the general prohibition. Instead, export subsidies on agricultural and certain other primary products were permitted except where the subsidy resulted in the subsidising country having more than an equitable share of world trade. There was also a broad exception to the prohibition on export subsidies for developing countries.

¹ J. Greenwald, partner at Cassidy Levy Kent (USA) LLP, Washington, D.C, was responsible, at the USTR, for negotiating international agreements on antidumping and subsidies/countervailing measures in the Tokyo Round. He passed away during the editing process of this e-book.

² The article is titled ‘The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences’.

The Subsidies Code did not limit the use of non-export subsidies by any country, but provided for the first time a specific framework for complaint and adjudication where a subsidy that caused or threatened “injury to the domestic industry of another signatory or serious prejudice to the interests of another signatory or may nullify or impair benefits accruing to another signatory under the General Agreement, in particular where such subsidies would adversely affect the conditions of normal competition.”³ That said, the dispute settlement provisions that emerged from the Tokyo Round negotiations allowed a country to block an unfavorable panel report.

The Subsidies Code also for the first time enumerated “possible forms” of domestic subsidies stating (albeit without any demonstrable basis for doing so) that “they are normally granted either regionally or by sector.”⁴

In return for modest incremental discipline over the use of subsidies, the United States agreed to include an equally modest material injury test in its countervailing duty law. The practical consequence of this “concession” was more, not less, activity under US countervailing duty law because (a) it removed the primary trade policy rationale against countervailing duty investigations, (b) the “material injury” standard codified in the Subsidies Code (and then in US law) is not a difficult standard to meet, and (c) one of the results of the Tokyo Round focus on subsidies/countervailing (and antidumping) was to move responsibility for enforcement of US trade law from the Treasury Department to the Commerce Department.

The Agreement on Subsidies and Countervailing Measures negotiated in the Uruguay Round was far more ambitious than, but built on the basic structure of, the Tokyo Round Agreement, i.e., an export subsidy prohibition for industrial goods with an exception for developing countries, agricultural subsidies left to the Agreement on Agriculture, and other subsidies subject to WTO dispute settlement where there was injury, nullification or impairments of GATT 1994 benefits or serious prejudices to the interests of another Member. However, whether the detail of the Uruguay Round Agreement added any effective new discipline over the use of subsidies is very much an open question.

Looking back at the Tokyo Round negotiations, an obvious question is whether more elaborate rules could have been agreed to. My own answer to that question is probably not, but even if something more ambitious would have been negotiated, it would have simply accelerated the introduction of the sort of discipline negotiated a decade later in the Uruguay Round — which raises the question “so what?” If there is no persuasive evidence that the Uruguay Round Agreement has introduced meaningful WTO discipline over subsidies, what useful purpose would have been served by accelerating its introduction? To me, the far more interesting question is whether the United States made a basic mistake in its Tokyo Round insistence on negotiating subsidy discipline. Would it have been better advised to simply incorporate a material injury test into its countervailing duty statute and leave the subsidy discipline issue alone?

The answer to that question is, I think, probably “yes.” Evidence over the thirty-five years since the conclusion of the Tokyo Round shows that it is all but impossible to subject national subsidy programs to strict WTO discipline. To be sure, the WTO prohibition on the use of export or import substitution subsidies on manufactured products by developed countries is meaningful, but only to the extent that the prohibited subsidies are clearly defined in a way that does not invite easy circumvention. And there is little evidence that the WTO rules on other types of subsidies have had any material effect on their use. The decade-plus WTO litigation between the United States and the EU over trade in commercial aircraft is a monument to the futility of the WTO on matters of subsidy discipline.

³ Agreement on Interpretation and Application of Articles VI, XVI And XXIII of the General Agreement on Tariffs and Trade, Article 11(2).

⁴ *Ibid.*, Article 11(3).

An important benefit of accepting a material injury test without a subsidies-related quid pro quo would have been less room for WTO intrusion into the administration of national countervailing duty laws. Experience demonstrates that national countervailing duty measures have a forcefulness that the WTO system lacks. The recent US countervailing duty investigation of sugar from Mexico, and a series of US/Canada softwood lumber cases, prove the point. If there were wider use of national CVD measures, it would curb the trade effects of subsidies in ways that WTO discipline will never do. To be fair, in the wake of the Tokyo Round Subsidies Code, administrators of the US statute *chose* to soften the bite of US law in ways not required by the Code (by, for example, adopting a “specificity test” that seems to be premised on the ill-considered notion that a subsidy program is not countervailable as long as it benefits a sufficiently wide range of recipients). However, it is also true that, over time, WTO dispute settlement has been decidedly counter-productive in limiting the reach of national (particularly US) law. Two WTO decisions illustrate the point.

In *US – Lead and Bismuth* (DS138), in its report circulated in May 2000, the WTO Appellate Body held that a subsidy to a government-owned production facility was extinguished when the facility was privatised. That decision entirely disregards a core subsidy-related problem, i.e., that subsidies create or maintain capacity that would not otherwise exist. Such capacity, once created, has continuing effects regardless of any change in ownership. The idea that the transfer of subsidised assets at their “fair market” (and generally depressed) value to new ownership eliminates the market impact of the subsidies is economic nonsense. To put the issue in concrete form, the evidence developed in the Boeing – Airbus dispute leaves little doubt that “but for” successive tranches of Launch Aid, Airbus would never have become a major producer of large commercial aircraft. The effect of decades of subsidies that have made Airbus what it is today would not be eliminated (or even mitigated) by the sale of government shares in EADS, the Airbus holding company.

A second WTO decision that threatens to undermine the effectiveness of national anti-subsidy regulation is the 2011 decision of the Appellate Body in *US – Antidumping and Countervailing Duties (China)* (DS379). There, the Appellate Body ruled that benefits conferred on an enterprise controlled by a government (such as the provision of material inputs at below market prices) is not an actionable subsidy unless the enterprise that provides the benefit “possesses, exercises or is vested with governmental authority”.⁵ Commercial activity by such an entity to further a national economic development program is evidently not considered an “exercise of governmental authority.” This ruling, if it holds in subsequent cases, permits businesses that are controlled by a government to subsidise with impunity other government-favoured enterprises by providing below market supply of goods and/or services. The exception it creates to international discipline over the use of subsidies by countries like China is breathtaking.

Because the Tokyo Round agreement on GATT dispute settlement did not contemplate that automaticity of the panel/Appellate Body process agreed to in the Uruguay Round, the impact of the GATT review of countervailing duty decisions by national authorities was not at the time a major issue. However, with the introduction of the Uruguay Round’s WTO dispute settlement procedures (that have been made all the more problematic by a decidedly activist Appellate Body), the effect of WTO intrusion into issues of subsidies and countervailing measures has been to lessen rather than tighten subsidy discipline. This is not to say that more aggressive use of countervailing measures could usher in broad new disciplines on subsidy usage, but it would at least serve to better limit their extraterritorial effects.

⁵ Appellate Body Report, *US – Antidumping and Countervailing Duties (China)*, para. 317.

What Shapes Subsidy Disciplines in the GATT and WTO?

Gary Hufbauer¹

Background Considerations

GATT members recognised, as early as the 1960s, that progressive liberalisation of market access (principally through lower tariffs) inspired some countries to nurture desirable sunrise industries with targeted subsidies. Generally left unsaid, but very much in policy minds, was that first mover and scale economy advantages could enable the capture of markets abroad. Sometimes this motivation became patently transparent, as when European value added taxes were imposed on the destination principle, or the United States enacted the Domestic International Sales Corporation (DISC) statute, or when both the United States and Europe dumped surplus agriculture on world markets.

Progressive liberalisation inspired other countries (and sometimes the same countries at the same time) to shelter beleaguered sunset industries with another set of subsidies. In such cases, the goal was to court political support by extending a helping hand to the affected industries, their communities, and indirectly the workers.

Trade ministers of the day knew that assorted subsidies to sunrise and sunset industries did damage to the global economy by distorting location decisions,² by favouring firms that were not necessarily the most efficient, and by slowing adjustment to the changing realities of the marketplace. They also knew that the United States – then the foremost champion of free market capitalism – had a countervailing duty statute that could be deployed to impose penalty duties on subsidised imports of merchandise (but not subsidised imports of services). Other countries had similar statutes or broad trade remedy powers that could be deployed to similar effect. Finally, trade ministers were aware of the troubled economic history of merchant marine fleets: intense competition and unfettered access to world ports prompted several countries to serve up construction and operating subsidies on a huge scale, so as to retain or enlarge their respective shares of the global shipping market.

Tokyo Round Code

By the time the Tokyo Round of Multilateral Trade Negotiations was launched in 1974, these background considerations had created a general disposition, at least among the Quad (Canada, the European Communities (EC), Japan, and the United States), to draft a code limiting the use of some subsidies. In particular, mindful of the long and acrimonious US-EC debates over tax practices designed to promote exports, the focus was on subsidies that differentially encouraged merchandise exports. This resulting code amplified GATT Article XVI, essentially dispensing with the bi-level pricing test which had previously rendered that Article ineffective as a disciplinary tool, instead making export subsidies (apart from those on agriculture) a *per se* violation of the GATT rulebook.

It is equally important to point out what else the Tokyo Round Subsidies and Countervailing Measures Code (Subsidies Code) did and did not do. A core objective of the EC, and to a lesser extent Canada and Japan, was to restrain US use of the countervailing duties. The main “discipline on the discipline” was the “injury test”: before a CVD could be imposed the imported merchandise had to be shown to “injure” a domestic industry. Various tests and procedural rules were designed to ensure fair

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² See, in this e-book, B. Hoekman, ‘Subsidies, Spillovers and the Trading System’.

notice and impartial hearings. In these ways, the Subsidies Code imposed a heavier burden on private firms that sought to bring CVD cases.

On the other hand, the Code opened the door for GATT members to bring cases against each other in Geneva, alleging the use of *per se* prohibited export subsidies, without having to show any trade effects. However, the GATT dispute settlement system then (as now) was not open to private parties.

Finally, the Tokyo Round Subsidies Code did not come to grips with the vast range of subsidies that aimed to attract new investment, lure sunrise industries, or prop up sunset industries. Only when such subsidies caused “injury”, within the meaning of a member’s CVD law, did they become the target of discipline, not under the GATT, but rather under the national statute.

All in all, it’s fair to conclude that the Tokyo Round took a modest forward step towards disciplining subsidies. GATT members were generally more concerned about ensuring a free hand for their own present or future subsidies than on limiting the subsidies of other members. Indeed there was no rigour in the reporting requirements; no consideration was given to the creation of a GATT ombudsman that could call out offensive national practices; any suggestion of private rights of action within the GATT system was akin to blasphemy; at the time services were completely off the GATT agenda; and agricultural subsidies of all kinds were still sacred cows.

Uruguay Round Codes

Between the end of the Tokyo Round (1979) and the conclusion of the Uruguay Round (1994) world trade grew briskly and foreign direct investment exploded. Public policy concerns were naturally aroused about the malignant effects of subsidisation in a world economy that was rapidly globalising. The disciplinary effects of occasional national CVD cases and a bare handful of GATT prohibited export subsidy cases were simply no match for the creative minds of federal and sub-federal authorities bent on using subsidies to lure and support local industries.

On the other hand, many multinational corporations (MNCs) were thankful recipients of government largesse, in the form of industrial parks, training programs, easy credit, and tax holidays. And many developing countries, along with struggling regions in advanced countries, felt it was their prerogative to spur the economy with assorted subsidies.

In an effort to balance these opposing forces, the Uruguay Round negotiators came up with an enlarged SCM Agreement and an Agreement on Trade-Related Investment Measures (TRIMs Agreement).

The SCM Agreement defined “subsidies” broadly to include measures that entailed a “financial contribution” from government and conferred a “benefit” on the receiving firm. However, apart from *per se* prohibited export subsidies, only “specific” subsidies were subject to WTO action, and then only if they imposed “adverse effects” on another WTO member. Members were supposed to report all subsidies in a timely manner to the WTO, but no penalties were attached for delinquent reports.

This may have looked like strong medicine when the Uruguay Round was concluded at Marrakesh in 1994, but in fact the new elements of the SCM Agreement proved relatively ineffective. Just as before, the main discipline on domestic subsidies remained national CVD laws, not WTO jurisprudence. And, following the example set in the Tokyo Round, this code resulting from the Uruguay Round put still more disciplines on CVD calculations and procedures.

The WTO put new restraints on domestic agricultural subsidies during the Uruguay Round, but not to the same extent as new restraints on domestic industrial products. (Industrial export subsidies were strictly prohibited though not agricultural export subsidies.) However, even the new restraints on domestic industrial subsidies were not particularly strong. The specificity test, proving the existence of a benefit when the subsidy was accompanied by conditions, and the difficulty of establishing “adverse

effects”, all combined to impose a heavy burden on complainants. Few if any domestic subsidy cases were brought to the WTO. The new reporting requirements were honoured in the breach, and recipient firms were generally happy to receive assistance without much publicity. No thought was given to establishing private rights of action or to creating a WTO ombudsman mandated to spotlight national subsidy practices.

The TRIMs Agreement had a narrower scope than the SCM Agreement, but with greater effect. It prohibited investment subsidies that were contingent on performance requirements – namely exporting a certain amount or using a certain amount of domestic inputs. MNCs generally dislike performance requirements because, when they bite, they raise costs or reduce revenues. Hence this aspect of TRIMs was popular in the business community and has been enforced in a few WTO cases.

A fair conclusion is that the Uruguay Round did rather little to enlarge WTO disciplines on subsidies, but it did somewhat tighten CVD calculations and procedures.

Aircraft Subsidies

From its birth a century ago, the aircraft industry has been generously subsidised. The United States, Britain, France, Germany, Canada, Brazil, Japan, Russia, China and even Indonesia have, at various times and in various ways, fostered both nascent and mature aircraft firms. The vision of creating a high-tech industry that employs thousands of well-paid workers exerts a powerful grip on the public mind.

In the 1990s, Canada and Brazil lodged three WTO cases against each other, respectively challenging subsidies to mid-sized aircraft producers Embraer and Bombardier. In the 2000s the United States and the European Union launched the largest and longest WTO cases ever filed over subsidies to Airbus and Boeing. Because aircraft sales reach a world market, subsidy practices that in other industries might be regarded as domestic subsidies were categorised as export subsidies in the aircraft cases. WTO panels and the Appellate Body duly found that the aircraft firms had all received prohibited support. To a modest extent, these findings may have limited the future flow of financial support to the aircraft producers. I have not seen research that pronounces a judgment on that question. The measures taken by the US and EU to implement the DSB ruling are currently under review of implementation panels. Pending this review, arbitration proceedings to determine the level of retaliation have been suspended. Even if lack of compliance is confirmed, it remains to be seen whether any retaliatory measure will actually be implemented by the prevailing complainants.

At the moment, a buoyant world market for civil aircraft has improved the finances of all producers, so charges and counter-charges of subsidisation are less vocal. However, the test of meaningful WTO discipline will come when the world market turns down, and when China breaks into export sales with well-constructed but highly subsidised aircraft.

Financial Crisis

In the wake of the 2008-2009 crisis, the United States, Europe and a few other countries were awash in subsidies – mainly to banks and insurers, but also to auto firms and a handful of other industries. These were last resort measures, designed to avert the Second Great Depression. In retrospect, the support turned out to be temporary, generally repaid within six years. Without these lifelines, leading firms would have gone out of business, permanently altering the industrial landscape. Sensibly no WTO cases were brought.

Doha Round

At this writing, the Doha Round is most notable for what it has not accomplished. Among its minor failings is the absence of any progress on writing subsidy disciplines for the service industries, though progress was promised two decades ago in the General Agreement on Trade in Services. Meanwhile, many airlines are heavily subsidised, either through government grants or public loans. A few private US universities are subsidising their expansion abroad, through online courses and campuses abroad (Yale in Singapore). More examples could be cited, but subsidies to the service industries completely escape the purview of the WTO system. So far, such subsidies also escape the notice of national CVD statutes. I have seen no reports that the plurilateral Trade in Services Agreement (TiSA) negotiations are meaningfully addressing the subsidy question.

Undervalued or Manipulated Exchange Rates

The biggest subsidy debate of the moment concerns exchange rates that are arguably undervalued or manipulated. In the context of the debate over the Trans-Pacific Partnership (TPP), many members of the US Congress insisted that such results or practices should be answered with countervailing duties or other measures. In the end, the TPP contained a side agreement without enforcement mechanisms – the “Joint Declaration of the Macroeconomic Policy Authorities of Trans-Pacific Partnership Countries”. If the US current account deficit significantly expands during 2016 while the Chinese yuan loses value relative to the US dollar, the exchange rate issue could return to the US political agenda.

The Shape of Things: Few Thoughts on Negotiating Rules on Subsidies in the GATT and WTO

Jan Woznowski¹

There is no doubt in my mind that the aim of a project “Enquiring into the Forces Shaping Subsidy and State Aid Laws” is very ambitious and very useful. However, I see a lot of difficulties and dangers in its implementation. The first difficulty is how to avoid preparing yet another sort of compendium duplicating existing records and official publications (e.g. Terence Stewart’s *The GATT Uruguay Round: A Negotiating History (1986-1992)*(Vols. I-III) or the WTO’s *Analytical Index*).

The second difficulty is inherent in the scope of the project. Here, there is the danger of deviating from what is really important for this project and discussing at length some issues that are secondary to the purpose of this exercise, e.g. rationale for subsidies, trade-distorting versus socially or politically justifiable objectives. I am sure that, in this respect, all has already been said.

The third danger is to get involved in ideological or purely academic discussions, detached from the real world of international negotiations in the area of subsidies. I can say, on the basis of my personal experience starting with the Tokyo Round, that most key and active negotiators knew how the disciplines on subsidies should look like in an ideal world but the reality of domestic interests, their governments objectives and policies, and the influence of powerful constituencies or lobbies strictly determined the instructions they had to follow.

At this stage, I have no recipe how to avoid these and other difficulties but it is of utmost importance that, for the sake of the project, we have a clear road-map for the way ahead.

The organisers of this project and the workshop that launched this project attach importance to the historical aspects of the subsidy negotiations, the origin and the forces that shaped the subsidy regulations in the GATT/WTO in the 20th century and up to now. I think that it would be helpful, in this context, to understand well the drafting process in the subsequent rounds and who were the direct drafters. In this brief essay, I would like to make some preliminary comments on these two aspects, to some extent based on my personal involvement in the negotiations.

There were three subsidy negotiation “rounds” in the GATT/WTO framework. The first one was the drafting of Articles 25 and 26 of the Havana Charter, the modified and much shorter version of which was used to draft Article XVI of the General Agreement, including its paragraph 4. The drafting history of these Articles can be found in the summary records of the Preparatory Committee, which are sufficiently detailed to understand why they were drafted in the way they were. One can follow the evolving drafters’ positions and see why the drafted rules were so general. These negotiations were, therefore, “traditional negotiations” where all interested participants were involved in the whole drafting process.

The second subsidy “round” took place during the Tokyo Round negotiations. Here the negotiating process was quite different than the one mentioned above. Although we still had the traditional negotiations (i.e. where the negotiators directly discuss proposals, make compromises and draft the treaty language) but these real negotiations took place in a very restricted group; there were no summary or other records of discussions, with drafting language proposals being submitted in non-papers or orally during private sessions. The text that was made available to all participants in the negotiations was very close to the final version of the Subsidies Code.

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It should be remembered, however, that the negotiations of interest to us in the Tokyo Round were formally a plurilateral process, which did not include all participants. This facilitated its limited and restricted nature.

The third and, so far, the last subsidy “round” took place during the Uruguay Round. Here, the process was even more “atypical“. This process could be described as the Chairman’s text process, where the Chairman, on the basis of negotiations between delegations and (more importantly) their discussions with him, drafted iterative versions of his text, each more comprehensive, until the final compromise text was achieved. Unlike in the Tokyo Round, each draft version was circulated as a GATT document, thus available to all participants. However, the real input came from a small group of key negotiators and the Chairman recast this input on his responsibility. As in the Tokyo Round, no detailed summary records or any other records from all informal discussion were prepared.

The enormous advantage of this way of proceeding, which was crucial to reaching the final compromise, was that the negotiators were, at least to some extent, relieved from their responsibility for each word and each formula in the subsequent drafts. The final draft could, therefore, be presented by them to their constituencies with a qualification: “we do not like it, but there is quite something for us in it and this is the best we can get from these negotiations”.

Finally, a short comment on the nature of the negotiations and the approach of negotiators. The negotiators normally attempted to develop very practical rules to regulate subsidies. They were concerned with making sufficiently comprehensive provisions so that governments would not be able to apply one set of rules fully, only to circumvent these rules with equivalent measures in another form or with another name. They were not thinking about public international law as such. The issues that were identified were specific, concrete questions that had arisen from the negotiators’ experience at that time. No one was thinking about conformity with any outside principles as such, or about trying to ensure any coherence with any other body of law. They saw the General Agreement as a contract among themselves, addressing very concrete problems affecting international trade (in this case in the area of subsidies).

The subsidy negotiations (like some other areas in the Uruguay Round) had been almost finalized when, at the end of the game, the rules were changed by the introduction of the new dispute settlement system. A question is frequently asked why governments agreed to bind themselves into such a legalistic and hard system. One of the answers given is that they probably did not fully realize all the consequences of their agreement and misjudged their own capacity to comply with the new rules. I submit that had this new system been introduced at an early stage, before the new rules were drafted, we would have been still in the Uruguay Round negotiations.

Each subsidy “round” had its own negotiating process which played a very important role in achieving the final result. The Chairman’s text process, very efficient in the subsidy negotiations, was adopted by the Chairman of the Trade Negotiations Committee (TNC) after the failure of the Brussels Ministerial Meeting in 1991. There is no doubt in my mind that without the so-called Dunkel Text, it would have not been possible to conclude the Uruguay Round.

It is also worth noting that each “subsidy round” had a promoter, namely a delegation that acted as a driving force, strongly pressed for more developed international rules on subsidies and was prepared to “pay”, to some extent, for more disciplines in the use of subsidies. It so happens that in all three “rounds” discussed above this role was assumed by the United States. In the Tokyo Round, the US payment was the injury test and in the Uruguay Round, further changes to the anti-dumping and countervail rules.

The negotiations in the Doha Round did not generate any new negotiating process. One may have the impression that the process used in most areas resembled the process widely used in the Havana Charter negotiations and, therefore, could not meet the requirements of the totally different WTO negotiating environment. The Chairman’s text process, so successful in the Uruguay Round, had been

used by Chairman Valles in the Rules negotiations and Chairman Falconer in the Agriculture negotiations but was not supported by the Chairman of the Trade Negotiations Committee, who did not use it at the TNC level. Furthermore, there was no promoter, in particular in the subsidy negotiations.

Perhaps it would be useful to analyse how these two factors, namely negotiating process and the role of the promoter, influenced the dynamics and results of the negotiations. It might also be useful to learn more about what the negotiators in the Tokyo Round and the Uruguay Round had in mind and what was behind some ambiguous language in both of the resulting agreements. It is even more important to do so given that the only real negotiating history of the Tokyo Round (in particular) and of the Uruguay Round is in the heads of very few people still left around. It would, therefore, be important to get a move on to download from them.

Forces that (may) Have Shaped Subsidy Regulation

Hugo Paemen¹

Governments' Approaches to Subsidies and Subsidy Disciplines

Extensive reading material indicates that the path followed by governments in international negotiations on subsidy regulation in foreign trade and the decisions by the same governments implementing their subsidy programs have not always been in full harmony. This seems particularly the case for policy commitments through multilateral agreements in the GATT or its successor organisation the WTO. Historic overviews going back to the unfortunate Havana Charter tend to qualify the discussions in this sector over the years as “slow”, “hesitant”, “arcane”, “inefficient”... and the like.

Apart from the inherent complexities of multilateral economic negotiations in general, it is likely that, at the two levels, independently of the possible ideological orientation of the decision-makers, a certain degree of ambivalence typifies governmental attitudes towards subsidies and countervailing measures.

Since subsidies have been discussed between governments, the gradual recognition of a systemic contradiction between the allowance of specific, direct financial governmental support for exports and the principle of open and free competition between market economies has been a constant theme. “Specific” export subsidies have been generally condemned, with some leniency for the agricultural sector. But uncertainty remains, when the question is about domestic governmental support of goods (and services, investment) that can also possibly be, totally or partially, exported. That’s where the arcane discussions, sometimes tucking in unambiguous interests, usually take over. Ill-defined categorising in “prohibited”, “actionable”, “non-actionable” (or: red, amber, ‘dark amber’, green, in the so-called ‘traffic light’ presentation), “specific”, “trade distortive”, “import substitution subsidies”, etc. did not always have an elucidating effect, especially when contested measures had to be justified or rejected. And defining the rather unusual “right to countervail” under certain conditions has been a continuing challenge.

It is likely that the implementing practice reflects the ambivalence that haunts the trade policy makers. Therefore, it is advisable that a study of the subsidy and regulatory activity of the main trading partners over the last decades should, beyond the textualising, take a more comprehensive view and also cover their underlying economic, political, social, military, security and sovereignty motivations, the roles governments want to play in the economy, their possible ideological orientations, the pressure from economic and political circumstances and the influence exercised by stakeholders.

Subsidy and State Aid laws are driven by the recognition that, also in a market economy, governments, federal or local, can feel obliged, and would be allowed, in certain circumstances, to actively support, financially or otherwise, some economic activities they consider to be in the general interest of the country.

By nature, any allocation of part of the budgetary resources of a country is a highly political decision. This means that it supposedly reflects the overall approach of the government on the matter at stake. At the same time, politics being the art of the possible, the decision will be dependent on the short- and long-term opportunities and limitations of the decision-making process that has to be followed.

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Subsidy Policy-Making and Regulation: Forces Likely at Work

As far as national and international subsidy policy-making and regulation are concerned, it is not illusory to think that, in some cases, and the following (amongst other) forces, beyond the legal “formatting”, are or may have been at work:

- i) The divergent and evolving views that governments have on their involvement with the economic, industrial activity in their country, including trade policy and possible subsidies. A substantial variety of attitudes, from liberal hands-off to more active strategic approaches, have been implemented over time. It is well known that in this respect the main founding fathers of the GATT (US and UK) leaned to the liberal side.
- ii) The changes in the global and regional economic growth affecting all or individual countries. The post- World War II economic expansion was followed by stagflation, the oil crisis, the floating exchange rates and the concomitant recession in the 1970/80s, leading to a “new protectionism”. American and European governments supported sunset (steel, shipbuilding...) as well as sunrise (aircraft, IT...) industries. Some promoted “managed trade” or some form of “strategic” trade policy, which, as we also see today, are recurring themes in times of low growth and unemployment. Then, the magic of an expanding globalisation, under a reassuring Washington Consensus, produced a bouquet of “bubbles” which lead to the 2008-11 crisis. General feelings towards government involvement and responsibility must have gone up and down in these successive phases, not without some impact on the policy-makers and regulators.
- iii) The relative political and economic weight and leadership by individual countries in general or on specific issues. The US initiated the multilateral trade rounds from the first to the Uruguay Round, but not the still ongoing Doha Round. The EC/EU has generally been a reluctant follower, mainly because it was held back by its agricultural constituency. Japan, the newly industrialised countries and other emerging and developing countries became active traders and co-authors of the agendas for international economic negotiations.
- iv) The action, authority and relevance of international organisations, agreements (multilateralism, United Nations, GATT, WTO, Marshall Plan, bilateral and regional agreements, OECD, EU...).
- v) The action, influence of individuals (Kennedy, Reagan/Thatcher, Michael Cartland, GATT/WTO Directors General, independent experts...).
- vi) Action and/or absence in the discussions and negotiations of organised stakeholders (agriculture, sunset and sunrise sectors, intellectual property, services, investments...). The absence of services and investments, together with the over-representation of agriculture led to a disproportionate streak in the negotiations until recently.
- vii) The increasing importance and complexity of the global supply chains, with a growing loss of autonomy of trade policy in the economic policy of individual countries. Instead of mainly dealing with exchanges of primary goods and manufactured products, international trade has become, as a result of the fragmentation of the production processes, increasingly an exchange of intermediate goods, but also of services, ideas, technology, capital, labour. It has become trade in value added under different forms.²
- viii) The negotiation techniques applied in bilateral and multilateral fora (rounds, “main suppliers”, “single undertaking”...).
- ix) The action and relative weight of state-owned enterprises/multinationals and unregulated sectors.
- x) Domestic policy/constitutional issues (national political constituencies: Presidency – Congress competencies in the US; Commission – Member States in EU, ...).

² See, e.g., B. Hoekman, ‘Subsidies, Spillovers and the Trading System’, in this e-book.

Negotiating Subsidies in the Gatt/WTO: The Tokyo Round and the Uruguay Round

Gerard Depayre¹

A Historical Perspective

Since their introduction in the GATT 1947, rules on subsidies and CVDs were successively amended, expanded and reinforced by the 1954-1955 Review Session²; the 1960 Declaration (Declaration Giving Effect to the Provisions of Article XVI:4 of the GATT); the Tokyo Round Subsidies Code, a plurilateral agreement accepted by 24 of the GATT contracting parties (members); and, lastly, by the WTO SCM Agreement.

This slow, difficult and sometimes hesitant evolution towards more precise and stricter disciplines regarding the use of subsidies and countervailing measures reflects the differences of interests and philosophy that have from the very beginning opposed GATT members on these matters. In this respect, it has to be understood that each of the various stages in the development of these rules represent in effect how far the members, given their differences, were collectively able or prepared to go at the time.

Origins of the Present Rules: Articles XVI and VI of GATT 1947

These rules had two distinct objectives, namely to impose disciplines on:

- the use of subsidies (article XVI), and
- recourse to countervailing duty measures (article VI).

Article XVI, based on a much shortened and modified version of Articles 25 and 26 of the Havana Charter that never came into force, and which, initially, only provided an obligation of notification, has been progressively reinforced. But its disciplines were limited to subsidies having the effect of “increasing exports”. Moreover these disciplines were weakened by the conditions attached to them and the reserves put by certain GATT signatories. For example, the prohibition of export subsidies was subject to the condition that the export price of the subsidised product be lower than that practiced on the domestic market.

Thus, Article XVI, even though it was invoked with success in some GATT cases, imposed weak disciplines. The only effective recourse was countervailing duties, but with the limitation that they only apply to the correction of damages caused by imports on the market of the complaining industry.

The 1979 Subsidies Code

This situation led GATT members to negotiate in 1979 – on the model of the Agreement on Anti-Dumping Practices concluded in the Kennedy Round, an Agreement interpreting Articles VI, XVI, and XXIII of GATT, with the objective of elaborating and reinforcing disciplines on subsidies. The objective was also to obtain from the US a commitment that it would no longer maintain the possibility which it had until then, and which it made use of until 1974, to impose countervailing duties without a demonstration of injury.

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² Ninth Session of the GATT Contracting Parties.

Besides getting rid, in the drafting, of conditions that weakened Article XVI, the main innovation was to create, or, more precisely, to formalise – in addition to the possibility of resorting to CVDs – a multilateral track to obtain remedies against subsidies having adverse effects on the interests of other signatories (i.e., effects on the market of the country granting the subsidy - import substitution, on third countries markets - export displacement, or on the market of the importing country - material injury).

Such possibility already resulted in principle from Articles XVI and XXIII, but this new agreement had the merit of formalising it and making it operational. The 1979 Agreement thus represented an important step forward in the direction of the clarification and reinforcement of disciplines on subsidies.

Negotiations on Subsidies in the Uruguay Round

Punta Del Este: The Launching of a New Negotiation on Subsidies and Countervailing Measures

But the US soon found that agreement to be insufficient, considering that the absence of definitions of key concepts like those of subsidy and serious prejudice rendered it largely inoperative. In 1986, when it was decided to launch a new round of multilateral negotiations, the US thus made the reinforcement of disciplines on subsidies, and more particularly on agricultural subsidies, one of their priority objectives.

The EU, for its part, was far from enthusiastic about new negotiations on these topics, particularly on agricultural subsidies, and many in Brussels thought that such negotiations were doomed to failure. However, given the very large range of subjects covered in this round, it would have been very difficult to resist the inclusion of subsidies in the negotiations.

It is in these circumstances that it was decided in Punta del Este to renegotiate the 1979 Subsidies Code. Along with the negotiations on agriculture, these negotiations were to prove the most difficult and controversial in the Uruguay Round.

Initial Negotiating Positions

From the beginning, two camps with sharply diverging views, confronted each other:

- The US wanted a draconian reinforcement of disciplines regarding the use of subsidies – their initial request was a general prohibition of subsidies on the ground that all subsidies distorted trade and had adverse effects on the interests of other signatories.
- For the EU and the countries sharing its position (Nordic countries, Japan, Switzerland, and, to a certain extent, with different objectives reflecting their specific interests, developing countries), subsidies were important instruments of economic, social and regional policies which States should be able to continue using.

In addition to these ideological differences, there was a deep disagreement as to whether a revised Agreement should or should not apply equally to agricultural subsidies.

Negotiating Process

For 4 or 5 years, negotiations consisted exclusively of exchanges of theoretical arguments on the effects of subsidies, without any progress. As an example participants will remember a meeting that was entirely devoted to a discussion on whether the negotiating mandate of the group should be “large” or “broad”.

At a certain point it had thus become evident

- That negotiations were not going anywhere,
- but also that a failure would have disastrous consequences for the Round as a whole, the US considering a revision of the Subsidies Code as an indispensable element of an acceptable package. Moreover, the fate of negotiations on agriculture and on civil aircraft were also linked to these negotiations.

To extract negotiations from this impasse, the President of the negotiating Group, Michael Cartland, with the active support of the WTO Secretariat, decided to present under his own responsibility a text attempting to put together, in the light of the discussions within the Group, what he felt could be the basis of an agreement. From a series of revisions of the initial text, eventually emerged the compromise on the basis of which agreement was reached.

The Deal

The deal can be summarised as follows:

- Reinforcement of disciplines on subsidies and of the multilateral avenues of recourse against subsidies.
- In exchange for what:
- States keep the possibility of granting subsidies, other than export subsidies and subsidies contingent upon local content, as long as the subsidies concerned do not have adverse effects on the interests of other signatories.
- Developing countries benefit from lesser obligations regarding subsidies in accordance with their level of development.

Disciplines on subsidies and multilateral avenues of recourse against subsidies are reinforced through:

- A precise and exhaustive definition of the concept of subsidy.
- The reinforcement of the provisions concerning the most trade distortive forms of subsidies which are prohibited:
 - Subsidies contingent upon the use of domestic over imported goods (local content requirement) are added to export subsidies, the definition of which is made more precise and thereby enlarged.
 - The prohibition is without condition: prejudice no longer needs to be demonstrated. Consequently when a subsidy is found to be prohibited, the signatory granting the subsidy has an obligation to withdraw it.
- Regarding actionable subsidies – that is all the subsidies other than the prohibited ones – which are allowed as long as they do not cause adverse effects, the definition of serious prejudice – one of the forms of adverse effects – is made more precise, and the demonstration by the complainants of such effect is made easier. It is made easier not only by the greater precision of the criteria of prejudice, but also by a certain bias in these criteria clearly intended to facilitate demonstrations of prejudice. This is obvious in Article 6.1 – since expired – which created a rebuttable presumption of serious prejudice for certain type of subsidies considered as particularly distortive, in particular those exceeding 5% of the value of a product. In Article 6.3, stipulating the circumstances in which a determination of serious prejudice can be made, there is – in contrast to the dumping and CVD contexts – no specific provision requiring an explicit demonstration of causality between the effect of the subsidy and the prejudice, suggesting that causality is more or less presumed. Also, undercutting is equated to serious prejudice.
- For the EU, this represented significant steps in the direction of the US. Indeed, the initial position of the EU was quite defensive. The primary reason for it was the fear that reinforced disciplines

could be transposed to agriculture. With respect to the industrial sector, although the EU had an internal control of State aids and should have thus been more forthcoming, its attitude was also defensive. One reason was that the Commission services were not totally certain of the exact levels of subsidisation received from particular industries benefited, and thus of their vulnerabilities to US attacks. There was also a fear that new WTO rules could come into conflict with the EU State aids ones.

But domestic subsidies remain permitted and some are exempted from discipline.

For the US, this represented an important retreat from their initial negotiating position:

- First, by giving up the idea that they defended, or at least pretended to defend, for most of the negotiations, of a complete prohibition of all subsidies.
- Then, by giving up their fallback position, failing such a radical solution, to extend the category of prohibited subsidies to domestic subsidies considered as particularly distortive, such as subsidies to cover operating losses, etc. Such extension would have put into question the principle according to which domestic subsidies were only objectionable and liable to remedial measures when they had adverse effects on the interests of another or other signatories. On this point, however, the US obtained, as a compromise, that there would be a rebuttable presumption that particularly distortive subsidies cause serious prejudice (Article 6.1).
- And lastly, by accepting at the very end of the negotiations and after 7 years of obstinate opposition, a green list of subsidies exempt from disciplines, thus not attackable. Such exemption was however subject to very restrictive conditions. Given the reluctance of some of the members to Article 6.1 and of others to the green list, it had been agreed, as part of the final compromise, that both provisions would expire after 5 years if they were not renewed by explicit agreement of all the signatories (consensus).

The Result: An Improved Set of Rules

- Thus, the WTO SCM Agreement significantly improved existing rules on a number of key aspects: Precise definition of the notion of subsidies and of the notion of serious prejudice; elaborate and precise criteria and procedures for determining the existence of such prejudice; reinforcement of disciplines, including through a strengthening of the notification obligation; special and more lenient regime for the developing countries under which their obligations were linked to their level of development. In sum, reinforced and more operational disciplines.
- By the reinforcement of disciplines and the more operational possibilities of recourse to the WTO dispute settlement mechanism, the SCM Agreement considerably improved the tools at the disposal of States to obtain redress against harmful subsidies.
- Another important and positive feature of the SCM Agreement – in its initial version – was the differentiated treatment applicable to subsidies depending on their presumed effects. To this end, four categories were identified: prohibited subsidies; domestic subsidies that are particularly distortive, and to which is attached a presumption of serious prejudice; other domestic subsidies, which can only be subject to remedial action when they cause adverse effects to other signatories; and green subsidies which are exempt from remedial action if they meet certain restrictive conditions. This categorisation constitutes a recognition of the reality that there are significant differences between subsidies – that some are clearly more distortive than others and that some serve important objectives and have benefits outweighing their distortive effects. Rather than dodge once again an issue, which from the very beginning has been at the centre of discussions and negotiations on subsidies, the SCM Agreement negotiators had thus chosen to address it in a constructive manner.

But in Practice Results Have Not Been Up to Expectations

- While the SCM Agreement thus brought significant improvements to subsidies rules, negotiators could only go so far in the reinforcement and elaboration of disciplines as what was, at the time, collectively acceptable to the membership. That left weaknesses in the system, which, after 20 years, are now clearly apparent.
- Regarding the enforcement of disciplines on trade in goods, contrary to expectations or fears, the new rules, while they have been the basis of emblematic dispute settlement cases, have been relatively ineffective to contain subsidisation due to a combination of factors: failure of the notification system; difficulties in the measurement of benefits leading to serious disagreements over the interpretation of rules; and perhaps above all, the reluctance of countries to invoke WTO rules against other countries for fear of counter attacks against their own schemes, as this was illustrated during the recession of 2008/2009 regarding the massive subsidies granted to car industries.
- The SCM Agreement did not lead to better disciplines in the area of fisheries where the standard test for action – adverse effects of subsidies on trade – is not relevant; nor was it able to respond to the problems posed by subsidisation in the energy sector where it has been ineffective against the massive subsidisation of fossil fuels and unadapted to the situation of the renewable energies sector.
- A grave weakness in these disciplines is the absence of rules applicable to the subsidisation of services – an area left to the negotiators on services who, to this day, have been unable to come to any agreement. Given the place now occupied by services in modern economies and the increasing share that they take in manufacturing activities, this creates an enormous loophole in the system.
- Finally, Article 6.1, which could have been an efficient tool in enforcing stricter disciplines on the most egregious forms of subsidies, was, like the green list, left to expire.
- To correct these shortcomings, but also to adapt it to an environment that has considerably changed in 20 years, the SCM Agreement thus now needs to be amended and updated. In particular, the massive injections of aids that took place during the 2008/2009 financial and economic crisis and the proliferation of new forms of subsidisation seriously put into question the adequacy of existing disciplines.

Lessons to be Drawn from 20 Years Experience

- One should not expect that future rules will be negotiated in the same configuration as was the SCM Agreement. Emerging countries that had a limited input in the definition of general disciplines now have the resources to subsidise and increasingly do so. They will consequently have an increased stake in the elaboration of new rules and will want their say. This will further complicate negotiations that have always been very controversial, all the more so if, as Mr. Koulen fears, there is no longer in the WTO what he calls a K-group,³ that is the minimum number of players needed for self sustaining cooperation.
- The path opened by the SCM Agreement in establishing different treatments for different categories of subsidies depending on their effects should not be abandoned, but restored to its original format and further developed. Disciplines will only be adhered to, and lead to a change of behaviour on the part of States, if they closely reflect the realities of the very diverse universe of subsidisation, and take account, in the treatment of subsidies, of their particular effects and objectives. To treat in the same way subsidies meant to serve environmental goals, promote renewable energies, stimulate research and, on the other hand, subsidies that compensate operating losses or subsidies to fisheries that contribute to the depletion of natural resources makes no sense and can only weaken the authority of rules that are too lenient regarding certain subsidies and too harsh on others.

³ See, in this e-book, M. Koulen, 'Reflections on the SCM Agreement'.

- Subsidy rules, given the way in which they have been elaborated over the years, need periodic updates. So does the SCM Agreement. Its most glaring and damaging shortcoming after 20 years, besides the absence of rules on subsidies to service industries, is the failure of the notification procedure. An effective notification system is a prerequisite to well functioning disciplines. How could it be possible to regulate practices without knowing them precisely? How can practices violating the rules be challenged if States not only do not notify them, but also do all they can to dissimulate them?

Also in need of improvements are the definition of subsidy, which on some points (definition of public body, *de facto* specificity) should be made more precise, and the criteria to calculate benefits. Articles 6.1 (particularly distortive actionable subsidies) and 8 (non-actionable subsidies) should be restored, improved, strengthened, and complemented by illustrative lists.

Multilateral procedures against subsidies should be made lighter, faster with increased recourse to mediation or arbitration. In general, they should be made more user-friendly and there should be reflections on the possibility, with some precautions, of direct access of private parties to the dispute settlement mechanism.

As to the absence of rules on subsidies to service industries, it creates an enormous gap in subsidy disciplines that needs to be corrected if such disciplines are to remain relevant. In this respect, experts tell us that there is insufficient data on subsidisation in this area to be able to develop adequate rules. This brings us back to the issue of collection of data and to the need for a properly working system of notification.

A Negotiator's Perspective on Enhancing Subsidies' Disciplines

Terry Collins-Williams¹

I am approaching the question of what shapes subsidy disciplines from the perspective of an international trade agreements negotiator (specifically in the context of the WTO Agreement on Subsidies and Countervailing Measures), and as an official who oversaw the implementation of this Agreement into national law.

The Subsidies Conundrum

The treatment of subsidies presents a basic dilemma in international rule-making. On the one hand, subsidies can be an effective tool with which governments can accomplish legitimate policy objectives. On the other, they can distort terms of competition both in the territory of the government which provides them, and more problematic from the international perspective, in markets to which the subsidised products are exported.

There is always a balance to be struck domestically for any government in deciding to use a subsidy. What may be a preferred instrument among available means of intervention, both from the point of view of economic efficiency and to achieve the clearest political impact, may run afoul of fiscal realities and must be circumscribed so as to avoid claims from other players in the domestic economy.

Having worked through the domestic policy minefield, governments then face the international dimensions. Subsidies can create some of the most obvious spillover effects on trading partners. While governments have a collective interest in co-operating to limit the adverse effects on trade, they also have a legitimate interest in seeking to influence economic activity within their jurisdiction. Thus we arrive at one of the clearest examples of tension arising in international trade negotiations: the exercise of national sovereignty over politically charged domestic policy determinations coming into conflict with the achievement of optimal economic conditions for the conduct of trade.

This has a compelling effect on negotiating dynamics, as demonstrated in the negotiation of the SCM Agreement in the Uruguay Round. Those from North America will recall that these negotiations took place in the midst of the interminable subsidy/countervailing duty disputes over softwood lumber between Canada and the United States. At stake was the lucrative timber frame construction market in the United States versus resource pricing policies and practices of more than one layer of government in Canada. Given the significant economic and political stakes, neither US nor Canadian negotiators, nor their political masters, could tolerate an outcome which could deliver a knockout blow to the positions they had advanced or would be advancing in the myriad of multilateral, bilateral and national subsidy and countervailing duty challenges that had been or would be mounted. These presented issues that were addressed directly in negotiation of the language of the SCM Agreement regarding the definition of subsidy, in the crafting of Article 14 dealing with the calculation of the amount of the subsidy, and elsewhere in the Agreement.

As frequently happens in negotiating deadlocks of this type, negotiators resort to the concept of creative ambiguity in which both sides can interpret the outcome as favouring, or at least allowing for the possibility of their position winning the day. Of course, as we all know, this happens at the expense of textual precision, leaving future dispute settlement panelists puzzled as to the intended meaning of provisions in the agreement in question, and sometimes coming up with novel interpretations which neither side might have foreseen nor welcomed.

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The Role of Transparency in Subsidies Disciplines

If governments are not going to be able to arrive at an understanding which perfectly captures the optimal extent of international subsidies discipline while allowing those same governments what they see as the necessary policy space to manage their own economies, what other approaches might be useful? From the outset of subsidy negotiations and agreements in the GATT, transparency has been a primary tool to promote subsidies discipline. In its original form, GATT Article XVI was based on a notification obligation. Contracting parties maintaining a subsidy were required to notify the extent and nature of the subsidisation, its estimated effect on the quantity of the affected product imported or exported from its territory, and the circumstances making the subsidisation necessary.

During the Tokyo Round negotiations, participants recognised that the Article XVI notification obligation had not worked. In consequence, negotiators attempted to make the notification provisions more effective by giving a Party the right to request information from another Party about a subsidy. In the event of insufficient response, the questioning Party could bring the matter to the attention of the Subsidies Committee.

The Uruguay Round SCM Agreement expands the notification obligations of WTO Members. Article 25 sets out detailed conditions for the annual notification by a Member of any subsidy granted within its jurisdiction falling within the scope of the subsidy definition in the Agreement. Article 26 then mandates the WTO Subsidies Committee to examine these notifications on a regular basis. After the entry into force of the ASCM, the new Subsidies and Countervailing Measures Committee designed a questionnaire for subsidy notifications and established procedures for the annual Committee review of notifications.

Unfortunately, these transparency provisions cannot be said to have worked. WTO Members, including many of the largest developed Members were, and some continue to be, woefully deficient in meeting their notification obligations. In 1999, only 7 of the largest twenty WTO Members met their notification obligations on time. In 2005, that record improved to only twelve of the top twenty-one. Part of the problem lies with the terms of the notification provisions – the SCM Agreement is silent on quantification and measurement standards. Another issue relates to the office responsible for notification within a WTO Member, likely within the Treasury or Trade Ministry. These officials may be remote from the myriad of domestic agencies (and within federated states often at different levels of government) who design and administer support, and who have little incentive to provide information to the WTO in the form and detail required by the SCM Agreement. Notification will not work if officials are asked to provide information without knowing the consequences of the use to which that information might be put.

If transparency is determined to be one of the essential tools for the enhancement of international subsidies discipline, and I firmly believe that it is, what might be done to improve the gloomy record produced to date. A paper that I wrote with Bob Wolfe of Queen's University (Ontario) in 2010 looks at notification provisions in other WTO Agreements and makes a number of suggestions.² Among them, assisting those Members who require it to understand and have the capacity to meet ASCM notification obligations. The WTO could expand third-party notification of subsidies and perhaps draw upon the resources of other international organisations (e.g., the OECD and World Bank), as well as some non-governmental organisations which have accumulated detailed information on subsidies practices.

What is clear is that without improved data on the extent of subsidies directed to goods, it will be impossible to move forward on an agenda to enhance existing subsidies disciplines, and to consider expanding to trade in services.

² T. Collins-Williams and R. Wolfe, 'Transparency as a Trade Policy Tool: The WTO's Cloudy Windows', *World Trade Review* 9/4 (2010), 551-81.

Subsidy Control in the GATT / WTO: The System in Action

Subsidy Control in the GATT/WTO: Surveillance and Litigation

William J. Davey¹

My main experience with subsidy control in the GATT/WTO has arisen from my involvement as a panelist in cases involving subsidies and my role as an occasional advisor to panels dealing with such cases while I was Director of the WTO Legal Affairs Division (1995-1999). As such, my experience is somewhat limited compared to those contributors who have been involved in shaping the GATT/WTO rules for decades. Nonetheless, I offer a few thoughts on how effectively the WTO rules seem to control subsidies today through surveillance and litigation.

The SCM Agreement broke new ground by providing for a relatively detailed definition of subsidies. Article 1 specifies that for a subsidy to be subject to the SCM Agreement, it must arise from a “financial contribution” (examples are given) by a government or a public body, which confers a “benefit” and which is “specific”. The interpretation of “public body” has proven to be problematic and remains somewhat unsettled, at least in my mind. While it makes sense to interpret “benefit” in terms of the advantage that the recipient receives, it is worth noting that this may raise difficult issues of proof, especially when it is necessary to define the interest rate available to an entity in the market since market rates vary and precisely comparable loan agreements may not be available. Otherwise, the definitions introduced by the SCM Agreement have been appropriately interpreted. It is worth noting, however, that they do narrow the range of government support that might appropriately be considered subsidisation subject to WTO control by requiring specificity and a financial contribution.

As to surveillance, Article 25 of the SCM Agreement requires periodic notification of subsidy programs. While this provides useful information and may facilitate committee discussions of subsidy issues, it has always seemed to me that many of the notifications are relatively incomplete. My experience with this aspect of the SCM Agreement is rather limited, but I understand that one benefit that increased transparency has provided is that it has probably made WTO Member governments more concerned with structuring subsidy programs so as to avoid using prohibited subsidies.

As to the use of the WTO dispute settlement system to control subsidies, the SCM Agreement takes two approaches. First with respect to (i) prohibited subsidies, defined as subsidies contingent on exportation or use of domestic goods over imported goods, and (ii) certain actionable subsidies, namely those that cause “adverse effects” to the interests of another WTO Member; these subsidies may be challenged in WTO dispute settlement. The burden is on the adversely affected WTO Member to initiate the dispute settlement process and prove its case, with the panel deciding the facts as well as applying the legal principles. Second, with respect to any subsidised imports that cause material injury to its relevant domestic industry, a WTO Member may apply countervailing duties pursuant to the rules and procedures specified in the SCM Agreement. The WTO dispute settlement system comes into play if it is claimed by the exporting WTO Member that those rules and procedures were not followed. The burden here is on the Member whose exports are concerned to prove its case. How have these rules been used in WTO dispute settlement?

Export Subsidies

Turning to export subsidies,² there have been relatively few cases, and for the most part, these cases date to the early years of WTO dispute settlement (although the two recent cases involving Airbus and

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² I will say little about domestic content subsidies since they have not figured prominently in cases brought under Article 3 of the SCM Agreement.

Boeing are certainly not insignificant). The definition of an “export subsidy” is one contingent “in law or in fact” upon export performance. With respect to a *de facto* export subsidy the agreement specifies that, in deciding whether the required contingency exists, “[t]he mere fact that a subsidy is granted to enterprises which export shall not be for that reason alone be considered to be an export subsidy”.³ As interpreted by the Appellate Body in the *Airbus* case, I think that it will be difficult to establish the existence of *de facto* export subsidies, absent the facts needed to satisfy the Appellate Body’s interpretation of the provision. Thus, Article 3 may well be used mainly to challenge *de jure* export subsidies.

There have been five main export subsidy cases to date that succeeded.⁴ Three of the cases concerned Canadian and Brazilian subsidies to their regional aircraft producers. The subsidies were not removed, and although both countries obtained authority to take retaliatory action against the other, they never did so. The other two cases were *US – FSC* and *US – Cotton*, and in both cases the objectionable US law was eventually changed after retaliatory action was taken or seriously threatened. All told, I suspect that the prohibition on export subsidies may have changed the practices of some export credit agencies, but has not otherwise had a major impact to my mind.

If an export subsidy is found, the remedy specified in the agreement is that the subsidy be “withdrawn” without delay. Since WTO remedies are considered to be prospective, this raises a particular problem. It would seem to preclude requiring repayment of subsidies already received.⁵ This further limits the usefulness of the export subsidy prohibition, although obviously it continues to be useful in the case of ongoing subsidy programs that will provide future subsidies. I would note that the ability of arbitrators to authorise the imposition of “appropriate countermeasures” may to some degree mitigate this problem, but any countermeasures not tied to trade effects, whether calculated separately or based on the amount of the subsidy at issue, would be controversial.⁶

Serious Prejudice

Article 5 of the SCM Agreement defined a new category of “actionable subsidy”,⁷ including any subsidy that causes serious prejudice to the interests of another WTO Member. As defined in Article 6, serious prejudice arises when the effect of the challenged subsidy/ies (i) is to displace or impede the complaining Member’s exports to a third country or the subsidising country or (ii) is significant price undercutting, price suppression, price depression, lost sales in a given market or an increase in the world market share of a primary product or commodity. If a WTO dispute settlement action succeeds on these grounds, then the offending country is to withdraw the subsidy or remove the adverse effects, subject to retaliatory action if it fails to do so.

There have been only a few serious prejudice cases: The principal ones have been Brazil’s case against US cotton, which was recently settled, and the *Airbus-Boeing* cases, which are forever pending.⁸ Thus, to date it must be said that the new serious prejudice rules have not had much of an

³ Note 4 to the SCM Agreement.

⁴ There were two other cases that were relatively insignificant or atypical (*Australia – Automotive Leather II*; *Canada – Autos*).

⁵ One could argue that “withdrawal” does require repayment, but when this was ordered in *Australia – Automotive Leather II*, the decision was universally criticised by WTO Members as inconsistent with accepted practice.

⁶ See *Canada – Aircraft Credits and Guarantees* (Article 22.6 arbitration).

⁷ Although also grouped under the new heading of actionable subsidies, non-violation actions against subsidies offsetting tariff bindings had long existed under GATT rules and practice.

⁸ Other cases include: The EU, the US and Japan challenged Indonesia’s subsidisation of Suharto’s son’s automobile enterprise, which was to create a national Indonesian car. After the Suharto government fell during the pendency of the case, Indonesia seemed to lose interest in it. The other case involved an unsuccessful challenge by the EU in respect of certain Korean shipbuilding subsidies.

effect, except that Brazil received some compensation from the US in the *Cotton* case. I suspect that there will be more cases from time to time in the future, but the experience to date may discourage such cases. It would appear that such cases require a great deal of economic analysis in order to establish the requisite effects of the challenged subsidies in the relevant markets. In addition, the subsidies and the market effects must be shown to have a “genuine and substantial relationship of cause and effect”. This test, which has been carried over from cases under the Safeguards Agreement, has proved to be rather problematic in those cases. Thus, there are real difficulties and considerable expense involved in bringing a serious prejudice claim. The record to date suggests to me that there will not be many, and hence I tend to think that this new provision has not had much effect on controlling subsidies. Indeed, in the aircraft cases, even though the US and the EU have in theory a much better idea of what might lead to a serious prejudice finding, subsidisation continues.

I would note that the remedy in adverse effects cases, including serious prejudice cases, is the withdrawal of the subsidy, as in export subsidy cases, or the removal of the adverse effects. The latter, while adding flexibility to this provision, also raises very difficult issues in the later stages of WTO dispute settlement. What does it mean to remove the adverse effects of a subsidy that was granted years ago? If retaliatory authority is sought, there are difficult calculation issues presented.

Countervail Actions

The SCM Agreement authorises the imposition of countervailing duties on subsidised imports that cause material injury to domestic industries to offset the amount of subsidy on the imports. The United States was and remains the main user of this trade remedy, but since the advent of the WTO, the use of countervailing duties has become more widespread (although nowhere near as much as the use of antidumping duties). For a country wishing to take action against the effects of subsidies in its own market, the use of countervailing duties is a more direct route to take than challenging subsidies at the WTO, since its own national authorities determine the amount of subsidisation and injury, and the remedy is a border tax on the subsidised imports, with, presumably, consequent market effects. It is not, of course, useful against subsidies that adversely affect a nation’s exports.

Challenges to Members’ countervailing actions have become common in WTO dispute settlement. The difficult issues seem to involve the definition of subsidies (i.e., what is a public body; treatment of state-owned enterprises) and causation. In many cases, panels and/or the Appellate Body have found the causation analysis of investigating authorities, and, in particular, the non-attribution aspect thereof, to be deficient. This problem of how to establish causation, of course, is a general problem across WTO dispute settlement in respect of trade remedy and subsidy cases. However, in respect of countervail actions, since WTO dispute settlement takes several years to produce a result, the fact that a countervailing duty may at some time in the future be found to be invalid because of a flawed non-attribution analysis, does not preclude its effectiveness in alleviating harm caused to domestic competitors in the meantime. Thus, countervail actions provide a direct means of controlling the injurious effects of subsidised imports.

Summary

Based on what I have observed in dispute settlement cases, I would say that the relatively few cases and difficulties in establishing the prerequisites for relief in export subsidy and serious prejudice cases mean that those provisions of the SCM Agreement have not had a major impact on the control of subsidies. The countervail provisions, on the other hand, since the investigation is initiated and controlled by national authorities are a more direct device for protecting a WTO Member’s domestic producers from injury caused by subsidised imports, notwithstanding the fact that such actions may eventually be found to be inconsistent with WTO rules.

How Subsidies Rules Have Been Shaped

Gary N. Horlick¹

Visible cash. Perhaps it is the sight of cold hard cash which attracts so much more rulemaking attention than equivalent amounts of other government action (or inaction). This is borne out by the wording of the first US countervailing duty statute, enacted in 1890, imposing a duty to offset any “bounty or grant”, which certainly sounds like a direct cash payment. It is also noteworthy that that first CVD law was aimed solely at bounties or grants given to sugar, which had also been the subject of perhaps the first multilateral subsidies discipline negotiations, the Brussels sugar talks, while there was no similar movement at the time to lower steep tariffs on sugar. Or perhaps it was a patriotic or constitutionalist defense of those tariffs - the new US CVD law was enacted to offset a system of cash grants set up by czarist Russia to exactly equal the US sugar tariff, so the US Congress arguably was only defending its prerogative to impose tariffs. This fixation on the cash payment may also explain why the doctrine of "specificity" is so counterintuitive, since it allows that financial flow if it goes to more people!

A related force that shaped the development of subsidy rules was **the increase in the amount of money being spent**. As large amounts of money were channeled into subsidies in the US and Europe for agriculture, those “primary products” became the subject of the first serious GATT rules on subsidies (“primary products” meant mainly, though not exclusively agriculture – no one was subsidising exports of oil or iron ore, for example). Similarly, the large inflows of government cash into domestic industrial plants after World War II and into the 1980s shifted the focus of trade policy makers from the focus on export subsidies to include large internal subsidies.

Ideology played a role as well; the SCM Agreement came at the apogee of Reagan-Thatcherism. This can be seen in the very strict limits placed in the definitions of “permissible” subsidies that, in any event, were only finally added after the election of Clinton, a pro-subsidy US president.

Institutional factors have played a role too. Subsidies have almost always been treated as a trade problem, probably because every government gives them and the people who receive subsidies internally are quite reluctant to do without. (I've seen this personally, some of the most vocal critics of foreign subsidies defending their right to receive subsidies at home, or, in the memorable words of the Chief Executive Officer of one America's largest steel companies, “but we don't get subsidies, we get tax breaks.”)

As noted, the first formal rule in response to subsidies was protection in the form of a countervailing duty. The lead negotiators for the US and EU in the SCM Agreement both had significant experience in trade remedy enforcement. Against this background, it is hardly surprising that the system for imposing countervailing duties produces most of the activity in the system of discipline of subsidies within the WTO. At a more detailed level, this means that CVDs are often treated the same as antidumping, despite the obvious huge differences in concepts, with the identical language for injury and causation, for example, which is laughable unless the purpose of CVD is protection, not subsidies discipline. At a higher plane of thought, it is also not surprising that there is a greater number CVDs, which favors large market countries (which have markets worth protecting, over small home markets for which a CVD would be useless strategically), than WTO subsidies cases.

Contingent factors played a role in shaping the details of the system. The United States proposed significant disciplines on domestic subsidies, as well as export subsidies, for the 1979 Tokyo Round

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Subsidies Code, but the US proposals mostly were watered down into exhortation.² Undaunted, the US Congress – in negotiations bookended by the 1974 Lockheed bailout and the 1979 Chrysler bailout – made CVD investigations on private petitions of domestic subsidies mandatory (until then Treasury in 99 percent of all cases had refused to investigate them), backed up by very short deadlines and strict judicial review, and moved jurisdiction from Treasury to the Commerce Department on the assumption that the latter would be protectionist (which did not occur for six years). This more or less guaranteed a large number of cases in cyclical industries as soon as the business cycle turned south. Curiously, despite a mild recession in 1980, the heavily protected US steel industry (which faced very subsidised competition from some countries, but which itself was considerably more subsidised than an equal number of countries) chose not to file CVD cases in 1980, instead relying on its tried and true friend, the antidumping (AD) laws. For whatever reason, in 1982, a flood of CVD cases started with the filing of more than 100 cases. Purely by chance, the author was head of the AD/CVD operation in the Commerce Department and I had no fixed or biased views on subsidies, having worked at a law firm that represented both domestic petitioners and foreign respondents. Even more unlikely, I'd become interested in the subsidy issues earlier (when very few lawyers cared much) through conversations with Bob Hudec in 1980 and then as chief international trade counsel at the Senate Finance Committee amid the gyrations of the world economy after the 1979 second oil shock.

I had also been convinced of the need to craft rules that would not harm US exporters in cases overseas by my immediate predecessor and by the indefatigable lobbyist for the US paper industry, who had me hauled before the (US) President's Export Council of business executives every quarter to explain why I wasn't doing more for US exporters in trade remedy cases outside the US. This concern can be seen in the "specificity" rule: USTR in 1980 had told the EU that cheap price-controlled natural gas in the US was not a subsidy because "everyone got it", and a CVD case brought claiming that cheap irrigation water for a wide variety of crops was a countervailable subsidy drove home the point. For similar reasons, we did not label as potentially countervailable subsidies the elements of a package put together in October 1980 by my predecessors for the US steel industry consisting of industry-specific relaxed (environmental) regulation, more favorable tax depreciation regulations and added import protection. A Commerce Secretary willing to take the political heat in 1982-83 also made it possible to reject claims for CVD duties based on US Marshall Plan and World Bank aid "outside the territory", government research and development, worker retraining to move industries, and so on.

More generally, the flood of CVD cases in the US, the willingness of Congress to spend the money to hire the 100-200 people to work on those cases at Commerce and the US International Trade Commission, and the coercive power of the cases, created a vast database of information on different types of subsidies far greater in number and depth than any other in the world, which served as a basis for developing the current rules.

Because of the trade focus of the Uruguay Round discussions, the current SCM Agreement focuses mainly on **harm to competitors**, rather than harm to competition or – much more important – harm to global public goods (such as fish stocks or climate) even in the absence of harm to competitors (and indeed, in the context that the competitors may be racing to deplete the relevant commons).

Which, if any, of these factors will shape subsidies rules in the future? Oddly enough, some of the stranger contingent factors may well be the easiest to repeat. For example, the current US/EU trade negotiations (Transatlantic Trade and Investment Partnership, TTIP) are going quite cooperatively, because of good personal relationships, even though the level of disagreement is just as much as the SCM Agreement negotiations. Much more important, however, the new factor, and the one that most likely will dominate the shape of future subsidy rules, is climate change. Nothing in the SCM Agreement except the defunct (and very limited) Article 8 does anything to protect global public goods *per se*. But it is quite certain that the challenge of climate change will require doing something

² This may have worked out for the best, as described below.

about subsidies which increase greenhouse gas emissions, and also subsidies which might help in that area. Since it is inevitable that something along these lines will be done, possibly by environment ministers not worried too much about WTO niceties it is important that it be done soon within the WTO, and done well!

Finally, we can expect **continued rewriting of the SCM Agreement by an Appellate Body** which clearly thinks it understands subsidies better than did the negotiators. For better or worse, the Appellate Body has been willing to create an agricultural subsidy system out of whole cloth in *Canada – Dairy*; to find nearly everything in China “specific” (a contradiction in terms); to allow national authorities to find subsidies without any actual evidence in the CVDs on Korea DRAMs (dynamic random access memory semiconductors) cases; and to delete the key words from the text of Article 14(d) in *Canada – Softwood Lumber IV*. Fortunately, the big players have won those cases, not lost, so they either quietly pocket the gains or loudly complain about any case lost.

Twenty Years of (Re)-Shaping WTO Subsidy Law by the Appellate Body and Panels

Dominic Coppens¹

Shaping WTO Subsidy Disciplines in a Nutshell: A Story of Three Bifurcations and a Dual Objective²

Under the original GATT, two instruments for reacting against foreign subsidisation were foreseen that (at that time) could help in safeguarding tariff negotiations: non-violation complaints and CVDs. Non-violation complaints could be formulated when subsidisation nullified benefits of tariff concessions in the subsidising market. CVDs could be imposed to safeguard bound tariff levels at home. However, the inability of this original GATT framework to halt subsidy competition in third countries provided the impetus for starting negotiations on disciplining export subsidies in the 1950s.

The resulting substantive disciplines (i.e., the 1955 GATT amendment and 1960 Declaration Giving Effect to the Provisions of Article XVI:4 of the GATT) put in place three types of bifurcation, all of which had already been circulating during the GATT/International Trade Organization negotiations.

First, there is a bifurcation between *export subsidies* and *domestic subsidies*. Export subsidies are, by their nature, more likely to distort trade than domestic subsidies, and are less often justified on the basis of market failures. This explains why countries have first disciplined export subsidies, and only in a later stage (and to a lesser extent) domestic subsidies.³

Second, we have a bifurcation between *agricultural subsidies* and *industrial subsidies*. As a sort of inverse special and differential (S&D) treatment, and resulting from the negotiating power of some subsidising developed countries, disciplines on agricultural subsidies are less severe than those on industrial subsidies.

Third, the final type of bifurcation is between *developed* and *developing* countries and reflects a form of genuine S&D treatment. The fact that only subsidies by so-called “large” countries hurt foreign producers and that subsidies might be a useful development tool explains why disciplines were first concluded among developed countries, and were only later gradually extended to developing countries.

All three asymmetries have gradually contracted over time, though they are still present today.

The SCM Agreement – and its predecessor, the Tokyo Round Subsidies Code – in essence reflects a compromise between two opposing forces: the United States, whose objective was more stringent rules on subsidies, and the EC and other members, whose objective was disciplining the extensive use of CVD laws by the United States.⁴ In influencing the final form of the SCM Agreement, the United States successfully advocated for narrowing the three above-mentioned bifurcations (though its position on agricultural subsidies was clearly mixed); while the other countries succeeded in curtailing the reach of CVD action by elaborating stronger procedural disciplines and defining the concepts of “subsidy” (defined more narrowly than the effect-based approach under US law) and “specificity”

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² For a more elaborated analysis, see D. Coppens, *WTO Disciplines on Subsidies and Countervailing Measures: Balancing Policy Space and Legal Constraints* (Cambridge, 2014), pp. 21-39.

³ See also Appellate Body Report, *US – Large Civil Aircraft*, para. 1253.

⁴ See GATT Committee on Subsidies and Countervailing Measures, Minutes of the Meeting held on 8 May 1980, SCM/M/3, 27 June 1980, at 4, 8.

(which according to the United States had “no economic justification” even though it originated from its own CVD laws⁵).

(Re-)Shaping WTO Subsidy Disciplines: The Role of the Appellate Body and WTO Panels

Since the birth of the WTO in 1995, subsidy law has been further shaped by the Appellate Body and WTO panels. In fact, an interesting switch happened with the establishment of the WTO: during the almost fifty years of the GATT, subsidy disciplines were developed by (certain) contracting parties (with virtually no influence of the largely inefficient GATT dispute settlement system); while, over the last 20 years, (re-)shaping of subsidy disciplines has been the result of judicial decisions. Over time, the Appellate Body and panels have learned that – with a stalled legislative branch⁶ – (re-)shaping of subsidy disciplines lies for the time being virtually exclusively in their hands.

At first sight, this virtual monopoly could have made these adjudicators reluctant to engage in any judicial activism, as any interpretation disliked by the WTO membership cannot be easily overturned by subsequent legislative action. But this does not seem to have happened. To the contrary, since the very beginning, the Appellate Body and panels have not mechanically applied the toolbox of the Vienna Convention (Vienna Convention on the Law of Treaties) and slavishly adopted the interpretation that came out of this interpretative process (as if such a mechanical application would technically be possible). More than once, decisions seem to have been guided by the adjudicators’ idea of *fairness* and systemic considerations (i.e., the implications of their decision for the broader system).

If we examine the decisions over the years, what ideas of fairness and systemic considerations appear to have guided the Appellate Body and panels in their decisions? What big picture (if any) of WTO subsidy law do the Appellate Body and panels appear to have in mind?

Recalling the three bifurcations discussed above, it seems that two bifurcations get sympathy and support from WTO panels and the Appellate Body (i.e., the different treatment of export versus domestic subsidies; and – not so clear as of yet – S&D treatment for developing countries), while the third bifurcation (i.e., the more flexible treatment of agricultural subsidies) is met with skepticism and is further narrowed.

Shaping the Scope of the SCM Agreement: Specific Subsidies

Regarding the interpretation of what constitutes a subsidy, the Appellate Body has clearly understood that the object and purpose of the SCM Agreement is not of much guidance here. Indeed, the SCM Agreement’s dual objective could be advanced to support a broad as well as a narrow interpretation of this specific subsidy definition: the objective of strengthening subsidy disciplines (pursued mainly by the United States) suggests a broad interpretation, whereas the objective of limiting the reach of CVDs (pursued mainly by all other countries) rather suggests a narrow interpretation. Hence, to paraphrase the Appellate Body, “considerations of the object and purpose of the SCM Agreement do not favour either a broad or a narrow interpretation” of the subsidy definition.⁷

Overall, panels and the Appellate Body have adhered to a rather broad interpretation – understanding that it is otherwise very easy to circumvent the rules.⁸ At the same time, they clearly do

⁵ See GATT Committee on Subsidies and Countervailing Measures, Minutes of the Meeting held on 15 October 1990, SCM/M/48, 21 December 1990, paras. 74, 76.

⁶ As is well-known, the Bali Decision made some changes in the margin to the agricultural subsidy disciplines.

⁷ Appellate Body Report, US – Anti-Dumping and Countervailing Duties (China), para. 303.

⁸ In the words of the Appellate Body, “a wide range of transactions falls within the meaning of ‘financial contribution’ in Article 1.1(a)(1)”. Appellate Body Report, US – *Softwood Lumber IV*, para. 52.

not want to go as far as a (good old US-based) effect-based approach (illustrated, for instance, by adopting a narrow interpretation of “income or price support”), as this would put too much pressure on the system and open the door for unlimited CVD action.⁹ To qualify as a financial contribution, the Appellate Body has suggested that a measure needs to have “sufficient characteristics in common” with one of the listed items (i.e., grants, loans, and equity infusion) and thus be of the “the same type as those listed”.¹⁰ Applied to a topical example, it seems therefore unlikely that an undervalued exchange rate would be considered a “subsidy” within the meaning of the SCM Agreement (for systemic reasons, panels and the Appellate Body will be keen to keep this politically and institutionally highly-sensitive topic outside the scope of the SCM Agreement, and thereby outside the scope of unilateral CVD action as well). *Pour la petite histoire* and somewhat ironic in light of the current debate, when it abandoned the par value system and devalued the dollar in the beginning of the 1970s, the United States fruitlessly suggested adding to the list of prohibited export subsidies “[s]pecial government measures to offset, in whole or in part, the price disadvantages on exports that result from its own or other countries’ exchange rate adjustments”.^{11,12}

Shaping Disciplines on Export Subsidies

The case law suggests that the adjudicating bodies want to avoid “discipline creep” on export subsidies; they consider it *fair* to take a strict stance on export subsidies, while giving more leeway to domestic subsidies.¹³ Therefore, subsidies are only contingent upon exportation if “the granting of the subsidy [is] geared to induce the promotion of future export performance by the recipient”.¹⁴ This standard, which resembles the definition of export subsidies in standard economic textbooks, is only met if the subsidy is designed to *increase* the firm’s ratio of export sales to domestic sales.

Regarding the bifurcation between developed and developing countries, one of the main innovations of the SCM Agreement was the (gradual) extension of the prohibition of export subsidies to larger developing countries. WTO panels considered that it would be unfair and indefensible from a systemic perspective if the Illustrative List of Export Subsidies, which was *de facto* drafted by developed countries, would work to the disadvantage of developing countries. This has inspired two interpretations that have fundamentally (re-)shaped the prohibition on export subsidies, in particular regarding official export credit support.

First, WTO panels understood that the cost-to-government standard in certain items of the Illustrative List (e.g., in items (j) and (k)) works against the (exporting) interest of developing countries, whereas the benefit-to-recipient standard under Article 1 of the SCM Agreement puts all countries on an equal footing. Hence, they have foreclosed an *a contrario* reading of these items of the Illustrative List (i.e., they could not be used to show, *a contrario*, that an export subsidy provided at better than market terms is not prohibited if it involves no cost to the government). *Second*, WTO panels have opted for a narrow interpretation of the safe haven for export credit support that is in conformity with the OECD Arrangement on Export Credit Support (item (k), second paragraph).

In this way, WTO panels have very much tied the hands of any Participants to this OECD Arrangement who might wish to (re-)shape the SCM Agreement indirectly by modifying their

⁹ See e.g., Panel Report, *US – GOES*.

¹⁰ Appellate Body Report, *US – Large Civil Aircraft*, paras. 615, 624.

¹¹ Proposal by the United States, Supplementary List of Practices that Constitute an Export Subsidy (INT(73)58, 26 June 1973) (emphasis added).

¹² Due to space constraints, a discussion of the (mixed) case law on “specificity” is left for another day.

¹³ The Appellate Body clearly wishes to preclude that, by defining the concept of “contingency” too loosely, the prohibition on export subsidies would creep into outlawing domestic subsidies.

¹⁴ Appellate Body Report, *EC – Large Civil Aircraft*, para. 1044.

gentlemen's agreement. To be sure, OECD Participants have tried to reverse this approach (both by proposing new language in the Doha Round (within the WTO context), and by modifying the language in the OECD Arrangement). But these efforts appear fruitless so far. (The intersection between the OEEC¹⁵/OECD and the GATT/WTO – which goes back to the very beginning of the development of multilateral subsidy disciplines in the 1950s – is a highly interesting research topic for this project. Elsewhere, a short overview has been given of how the intersection between these two fundamentally different approaches to disciplining subsidies has evolved over the years.¹⁶) The wide implications of the panels' interpretations seem not always very well understood; even Pascal Lamy, after the outbreak of the financial crisis, called upon WTO Members to provide export credit support that was simply prohibited in light of the WTO's own case law.

Turning to the bifurcation between industrial and agricultural subsidies, this bifurcation was narrowed under the Agreement on Agriculture, though there is still much more flexibility given to agricultural export subsidies. Here, the Appellate Body and panels seem to consider it *fair* to reduce this bifurcation further as much as possible. For instance, an expansive reading of the disciplines on agricultural export subsidies was adopted in both *EC – Sugar* and *Canada – Dairy*. In *US – Cotton*, the Appellate Body found that the substantive disciplines on export subsidies applied to export credit support for agricultural products. Ironically, in light of the interpretation by the Appellate Body, WTO Members were inadvertently discussing more *flexible* instead of more *stringent* rules on export credit support at the time of the ruling during the Doha Round. By inscribing a peace clause subject to extinction, WTO Members have also opened the door to narrowing further this bifurcation, as it seems – and panels and the Appellate Body might be keen to agree with this reading – that agricultural export subsidies in conformity with the Agreement on Agriculture have become vulnerable to actionable subsidy claims under the SCM Agreement.

Shaping Disciplines on Domestic Subsidies

The Uruguay Round also narrowed the bifurcation between export and domestic subsidies, as the United States successfully pushed for more stringent disciplines on domestic subsidies. At the same time, even after the expiration of the green light for certain subsidies, the disciplines on domestic subsidies are still much more flexible. These subsidies are only WTO inconsistent if they cause adverse effects to other Members.¹⁷ WTO panels and the Appellate Body seem keen to preserve this flexibility, and, to the extent possible, expand it further.

First, the case law on actionable subsidies has placed a relatively high burden on complainants for bringing a successful actionable subsidy claim: they have to show, in principle using complicated economic modeling (except in rare circumstances, such as duopolistic markets), that the challenged *subsidies* have effectively *caused* adverse *price and/or volume effects* in the market. This evidentiary burden is more demanding than for (i) prohibited subsidy claims (no need to quantify trade effects); (ii) GATT discrimination claims (no need to quantify adverse trade effects in order to show that the measure hurts importers' competitive opportunities); and (iii) CVD action (no need to show that the *subsidy* has caused material injury – only that *subsidised imports* have caused material injury to domestic producers; see also below).

Second, and more fundamentally, the Appellate Body in *Canada – Renewable Energy* has created more policy space for certain types of subsidies pursuing legitimate non-trade objectives. This case is

¹⁵ Organisation for European Economic Co-operation.

¹⁶ See D. Coppens and T. Friedbacher, *A Tale of Two Rules: The Intersection Between WTO and OECD Disciplines on Export Credit Support*, Global Policy (November 2014). Available at: <http://www.globalpolicyjournal.com/blog/26/11/2014/tale-two-rules-intersection-between-wto-and-oecd-disciplines-export-credit-support>

¹⁷ One type of domestic subsidies, i.e., local content subsidies, is simply prohibited. Such measures are already inconsistent with both Article III of the GATT and the TRIMs Agreement.

probably the best example of how the Appellate Body “thinks outside the (Vienna Convention) box”, guided by an idea of fairness and reflecting upon the implications of its interpretation beyond the facts at hand (the implications for the case itself were trivial, as the local content element made the measure WTO inconsistent anyway).

In order to grant more policy latitude to Members wishing to stimulate non-trade values, the Appellate Body deemed it unfair that, since the expiration of green light subsidies, the SCM Agreement only takes into consideration the potential adverse effect on other Members (or more precisely, on their producers), and disregards the objective pursued by the challenged measure. To achieve a *fair* outcome, the Appellate Body considered that it needed to advance an interpretation of the “benefit” element of the subsidy definition, which (i) fundamentally departs from its established case law (the so-called private market test); (ii) was not articulated by any of the parties in this dispute at hand; and (iii) excludes from the subsidy definition what, from an economic perspective, would be a textbook example of what constitutes a subsidy. In short, the Appellate Body found that, if the government *creates* a market through providing financial contributions (e.g. for solar energy), the benchmark for the benefit determination has to be found *within* the contours of this newly created market (i.e., for solar energy); and suggested that no benefit might be conferred if the price is not above production costs (i.e., for solar energy).

However, in the author’s view, there was no need for the Appellate Body’s innovative interpretation to reach a fair outcome. The present WTO framework offers a valuable incentive to Members wishing to stimulate non-trade values to turn gradually from inherently discriminatory production subsidies (disciplined under the SCM Agreement) towards non-discriminatory – and thus more efficient – consumption subsidies (disciplined under the GATT).

Turning back to the other bifurcations in WTO subsidy disciplines, the correct interpretation of the existing policy space is surprisingly unclear and the adjudicating bodies have not yet had the opportunity to reduce this uncertainty. Regarding domestic subsidies by developing countries, an argument could be made – and might get traction with panels keen to deliver a *fair* interpretation – that, since the expiration of the presumption in Article 6.1 of the SCM Agreement, no claims could be formulated based on the broadest type of “adverse effects”, i.e., the presence of “serious prejudice”. Regarding agricultural subsidies, strong arguments could be made – which again could get traction for the same reason – that such support is, since the expiration of the peace clause, fully exposed to potential actionable subsidy claims under the SCM Agreement.

Shaping Disciplines on CVDs

Regarding the CVD-related case law, the Appellate Body’s ruling in *US — Anti-Dumping and Countervailing Duties (China)* is undoubtedly the prototypical example of backward engineering of a *fair* interpretation into the Vienna Convention box. In this case, the Appellate Body found a prohibition on “double remedies” (CVDs and anti-dumping duties) in the SCM Agreement.

Overall, the panels and the Appellate Body seem keen to ensure that the procedural disciplines on investigating authorities are sufficiently rigorous and result in an objective examination, in which competing (producers’) interests are (at least formally) taken on board.¹⁸

At the same time, the Appellate Body has not gone so far as to require the investigating authority to demonstrate that the injury is caused by the effect of the *subsidy*.¹⁹ It suffices, by reliance for instance on regression analysis, to demonstrate that *subsidised imports* cause injury. Hence, there is still no guarantee that CVDs undo only injury that has effectively been caused by subsidisation.

¹⁸ See e.g., Panel Report, *Mexico — Olive Oil*, paras. 7.120-7.123.

¹⁹ Appellate Body Report, *Japan — DRAMs (Korea)*, paras. 266-267.

Concluding remarks

The beauty – but also Achilles heel – of trade law is that it is shaped by negotiators mainly pursuing (narrow) producers' interests, whereas the negotiated outcome (the so-called Nash equilibrium) broadly makes all parties better off, not so much because of what each party has received in return from *others* but rather from what it has committed to give up *itself*. Tying your own hands is a cost in political terms, but it is often the big win in economic terms. As a result, WTO rules shaped at the negotiating table are often more fair (in overall welfare terms) than the non-cooperative counterfactual, even if fairness is not “talk of the town” during the negotiations.

Twenty years of WTO case law suggest that the Appellate Body and panels have been willing to further (re-)shape the rules in the direction of their idea(s) of a (more) *fair* outcome, also taking into consideration non-trade values. The toolbox of the Vienna Convention is itself interpreted creatively to achieve a more *fair* outcome, which in the eyes of the adjudicators (therefore) serves the systemic interests of the WTO. To be sure, a careful balancing exercise remains: to ensure that such *substantive* fairness does not come at the cost of *procedural* unfairness, occurring if the decisions were perceived to result from undue judicial activism.

Reflections on the SCM Agreement

Mark Koulen¹

This research project aims to analyse (1) the “actors and forces” that shape subsidy regulations and affect the drafting, interpretation and application of rules; and (2) the initial purpose of the rules, whether and how that purpose has been reflected in administrative and judicial decisions, and how it has evolved. In this essay I offer some comments on ideas and concepts that may be relevant to an analysis of these themes.

Actors and Forces that Shaped Subsidy Regulation and which Affect the Drafting, Interpretation and Application of Rules

Regarding the “actors and forces” that have shaped subsidy regulations, the project obviously will have to include an analysis of the politics and political economy of international negotiations on subsidies and countervailing measures in the GATT-WTO context.² The agenda and conduct of past negotiations on subsidies and countervailing measures have been shaped by the (offensive and defensive) interests of certain dominant actors and the ongoing shift in the balance of power within the trading system³ and the changing policy preferences of key actors will have a major impact on the prospects for future developments of WTO rules in this area. Contrary to functionalist accounts of international regimes, the development of rules on subsidies and countervailing measures is better explained by political factors than in terms of an adaptation of the trading system to the needs of an evolving international economy. For example, the inclusion of subsidies as a separate subject for negotiation in the Uruguay Round resulted from controversies that existed in the early 1980s between the United States, the then European Community and several other developed countries with regard to matters such as the countervailability of domestic subsidies and the use of export subsidies in agriculture. In future the political dynamics of negotiations on subsidies will be different and are likely to be determined more by the relationship between the developed economies, on the one hand, and China and other emerging economies, on the other, than by the relationship among the main developed economies.

In analysing the evolving balance of power and changing configuration of interests, the concept of a K-group, defined as the minimum number of players needed for self-sustaining cooperation, may be relevant. John Odell argues that the evolution of the post-World War II multilateral trading system as a global public good can be explained to a large extent by the existence of such a K-group, and that the WTO no longer has such a K-group.⁴ This suggests that an important theme for further analysis in the framework of this research project could be the composition and internal dynamics of the K-group in negotiations on subsidies and countervailing measures in the Tokyo Round and Uruguay Round and the implications of the current absence of such a group for the prospects of normative development of rules on subsidies and countervailing measures. Closely related to this, the research project could

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² On the central role of politics in explaining the evolution of the multilateral trading system, see J.H. Barton, J.L. Goldstein, T.E. Josling and R. Steinberg, *The Evolution of the Trade Regime: Politics, Law and Economics of the GATT and the WTO* (Princeton and Oxford: Princeton University Press 2006).

³ C. VanGrasstek, *The History and Future of the World Trade Organization* (Geneva: World Trade Organization 2013), pp. 32-33.

⁴ J. Odell, “How Should the WTO Launch and Negotiate a Future Round?”, *World Trade Review* 14/1 (2015), 117-134, at 119-120: “In the unusual early decades after World War II, the capitalist world had a K group, a small set of players, dominated by the USA and the European Community, that were large enough economically to believe they could capture much of the benefit of the GATT, and so believed it was in their self-interest to create it and pay the costs, disregarding free riders.....Today the WTO no longer has a K group”.

study the evolution of, and perhaps decline in, (intellectual) leadership in the multilateral trading system, including in the specific context of GATT-WTO negotiations on subsidies and countervailing measures.⁵

In studying “actors and forces” in relation to the evolution of international rules on subsidies and countervailing measures, the concepts of epistemic community and community of practice may also be relevant.⁶ The epistemic community or community of practice involved in international debate and negotiations on subsidies and countervailing measures has evolved significantly since the 1980s, mainly as a result of the growing prominence of non-state actors. Indeed, the area of subsidies and countervailing measures is a good illustration of the point made by Barton et al. that “trade policy, in the view of many groups, has become too important to be left to governments”.⁷ It is probably fair to say that in the 1970s and 1980s international debate on subsidies and countervailing measures mainly involved government officials, academics and lawyers. The Tokyo Round Committee on Subsidies and Countervailing Measures⁸ was an important forum for discussions among officials on methodological and conceptual issues relating to the definition and calculation of subsidies.⁹ By contrast, today, non-governmental organisations play a major role in conducting analytical work and in organising international dialogue on subsidy issues. Obviously, another major change that has affected the relevant community of practice is the transformation of the dispute settlement system, the attendant process of legalisation and growing influence of the Appellate Body. Overall, the community of practice in the area of subsidies and countervailing measures is probably more fragmented and pluralistic than several decades ago.¹⁰

Looking at actors and forces through the lens of the possible relevance of the concepts of epistemic communities/communities of practice naturally raises the question of the role of knowledge and learning in the evolution of GATT-WTO rules on subsidies and countervailing measures. To what extent have negotiations on subsidy rules and implementation of those rules given rise to collective learning and production of consensual knowledge?¹¹ Could a case be made that there currently exists insufficient “epistemic capacity” in the trading system to produce the type of consensual knowledge that is necessary for Members to reach agreement on the significant changes that some authors have recently advocated, such as exempting new categories of domestic subsidies from actionability under the SCM Agreement? It is sometimes argued that the WTO offers too little space for “deliberation”. Is this absence of space for deliberation a problem in the area of subsidies and countervailing measures and does this explain why certain topics that are subject of intense debate in the academic literature or in the NGO community are not discussed in the WTO?

The Purpose or Rationale of Subsidy Rules

International rule-making on subsidies and countervailing measures in GATT and WTO has not proceeded on the basis of a common vision as to the purpose of those rules. On the contrary, the

⁵ D. Deese, *World Trade Politics: Power, Principles and Leadership* (London and New York: Routledge 2008).

⁶ E. Adler, *Communitarian International Relations: The Epistemic Foundations of International Relations* (London and New York: Routledge 2005), p. 15; J. Brunnée and S. J. Toope, *Legitimacy and Legality in International Law: An Interactional Account* (Cambridge: Cambridge University Press 2010), p. 69; P. M. Haas (Ed.), *Knowledge, Power, and International Policy Coordination* (Columbia: University of South Carolina Press 1992), pp. 2-3.

⁷ Above n 2 above, at 182.

⁸ Including subsidiary bodies, notably the Group of Experts on the Calculation of the Amount of a Subsidy.

⁹ See, for example, G. N. Horlick, ‘An Annotated Explanation of Articles 1 and 2 of the WTO Agreement on Subsidies and Countervailing Measures’ *Global Trade and Customs Journal* 8/9 (2013), 297-299.

¹⁰ Thus, instead of a community of practice, it may be better to speak of a plurality of communities of practice.

¹¹ R. Wolfe, “Endogenous Learning and Consensual Understanding in Multilateral Negotiations: Arguing and Bargaining in the WTO”, Canadian Agricultural Trade Policy Research Network Working Paper 2010-02.

development of GATT-WTO rules on subsidies and countervailing measures has witnessed fundamental, philosophical differences regarding the role of subsidies and the rationale and architecture of international rules in this area.¹² For instance, with respect to the Uruguay Round SCM Agreement, Cartland et al. contend that “the SCMA does not contain any preamble or explicit/implicit indication of its object and purpose because the drafters specifically decided that it would be impossible to agree on these matters...”¹³ Notwithstanding the absence of an explicit statement of object and purpose of the SCM Agreement, panels and the Appellate Body have sometimes expressed views on what they consider to be the object and purpose of the SCM Agreement.

Several WTO panels have characterised the object and purpose of the SCM Agreement in terms of the imposition of multilateral disciplines on subsidies that distort international trade. For example, the panel in *Brazil – Aircraft* considered that the object and purpose of the SCM Agreement “is to impose multilateral disciplines on subsidies which distort international trade”,¹⁴ “to reduce economic distortions caused by subsidies”¹⁵, and “to impose multilateral disciplines on trade-distorting subsidization”.¹⁶ The Appellate Body has adopted a somewhat different approach in characterising the object and purpose of the SCM Agreement. In *US – Carbon Steel*, the Appellate Body while noting that the SCM Agreement “contains no preamble to guide us in the task of ascertaining its object and purpose” considered that “taken as a whole, the main object and purpose of the SCM Agreement is to increase and improve GATT disciplines relating to the use of both subsidies and countervailing measures”.¹⁷

Thus, insofar as panels and the Appellate Body have attempted to identify object and purpose of the SCM Agreement, they have done so in very general terms. The absence of a clear statement on the purpose of the SCM Agreement and the fairly general characterisations of object and purpose offered by panels and the Appellate Body would appear to support the argument recently advanced by Andrew Lang that “the regime of global subsidies regulation is organised so as to remove space for the collective definition or redefinition of its underlying purposes”.¹⁸

¹² See, e.g. G. C. Hufbauer and J. Shelton Erb, *Subsidies in International Trade* (Washington, DC: Institute for International Economics 1984); G. Depayre, “Subsidies and Countervailing Measures after the Uruguay Round: An Overview”, in J.H.J Bourgeois, F. Berrod and E. Gippini Fournier (Eds.), *The Uruguay Round Results. A European Lawyers' Perspective* (Brussels: European University Press 1995), pp. 247-254; J.H. Jackson, *The World Trading System: Law and Policy of International Economic Relations* (Cambridge, Massachusetts and London, England: The MIT Press 1997).

¹³ M. Cartland, G. Depayre and J. Woznowski, “Is Something Going Wrong in the WTO Dispute Settlement?”, *Journal of World Trade* 46/5 (2012), 979-1016, at 992.

¹⁴ Panel Report, *Brazil – Aircraft*, para. 7.26.

¹⁵ *Ibid.*, para. 7.66.

¹⁶ *Ibid.*, para. 7.80. See also Panel Report, *Canada – Civil Aircraft*, para. 9.119 (“the object and purpose of the SCM Agreement could more appropriately be summarized as the establishment of multilateral disciplines on the premise that some forms of government intervention distort international trade, [or] have the potential to distort [international trade]”); Panel Report, *US – FSC (Article 21.5 – EC)*, para. 8.39 (the object and purpose of the SCM Agreement might be viewed “in terms of disciplining trade-distorting subsidies in a way that provides legally binding security of expectations to Members”); Panel Report, *EC – Commercial Vessels*, para. 7.162 (referring to “the object and purpose of providing strengthened disciplines on the use of trade-distorting subsidies”); Panel Report, *EC – Countervailing Measures on DRAM Chips*, para. 7.58 (noting that “the object and purpose of the SCM Agreement [is] to discipline certain – but not all – forms of government action which distort international trade”).

¹⁷ Appellate Body Report, *US – Carbon Steel*, para. 73. See also Appellate Body Report, *US – Softwood Lumber IV*, para. 64 (noting that the object and purpose of the SCM Agreement “is to strengthen and improve GATT disciplines relating to the use of both subsidies and countervailing measures, while recognizing at the same time, the right of Members to impose such measures under certain conditions”); Appellate Body Report, *US – DRAMS*, para 115 (the SCM Agreement “reflects a delicate balance between the Members that sought to impose more disciplines on the use of subsidies and those that sought to impose more disciplines on the application of countervailing measures”).

¹⁸ A. Lang, “Governing ‘As If’: Global Subsidies Regulation and the Benchmark Problem”, LSE Law, Society and Economy Working Papers 12/2014, at 29.

Similarly, there is a long history of academic discussion on the economic rationale of GATT-WTO rules on subsidies and countervailing measures. Most commentators have questioned whether these rules can be justified on economic grounds.¹⁹ Some have argued in favour of a more rational economic approach to interpretation of the SCM agreement by emphasising a particular policy rationale. For instance, Grossmann and Mavroidis argue that an analysis of the structure of the SCM Agreement shows that the main objective of the SCM Agreement is not to discourage Members from using subsidies that cause an aggregate welfare loss in the importing country but from using subsidies that cause harm to competing producer interests importing countries.²⁰ This approach is similar to the theory advanced by Richard Diamond in the late 1980s that United States countervailing duty law should be understood as aimed not at promoting global efficiency but at protecting an entitlement of domestic producers to protection from the harmful effects of foreign subsidies.²¹ Other authors have questioned whether the SCM Agreement reflects such an entitlement rationale.²² Zheng observes more generally that "...the current subsidy regulation regime could be described as a paradoxical amalgam of the efficiency rationale and the entitlement rationale".²³

In sum, current WTO rules on subsidies and countervailing measures exist in a context of lack of clarity and controversy regarding their purpose and economic rationale.²⁴ Against this background, I am somewhat skeptical that it will be possible to identify "the purpose or rationale of the rules that the law creators had in mind" and to analyse whether this purpose is "duly reflected in administrative and judicial decisions" and whether "an evolution of the initial purpose [can] be identified".²⁵ Rather the more pertinent question may be how the indeterminacy of the rules with regard to their purpose and economic rationale has played out in practice, for example, in the type of methods of interpretation and modes of legal reasoning employed by WTO dispute panels and the Appellate Body. An interesting theme is that while the literature often laments the lack of rationale of the SCM Agreement, the indeterminacy of the agreement with respect to its underlying purpose and economic rationale may actually be a source of its strength. Andrew Lang has recently argued, in this respect, that "[g]lobal subsidies regulation, in other words, is made stable precisely because, and to the extent that, it offers a

¹⁹ See, e.g. K. Bagwell and R.W. Staiger, "Will International Rules on Subsidies Disrupt the World Trading System?", *The American Economic Review* 96/3 (2006), 877-895; R. Diamond, "Economic Foundations of Countervailing Duty Law", *Virginia Journal of International Law* 29 (1989), 767-812; R. Diamond, "Privatization and the Definition of Subsidy: A Critical Study of Appellate Body Textualism", *Journal of International Economic Law* 11/3 (2008), 649-678; W.F. Schwartz and E.W. Harper, Jr., "The Regulation of Subsidies Affecting International Trade", *Michigan Law Review* 70 (1972), 831-858; A.O. Sykes, "The Questionable Case for Subsidies Regulation: A Comparative Perspective", *Journal of Legal Analysis* 2/2 (2010), 473-523; A.O. Sykes, "Second-Best Countervailing Duty Policy: A Critique of the Entitlement Approach", *Law & Policy in International Business* 21 (1989), 699-721; W. Zheng, "The Pitfalls of the (Perfect) Market Benchmark: The Case of Countervailing Duty Law", *Minnesota Journal of International Law* 19/1 (2010), 1-54; W. Zheng, "Counting Once, Counting Twice: The Precarious State of Subsidy Regulation", *Stanford Journal of International Law* 49 (2013), 427-76.

²⁰ G.M. Grossman and P.C. Mavroidis, "1043-1070. Hot-Rolled lead and bismuth II - United States - Imposition of Countervailing Duties on certain Hot-Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom: Here Today, Gone Tomorrow? Privatization and the Injury Caused by Non-Recurring Subsidies", in H. Horn and P.C. Mavroidis (eds.) *The WTO Case Law of 2001* (The American Law Institute Reporters' Studies 2004), 170-200, at 185-186.

²¹ Diamond (1989), above n 19.

²² Sykes (1989), above n 19.

²³ Zheng (2012), above n 19, at 65-66.

²⁴ The debate on normative rationales WTO rules on subsidies and countervailing measures has been dominated by economists and trade lawyers. It would be interesting to explore whether insights from recent academic work in international legal theory and philosophy on the concept of distributive justice as applied to the trading system could be applied to the subsidies rules. See, for an important recent contribution, O. Suttle, "Equality in Global Commerce: Towards a Political Theory of International Economic Law", *European Journal of International Law* 25/4 (2015), 1043-1070.

²⁵ Mission statement of the research project.

set of techniques which can be used by China as much as the US, by West African cotton producers as much as European farmers. It is made stronger, rather than weaker, by the fact that many of us disagree about its underlying purposes – precisely because of its ability flexibly to adapt itself to a variety of different interests and goals, both individual and shared, as the context requires.²⁶

²⁶ Lang, above n 18, at 28.

Surveillance and Litigation of the GATT/WTO Subsidy Disciplines

Eduardo Chikusa¹

What were the forces that shaped subsidy regulation in the 20th and early 21st century? It is fair to recognise that many factors have influenced the current disciplines on subsidies in the multilateral trading system. But in search of this answer, it is important to take into account the reason why countries accepted to negotiate disciplines that would eventually restrain their own policy space. The willingness to give away some part of government's autonomy may give us a hint of the driving forces that have shaped subsidies disciplines in the multilateral arena.

Government intervention is a fact that remains resilient in the economic history of all countries. There is a wide range of reasons why governments would pursue active policies, which has been extensively described and analysed in the economic literature. But the need for disciplines to avoid distortion in international trade caused by subsidies is a relatively modern feature of the multilateral trading system. Although attempts to address the issue were made in the GATT 1947, only with the conclusion of the Uruguay Round were countries able to consent to substantive disciplines on the matter. But, as one might expect from newborns, these rules are still feeble and far from being stringent upon the activities of the main trading nations.

On the one hand, through the lenses of economic theory, it may be possible to identify a variety of benefits in limiting the concession of subsidies. The multilateral disciplines, thus, can be seen as a result of this economic rationale, which propagates the idea of limitations for active industrial policies. On the other hand, one must face the fact that countries around the world continue to pursue a multitude of objectives that require some degree of intervention and policy space.

In this sense, negotiators had to find a common ground between these two distinct positions: one, which defended limitations; the other, which advocated for policy space. No matter how important the need to control subsidies might be, governments have faced clear redlines to give away policy space throughout the years, especially if that process would translate into limitations to their capacity to formulate policies for strategic sectors. ***The protection of policies for strategic sectors has been an important driving force for the shape of subsidies regulation.***

The analysis of the economic sectors which were subject to subsidies disciplines at the end of the Uruguay Round gives us a clue for this hypothesis. Trade in services, agriculture products and industrial goods were all subject to commitments on subsidies but in a very different manner.

In the services sector, no substantive disciplines on subsidies were established. Article XV of GATS reveals that WTO Members were only able to agree on a few generic parameters for future work. Apart from recognising that, in certain circumstances, subsidies may have distortive effects on trade in services, a mandate to commence “negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects” was established. These negotiations, as for now, have been bogged down for years in the *Working Party on GATS Rules* with no prospect of being concluded in the near future.

In the agriculture sector, Members did agree on disciplines for agricultural subsidies – an exceptional result for the Uruguay Round – but with many important caveats. The Agreement on Agriculture established commitments on domestic support and export subsidies through Articles III, VI – XI and Annexes, which, unlike what happened with industrial subsidies, left considerable room

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for active policies in the agriculture sector. Besides a “traffic light approach” which only confirmed the possibility of granting a myriad of support programmes domestically, Members accepted the possibility of subsidies directed to exports, subject to some limitations. An important sector such as agriculture, which is deemed strategic for the majority of the countries, was not considered ripe enough for strict rules on subsidies.

In the industrial sector,² Members were able to deliver the most complete set of rules on subsidies – when compared to the other sectors – of the multilateral trading system: the SCM Agreement. The SCM Agreement established very strict limits for interventionist policies in two paths: firstly, by prohibiting all measures of support contingent on export performance and on local content requirements, in clear contrast with the agriculture sector; and secondly, by incorporating rules on investigations which would justify the application of countervailing measures against subsidy programmes causing injury to the domestic industry. Both alternatives were idealised as barriers to interventionist policies which could, henceforth, be challenged before the newly-created Dispute Settlement Mechanism (DSM) or be remedied by countervailing measures.

Notwithstanding the fact that the SCM Agreement limited the scope of subsidies policies, Members continued to grant billions of dollars to support their economies. One possible explanation for this fact resides on the need for policy space to develop strategic sectors, deemed essential by decision takers. In the last couple of decades, many sectors such as agriculture, aircraft, automotive, green energy, steel, oil and gas, among many others have benefited from subsidy policies. During the 2008 financial crisis, governments had to resort to similar policies to support their economies. The fact that strategic sectors still receive considerable support around the world has pushed the multilateral trading system to its limits. This pressure on the rules, caused by the continuous subsidisation of strategic sectors, can be observed in two areas of the WTO system: surveillance and litigation.

The first moment that a subsidy can appear in the multilateral trading system is through a notification or a process of questions and answers that follows it. In the field of surveillance, Members currently count on a system of notifications for industrial goods within the regular work of the Committee on Subsidies and Countervailing Measures (CSCM). It has been definitely an evolution in terms of increasing transparency for all countries. However, the quality of rules on notification delivered in the Uruguay Round and the current level of compliance with them shows that governments kept a considerable level of discretion on what and how to notify subsidies programmes.

A clear example is the level of compliance with subsidy notification obligations under the SCM Agreement. It contains specific provisions on the notification of subsidies,³ countervailing measures,⁴ competent authorities,⁵ new and full subsidy notifications,⁶ special and differential treatment for developing countries,⁷ laws and regulations,⁸ and a variety of other disciplines that are no longer in force.⁹

² The SCM Agreement also applies to agricultural goods except when subsidies are granted in accordance with the Agreement on Agriculture.

³ Article 25.1 of the SCM Agreement.

⁴ Article 25.11 of the SCM Agreement.

⁵ Article 25.12 of the SCM Agreement.

⁶ Article 26.1 of the SCM Agreement.

⁷ Article 27 of the SCM Agreement.

⁸ Article 32.6 of the SCM Agreement.

⁹ Articles 8, 28 and 29 of the SCM Agreement.

When we analyse the status of compliance with notifications under Article 25.1 in the period of 1995 – 2013,¹⁰ we observe that the number of Members notifying subsidies remained stable over this period, in spite of the increase in the number of WTO Members. On the other hand, Members failing to comply with this obligation increased sharply, from 31 Members in 1995 to 68 Members in 2013.

Another important point to analyse is the quality of the information provided. Currently, the completeness of notifications has raised a considerable number of questions and, sometimes, acrimonious disputes in the regular meetings of the CSCM. The system of notifications is based on the self-analysis of a Member's programmes in the light of the obligations established in the SCM Agreement. It is only natural that the programmes that are aimed at strategic sectors are not exactly those that will present detailed and refined information for all the membership.

The system of surveillance is also limited in relation to what Members can do to question the alleged subsidies if they are not comfortable with the timeliness and completeness of notifications. Under the process of the Trade Policy Review, Members may present questions concerning any subsidy programme that are presumably not in accordance with the SCM Agreement. Additionally, under Articles 25.8 and 25.9 of the SCM Agreement, any Member may request information on the nature and extent of a subsidy granted by another Member, with sufficient details to enable them to assess its compliance with the disciplines of the Agreement. Furthermore, under Article 25.10, "any Member that considers that any measure of another Member having the effects of a subsidy has not been notified" may bring the matter to the attention of the Committee through a counter-notification.

In spite of all those instruments established during the Uruguay Round, there is still considerable room for discretion. Ultimately, nothing in the current agreements is stringent enough to oblige a Member to notify in detail its subsidies programmes. The surveillance mechanism lacks capacity to effectively monitor the concession of subsidies.

The second instance in which subsidies fall into the purview of the WTO membership is through a process in which a Member raises a complaint against a given programme. The path of litigation sets the procedural rules that Members will use to confront each other and question the legitimacy of the programme. As a result, following an investigation or a panel, depending on the case, the complaining Member may be entitled to the right (i) to apply a countervailing measure in order to restore the capacity of its domestic industry to compete in a given market and remedy the injury caused by a subsidy programme; (ii) to demand the withdrawal of the subsidy or that the conceding Member brings its programme into conformity; or (iii) to retaliate.

If a country deems it essential to support a strategic sector with subsidy programmes, there is some ground to affirm that they will be implemented in spite of all three possible results envisaged in the litigation path. In these cases, Members stand ready to defend their positions for years and years of litigation, maintaining their policies in force and obtaining the results expected. Even when found to be inconsistent, governments may choose to keep their programmes with minor changes or even prefer to negotiate alternative solutions.

Thus far, the DSM has had 109 cases that cited the SCM Agreement, according to the table below:

¹⁰ CSCM, Notification Requirements Under the Agreement on Subsidies and Countervailing Measures: Background Note by the Secretariat, G/SCM/W/546/Rev.6, 14 April 2015.

<i>Description</i>	<i>DS Number</i>	<i>Cases</i>
<i>Countervailing Measures</i>	<i>DS 97, DS 112, DS138, DS145, DS147, DS167, DS194, DS206, DS212, DS213, DS217, DS218, DS221, DS234, DS236, DS257, DS262, DS277, DS280, DS295, DS296, DS299, DS310, DS311, DS314, DS330, DS336, DS338, DS341, DS345, DS368, DS379, DS385, DS414, DS427, DS436, DS437, DS440, DS449, DS464, DS470, DS474, DS486, DS491, DS494</i>	45
<i>Automotive Sector</i>	<i>DS51, DS52, DS54, DS55, DS59, DS64, DS65, DS81, DS106, DS126, DS139, DS142, DS195, DS339, DS340, DS342, DS450, DS472, DS497</i>	19
<i>Tax Regimes</i>	<i>DS108, DS126, DS127, DS128, DS129, DS130, DS131, DS358, DS359, DS387, DS388, DS389, DS489</i>	12
<i>Aircraft Sector</i>	<i>DS46, DS70, DS71, DS172, DS173, DS222, DS316, DS317, DS347, DS353, DS487</i>	11
<i>Agriculture Sector</i>	<i>DS103, DS104, DS265, DS266, DS267, DS283, DS357, DS365</i>	8
<i>Renewable Energy Sector</i>	<i>DS412, DS419, DS426, DS452, DS456, DS459, DS476</i>	7
<i>Vessels Sector</i>	<i>DS273, DS301, DS307</i>	3
<i>Textile Sector</i>	<i>DS57, DS451</i>	2
<i>Wine Sector</i>	<i>DS354, DS380</i>	2
	<i>TOTAL</i>	<i>109</i>

It is worth mentioning that, excluding the 45 CVD cases, disputes were brought to the DSM on a limited range of sectors, mainly on automotive, aircraft, agriculture and renewable energy. A first possible explanation for this is that countries remain supportive of strategic sectors regardless of possible limitations that the SCM Agreement might impose, leaving a request for dispute as the sole alternative for negatively-affected Members. The concentration rate may also be a result of the lack of compliance with rulings against subsidies programmes in strategic sectors – such as the aircraft cases – which leads to the recurrence of similar panels in the DSM.

As the withdrawal of a policy could be brought about by many factors, it is difficult to assess the conclusions of each of the 64 remaining cases. The capacity that the initial phases of litigation (consultations and establishment of panels) have to change a given policy deserves careful analysis, which is beyond the scope of this paper. Notwithstanding the fact that 33 of them are still on the initial proceedings, around half of the remaining processes have reached a conclusion, giving an idea about the compliance rate for subsidies litigation.

Much of the information used in the litigation path had never appeared in the notification system of the WTO. That fact only reinforces the conclusion that Members willing to grant subsidies will only bring the information to the system when obliged through a litigation process.

Conclusion

Multilateral disciplines on subsidies reflect the lowest common denominator of the interests of key Members who have real interests at stake when it comes to limiting their capacity to intervene in the economy. An unbalanced double standard was consolidated in the Uruguay Round, with a lenient approach for the services and agriculture sectors, leaving a more stringent system – with litigation and remedies established by the SCM Agreement – for industrial goods. Even so, currently, the multilateral trading system does not have enough rules on surveillance and litigation to completely control the action of Members to subsidise the development of strategic sectors.

Disciplines on surveillance and litigation constitute the basis for eventual complaints that Members have over a given subsidy policy, but with questionable results when tested against the willingness of governments to support strategic sectors. Even when considering the dispute settlement evolution

throughout the years, one can observe its tendency to encroach over issues that were not entirely clear to negotiators, giving rise to legal interpretations of all sorts. Had the negotiators known this fact, the results of the Uruguay Round on this matter would probably have been different. Governments would not have left the definition of subsidy policies open to the DSM which, in a context of lack of clarity, functions as a legal interpreter. Currently, the existing system seems to have been pushed to its limits.

Is there any possibility to change this scenario? Only on those restricted areas in which key Members agree on how to limit the role of governments in some specific sectors. As an example, we see key players negotiating sectoral disciplines under the *Arrangement on Officially Supported Export Credits* (of the OECD). Thus, if and when key Members are ready, we will be able to see some evolution of the disciplines.

In any case, it is important to point out that strategic decisions of new emerging economies will have an important influence over the shaping of the subsidies rules in the future. Both disciplines of surveillance and litigation – negotiated in a scenario with a reduced number of developed countries – have suffered with the rise of important emerging countries that use their policy space for development objectives. Countries which did not have a significant say in the past are now the main concerns for the like-minded group that agreed past the rules. We can see this fact in the numbers of disputes, questions raised in the SCM Committee and the problems we are currently facing to include their interests in the agriculture negotiations to conclude the Doha Development Round. The game has changed.

Reform through Accommodation: How External Factors Push for Greater Flexibility in Interpreting the SCM Agreement

Philippe De Baere¹

From a practitioner's viewpoint, the main forces shaping the rules governing subsidies and countervailing measures are political expediency and the changed economic power balance between WTO Members.

The WTO Membership has fundamentally changed since the SCM Agreement was negotiated. The accession of countries such as China, Russia and Vietnam as well as the emergence of India and Brazil as main players has caused the traditional axis of the US – EU to lose its predominance.

The perceived distortion of the market in those countries by the intervention of the government either directly through subsidisation or indirectly through the substantial role of state owned enterprises (SOEs) has led to increasing domestic pressure on the traditional WTO powers to take action against quickly growing exports from new Members.

The financial crisis starting in 2008 has compounded the economic impact of the emergence of new economic powerhouses. A number of WTO Members have tried to mitigate the impact of the crisis by monetary policies resulting in a devaluation of their domestic currencies. Such currency devaluation has made imports more expensive while providing a boost to exports.

Finally, the nature of international trade has changed. Globalisation of value chains has been accompanied by a globalisation of social values. Environmental protection, workers' rights, animal welfare, public health are no longer seen as domestic policies unrelated to international trade but as policy objectives that must be fully reflected in any WTO Member's trade policy.

The SCM Agreement, as it currently stands, only partially addresses the above issues. Attempts to amend the SCM Agreement during the rules negotiations in the Doha Development Agenda have failed. Increasingly, WTO Members are looking for other solutions. The dispute settlement mechanism is perceived as one way of achieving an interpretation of the SCM Agreement that could justify measures counteracting export enhancing policies while allowing policies reflecting domestic policy objectives.

So, what are the problems? And are there any solutions?

1) The SCM Agreement does not recognise policy justifications for otherwise illegal or countervailable subsidies.

Since 31 December 1999, the SCM Agreement no longer contains an exception for certain types of socially acceptable subsidies relating to fundamental research, environment or unemployment. The WTO has failed to extend the non-countervailable nature of these subsidies. This would seem to close the door to any further subsidies for otherwise legitimate purposes. Indeed, the justifications of Article XX of the GATT 1994 do not apply to the SCM Agreement. Yet, it is broadly accepted that certain subsidies even when causing adverse effects on other WTO Members could or should be justifiable.

In response to the manifest conflict between the clear wording of the SCM Agreement, on the one hand, and the societal aspirations of many WTO Members, on the other hand, it is being argued that the SCM Agreement should be interpreted as justifying subsidies serving legitimate policy objectives. In the absence of textual support in the SCM Agreement, support for this argument is being sought in

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the preamble of the WTO Agreement or in the Appellate Body ruling in *Canada — Measures Relating to the Feed-in Tariff Program* (DS 426).

2) The SCM Agreement does not recognise currency devaluation as a countervailable specific subsidy or a prohibited export subsidy.

It has been undisputed until now that monetary policies, and currency devaluations in particular, can confer a benefit that is general to all economic operators in the country concerned. Yet, confronted with a perceived undervaluation of the Chinese Renminbi, the Japanese Yen and, more recently, the Euro, US interest groups have lobbied in favour of an interpretation of the SCM Agreement as authorising investigating authorities to treat currency undervaluation as a prohibited subsidy.

Support for this interpretation is sought in *EC and certain member States - Large Civil Aircraft*

We find that the factual equivalent of de jure conditionality between the granting of a subsidy and anticipated exportation can be established where the granting of the subsidy is geared to induce the promotion of future export performance of the recipient. The standard for de facto export contingency under Article 3.1(a) and footnote 4 of the SCM Agreement would be met when the subsidy is granted so as to provide an incentive to the recipient to export in a way that is not simply reflective of the conditions of supply and demand in the domestic and export markets undistorted by the granting of the subsidy.²

On the basis of the above finding, a recent legislative proposal in the US House of Representatives expressly prohibits the Department of Commerce from refusing to find that there is an export subsidy where the subsidy is not limited exclusively to circumstances of export, for instance, where domestic non-exporters also benefit. If accepted, the proposal could justify findings that an export subsidy exists because a currency undervaluation provides an incentive to export.

3) Countervailing measures as an alternative for antidumping measures for non-market economy countries.

The majority of the US and EU antidumping investigations are brought against China. Russia and Vietnam are also main targets. Currently, high dumping margins are achieved by using analogue country methodologies against exporters from China and Vietnam or by adjusting input costs for Russia. From a protectionist viewpoint, this approach has been successful. It is however doubtful that investigating authorities can continue to use the same approach in the future.

Section 15, subparagraph (a)(ii) of China's Protocol of Accession allows investigating authorities to base normal value on prices and costs in an analogue country. This methodology generally leads to a substantial inflation of the dumping margins. Pursuant to subparagraph 15(d) of China's protocol of Accession, this possibility expires at the end of 2016. In case investigating authorities have to use the normal methodologies foreseen in the Antidumping Agreement, antidumping action against China may well result in significantly lower antidumping duties.

As an alternative to the analogue country methodology, several investigating authorities are considering using a methodology consisting of recalculating production costs (and indirectly normal value) on the basis of "undistorted" production costs. This methodology, frequently used by the EU in investigations against Russia, is currently being challenged in several DS proceedings. If the DSB were to find against the use of out-of-country benchmarks for adjusting production costs, it will become much more difficult to prove the existence of significant dumping margins.

The SCM Agreement could offer a useful alternative in such a case. The Chinese Protocol of Accession authorises in subparagraph 15(b) the use of out-of-country benchmarks. Contrary to the

² Appellate Body Report, *EC and certain member States - Large Civil Aircraft*, para 1102.

non-market economy provision in subparagraph 15(a)(ii), this provision has no expiry date. Moreover, the case law of the Appellate Body in relation to Article 14 of the SCM Agreement has made it clear that out-of-country benchmarks may be used to determine both the existence of a benefit as well as its quantification.

I expect that the foregoing three issues will create an impetus towards a more flexible interpretation of the SCM Agreement by the DSB. This is, in my view, not necessarily a good thing.

First, making certain subsidies non-actionable as long as they serve legitimate policy objectives should be done by amending the text of the SCM Agreement, not by importing language from other covered agreements. The fact that the WTO Members first provided for an express exception for a limited number of “green” subsidies and then let it lapse strongly indicates that no implicit legitimate policy objective exception may be read into the SCM Agreement. An analogy with the Appellate Body’s creative interpretation of Article 2.1 of the Agreement on Technical Barriers to Trade (TBT Agreement) is inapposite. TBT Article 2 was clearly not the best drafted piece of treaty text and the Appellate Body correctly looked to the preamble to arrive at a coherent interpretation of all provisions of the TBT Agreement. No such problem exists in relation to the SCM Agreement, however.

In fact, a similar line of reasoning has been tried by the EU in the *Seals* dispute in relation to Articles I and III.4 of the GATT 1994. The Appellate Body rejected this attempt and I expect that it will do the same with the argument that an implicit legitimate policy objective has to be read into the SCM Agreement by reference to the preamble of the Marrakesh Agreement.

Second, an interpretation of the concept of “de facto” export subsidies to cover currency undervaluation finds even less support in the text of the SCM Agreement. A devaluation of the exchange rate undeniably promotes exports. It is however very doubtful that this fact would be sufficient to prove the close connection between the alleged subsidy and the export performance required by Article 3.1(a) and footnote 4 of the SCM Agreement. This close connection must be apparent from the facts and, as stressed by the Appellate Body in *Canada - Aircraft*, “[i]t does *not* suffice to demonstrate solely that a government granting a subsidy *anticipated* that exports would result.”³ Additionally, the qualification of currency undervaluation as a financial contribution by the government and the identification and quantification of the benefit conferred as a result give rise to similar interpretative challenges.

Thirdly, it seems unavoidable that the use of out-of-country benchmarks for the quantification of the benefit conferred by a subsidy will grow in line with the increase in countervailing duty investigations against WTO Members such as China and Russia. It will therefore become relevant to develop further the criteria governing the choice of such alternative benchmarks. In particular, the requirement that “the benchmark chosen relates or refers to, or is connected with, the conditions prevailing in the market of the country of provision”⁴ and the obligation to make adjustments to such benchmark in order “to reflect conditions in the market of purchase”,⁵ will certainly require further clarification.

In conclusion, the current text of the SCM Agreement is not suited to address a number of recent political and economic developments. Yet, WTO Members expect that its provisions are sufficiently flexible to be squeezed in a form that accommodates their political concerns. Since the adoption of binding interpretations or amendments by the WTO membership is extremely unlikely, it is to be expected that the pressure on panels and Appellate Body to adopt expansive interpretations of a number of SCM Agreement provisions will grow. This obviously creates a risk of judicial activism and the danger that increased policy space for the WTO Members effectively translates into more

³ Appellate Body Report, *Canada – Aircraft*, para. 170.

⁴ Appellate Body Report, *US – Softwood Lumber IV*, para. 89

⁵ *Ibid.*, para. 103

arbitrary measures by the more powerful WTO Members to the detriment of the existing horizontal disciplines on subsidies. Without trying to force the Appellate Body to read the SCM Agreement in “wilful isolation”, I do plead in favour of a large measure of judicial restraint.

Preserving the Balance between Trade and Non-Trade Interests through a Systematic Interpretation of WTO Subsidies Law

James Flett¹

The problem with the SCM Agreement is not to understand where it is *coming from*, but rather to understand where it is *going*. The two concepts are connected, insofar as they both relate to an overall sense of *direction*. But from the point of view of litigation the latter is of far greater importance. Preparatory work and circumstances of conclusion are merely *supplementary* means of interpretation under Article 32 of the Vienna Convention on the Law of Treaties (Vienna Convention).² Object and purpose, on the other hand, is one of four elements of the single³ interpretative rule in Article 31, and one that *illuminates* all the others.⁴ From this perspective, looking backwards is of less value and may in fact distract attention from the more important question of what the future holds.

Of fifteen⁵ agreements in Annex 1 of the WTO Agreement, only two have no preamble: the Anti-Dumping Agreement and the SCM Agreement. Two distinct but related questions therefore arise: (1) why does the SCM Agreement have no preamble; and (2) what would the preamble look like if we were to reverse engineer it?

An initial draft for a preamble is attached to this essay, inspired by the preambles of the other agreements. It is submitted that engaging in this exercise could contribute to a better understanding of what the object and purpose of the SCM Agreement is, and therefore what its various provisions might mean.⁶ It could also form the basis for understanding what the preamble of the next subsidies agreement might look like (even though the current Doha draft still contains no preamble).⁷

The absence of a preamble cannot be explained by the fact that the SCM Agreement is divided into four main parts: prohibited subsidies; actionable subsidies; non-actionable subsidies; and countervailing duties. It would have been possible to have recitals dealing with each part. Other agreements have comparably complex structures, yet include preambles.

The preambles of other agreements typically do one or more of four things. They explain: the objective or teleology of the agreement and/or the reasons for particular provisions; the relationship between the agreement and the GATT 1994 or other agreements; the relationship between different parts of the agreement; and the general principles governing the interpretation and application of the agreement. The absence of a preamble in the SCM Agreement reflects an absence of agreement between the Members on such matters. These disagreements are the *fault lines* running *beneath* the SCM Agreement. ***It is the interaction of the forces opposed to each other across these fault lines that shapes, in litigation, the development of WTO subsidies law, and will continue to do so.***

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² Vienna Convention, Article 32: ("Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion ...").

³ Vienna Convention, title to Article 31: ("General rule of interpretation").

⁴ Vienna Convention, Article 31: ("A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.") (underline emphasis added)

⁵ Counting the GATT 1947, but not the GATT 1994.

⁶ See, for example, Appellate Body Report, *US – Anti-Dumping and Countervailing Duties (China)*, paras. 302 ("As we see it, considerations of object and purpose are of limited use ...") and 574 ("We do not see that the object and purpose of the *SCM Agreement* provides clear indications as to the intentions of the drafters of the *SCM Agreement* ...").

⁷ TN/RL/W/236, 19 December 2008 ("New Draft Consolidated Chair Texts of the AD and SCM Agreements"); TN/RL/W/255 of 25 March 2014 ("Report by the Chairman of the Negotiating Group on Rules").

In particular, one can discern in some quarters a tendency to refer to subsidies in a pejoratively negative way that is generally not used when referring to regulations or fiscal measures. This may be linked to the fact that the discussants are often lawyers or economists focussed on international trade or competition law, as opposed to people whose focus is on the policies designed to address particular market failures. The situation is also influenced by the position with respect to agricultural subsidies. But what is the basis for this apparently ingrained conventional wisdom? Is there any solid intellectual foundation for it, or does it rather reflect a pseudo-ideological and incoherent perspective? In the latter case, do such views, whether express or implied, have any useful role to play in WTO law, or on the contrary, do they risk to render it subjective and diminish its authority?

WTO law is *always* about finding a reasonable balance between a trade interest on the one hand and some other interest on the other hand. It is always a question of *compromise*. There is never an absolute resolution in favour of one or the other. That would be excessively rigid and, in the long run, unsustainable. This is already tolerably clear from the preamble to the GATT 1994,⁸ and now very clear from the preamble to the WTO Agreement itself.⁹

This reflects the fact that State intervention *always* involves, by definition, an interaction between the State and the market, generally in pursuit of a common interest – we may say, in principle, in the presence of what that State deems to be a market failure. In this sense, State intervention *always* involves some actual or potential departure from the market, otherwise it would be ineffective and pointless. As a result, it is reasonable to posit that, if a measure is effective, costs and/or benefits are *always* allocated differently, now and/or in the future, compared to the allocation that market forces would produce. ***This is so irrespective of the form that the State intervention takes: regulatory; fiscal; or subsidisation.*** Costs and benefits are, in this sense, simply the obverse of one another. Finally, *all* such interventions are capable of impacting where capital locates.

Consistent with this, in the design and architecture of the GATT 1994 we can discern a principle of neutrality: essentially, it makes little if any difference which kind of measure (regulation, fiscal, subsidy) a Member reaches for from the toolbox available to it in order to address a market failure.

In particular, subsidies are carved out of the national treatment rule by Article III:8(b) of the GATT 1994.¹⁰ This is logical. Regulations impose costs. In economic terms, they are essentially financed by consumers in the regulated market. Similarly, subsidies are essentially financed by taxpayers in the

⁸ "... *Recognizing* that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods, ..."

⁹ "... *Recognizing* that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development,

Recognizing further that there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development, ...

... *Resolved*, therefore, to develop an integrated, more viable and durable multilateral trading system encompassing the General Agreement on Tariffs and Trade, the results of past trade liberalization efforts, and all of the results of the Uruguay Round of Multilateral Trade Negotiations,

Determined to preserve the basic principles and to further the objectives underlying this multilateral trading system, ..."

¹⁰ It is a widely-held view that the case law has construed this provision in an artificially narrow manner. This confirms the proposition set out in this essay that there exists an express or implied preference for the trade interest and a pejoratively negative assumption about subsidies, based on a poor appreciation of the overall balance struck by the design and architecture of the GATT 1994 and the SCM Agreement.

regulated market. It makes sense that they may be limited to producers in that market. If subsidising Members would be required to subsidise all producers in all countries, the subsidy instrument would be unsustainable and dysfunctional. That is precisely why the subsidies disciplines come into play with respect to the effects that subsidies may have on non-recipient firms.

This overall logic is also reflected in Article XVI:1 of the GATT 1994. Article XVI:1 subjects subsidies to a *necessity* test¹¹ – just like regulatory and fiscal measures. In case of *effects* on the *volume of exports or imports causing serious prejudice*¹² it does not envisage that the subsidies would be abolished, but merely *limited*,¹³ that is, limited to what is necessary in order to ensure the achievement of a legitimate objective. Article XVI:5 makes it clear that the focus is on the objectives of the GATT 1994 *as a whole*,¹⁴ that is, not only the objectives associated with the trade interest, considered in isolation, but also the objectives associated with the relevant non-trade interests.

This overall logic is also reflected in Articles XVI:2 to XVI:4 of the GATT 1994, which refer to "export subsidies". Article XVI:2 also focuses on the effects¹⁵ that subsidies may have in export markets. Action is only required if the subsidy causes¹⁶ volume¹⁷ or price¹⁸ effects – phenomena that will *not* generally arise in the case of necessary and limited subsidisation directed towards ensuring a common good – because the funds are directed towards the market failure and not towards altering the competitive conditions between firms.

Consistent with this, Article XX of the GATT 1994 refers to the Agreement as a whole, including Article XVI.

Thus, the issue with Article XVI is *not* its design and architecture, which is logical and coherent with the overall design and architecture of the GATT 1994. Rather, the issue is simply that, although invoked in some GATT cases,¹⁹ as drafted, Article XVI lacks bite, because it lacks sufficiently

¹¹ GATT 1994, Article XVI:1: ("... the circumstances making the subsidisation necessary."). (underline emphasis added)

¹² GATT 1994, Article XVI:1: ("... to increase exports ... or to reduce imports ..."); ("... the estimated effect ..."); ("... serious prejudice ... is caused ..."). (underline emphasis added)

¹³ GATT 1994, Article XVI:1: ("... the possibility of limiting the subsidization."). (underline emphasis added)

¹⁴ GATT 1994, Article XVI:5: ("... in promoting the objectives of this Agreement ...").

¹⁵ GATT 1994, Article XVI:2: ("... may have harmful effects ..."). (underline emphasis added)

¹⁶ GATT 1994, Article XVI:2: ("... may cause ..."). (underline emphasis added)

¹⁷ GATT 1994, Article XVI:3 (referring to primary products): ("... increase the export ...").

¹⁸ GATT 1994, Article XVI:4 (referring to products other than primary products): ("... at a price lower than the comparable price charged for the like product ...").

¹⁹ See, in particular: Working Party Report, *The Australian Subsidy on Ammonium Sulphate*, GATT/CP.4/39, adopted 3 April 1950, BISD II/188; GATT Panel Report, *Italian Discrimination Against Imported Agricultural Machinery*, L/833, adopted 23 October 1958, BISD 7S/60; GATT Panel Report, *French Assistance to Exports of Wheat and Wheat Flour*, L/924, adopted 21 November 1958, BISD 7S/46; GATT Panel Report, *European Communities – Refunds on Exports of Sugar*, L/4833, adopted 6 November 1979, BISD 26S/290; GATT Panel Report, *Income Tax Practices Maintained by The Netherlands*, L/4425, adopted 7 December 1981, BISD 23S/137; GATT Panel Report, *Income Tax Practices Maintained by Belgium*, L/4424, adopted 7 December 1981, BISD 23S/127; GATT Panel Report, *Income Tax Practices Maintained by France*, L/4423 adopted 7 December 1981, BISD 23S/114; GATT Panel Report, *United States Tax Legislation (DISC)*, L/4422, adopted 7 December 1981, BISD 23S/98; GATT Panel Report, *European Economic Community – Subsidies on Export of Wheat Flour*, SCM/42, 21 March 1983, unadopted; GATT Panel Report, *European Economic Community – Subsidies on Export of Pasta Products*, SCM/43, 19 May 1983, unadopted; GATT Panel Report, *European Economic Community – Production Aids Granted on Canned Peaches, Canned Pears, Canned Fruit Cocktail and Dried Grapes*, L/5778, 20 February 1985, unadopted; GATT Panel Report, *European Economic Community – Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins*, L/6627, adopted 25 January 1990, BISD 37S/86; GATT Panel Report, *European Economic Community – Follow-Up on the Panel Report "Payments and Subsidies Paid to Processors and Producers of Oilseeds and Related Animal-Feed Proteins"*, DS28/R, 31 March 1992, BISD 39S/91; GATT Panel Report, *German Exchange Rate Scheme for Deutsche Airbus*, SCM/142, 4 March 1992, unadopted.

effective mandatory language. Article XVI:1 merely requires the subsidising Member to "notify" and "discuss". Article XVI:2 merely records that the Members "recognize" the issues. Article XVI:3 uses the term "should" and a test based on what is "equitable". Article XVI:4 is qualified by the term "practicable". All of these provisions are further qualified by the relevant *Ad Notes*.

In adopting the SCM Agreement, it is reasonable to assume that, as in the case of other agreements, the Members were seeking to further the objectives of the WTO Agreement and of the GATT 1994, ***not destroy, without explanation, the basic design and architecture and governing principles of the GATT 1994 – that is, the very principle of compromise itself***. The GATT 1994 and the SCM Agreement are both contained in Annex 1A of the WTO Agreement, and are both part of the single undertaking.²⁰ The SCM Agreement contains 22 cross-references to the GATT 1994²¹ and interprets the provisions of the GATT 1994.²² The two Agreements must be read together.²³ A treaty interpreter

²⁰ Appellate Body Report, *US – Large Civil Aircraft*, para. 530 (“The draft *SCM Agreement* was subsequently modified as part of the process of harmonizing all of the Uruguay Round agreements to bring them into line with the single undertaking and the unified system of dispute settlement ...”); Appellate Body Report, *Korea – Dairy*, para. 74 (“We agree with the statement of the Panel that: ‘It is now well established that the WTO Agreement is a “Single Undertaking” ...’”); Appellate Body Report, *Brazil – Desiccated Coconut*, p. 12 (“Unlike the previous GATT system, the *WTO Agreement* is a single treaty instrument which was accepted by the WTO Members as a single undertaking.”), p. 13 (“The single undertaking is further reflected in ...”), (“The DSU provides an integrated dispute settlement mechanism applicable to disputes arising under any of the “covered agreements”.”), p. 18 (“The single undertaking is further reflected in ...”).

²¹ See the following provisions of the SCM Agreement: Article 1.1(a)(2) (“... any form of income or price support in the sense of Article XVI of the *GATT 1994*”); footnote 1 (“In accordance with the provisions of Article XVI of *GATT 1994* (Note to Article XVI) ...”); Article 5(b) (“nullification or impairment of benefits accruing directly or indirectly to other Members under *GATT 1994* in particular the benefits of concessions under Article II of *GATT 1994*”); footnote 12 (“the term ‘nullification or impairment’ is used in this Agreement in the same sense as it is used in the relevant provisions of *GATT 1994* ...”); footnote 13 (“The term ‘serious prejudice to the interests of another Member’ is used in this Agreement in the same sense as it is used in paragraph I of Article XVI of *GATT 1994* ...”); footnote 18 (“The fact that certain circumstances are referred to in this paragraph does not, in itself, confer upon them any legal status in terms of either *GATT 1994* or this Agreement ...”); Article 10, title (“Application of Article VI of *GATT 1994*”); Article 10 (“... in accordance with the provisions of Article VI of *GATT 1994* and the terms of this Agreement...”); footnote 36 (“... as provided for in paragraph 3 of Article VI of *GATT 1994* ...”); Article 11.2 (“... injury within the meaning of Article VI of *GATT 1994* as interpreted by this Agreement ...”); Article 15.1 (“A determination of injury for purposes of Article VI of *GATT 1994* ...”); Article 16.4 (“Where two or more countries have reached under the provisions of paragraph 8(a) of Article XXIV of *GATT 1994* such a level of integration that they have the characteristics of a single, unified market, the industry in the entire area of integration shall be taken to be the domestic industry ...”); Article 20.6 (“... subsidies paid or bestowed inconsistently with the provisions of *GATT 1994* and of this Agreement ...”); Article 25.6 (“... under paragraph 1 of Article XVI of *GATT 1994* and this Agreement ...”); Article 25.10 (“... the provisions of paragraph 1 of Article XVI of *GATT 1994* and this Article ...”); Article 26.1 (“... under paragraph 1 of Article XVI of *GATT 1994* and paragraph 1 of Article 25 of this Agreement ...”); Article 27.9 (“... other obligations under *GATT 1994* ...”); Article 30 (“The provisions of Articles XXII and XXIII of *GATT 1994* ...”); Article 32.1 (“No specific action against a subsidy of another Member can be taken except in accordance with the provisions of *GATT 1994*, as interpreted by this Agreement.”); footnote 56 (“This paragraph is not intended to preclude action under other relevant provisions of *GATT 1994*, where appropriate.”); footnote 59 (“... without prejudice to the rights and obligations of Members under *GATT 1994* ...”); Annex I, item (l) (“... and export subsidy in the sense of Article XVI of *GATT 1994*”).

²² SCM Agreement, Article 32.1 (“No specific action against a subsidy of another Member can be taken except in accordance with the provisions of *GATT 1994*, as interpreted by this Agreement”). Appellate Body Report, *Brazil – Desiccated Coconut*, p. 16 (“The relationship between the *SCM Agreement* and Article VI of the *GATT 1994* is set out in Articles 10 and 32.1 of the *SCM Agreement*”).

²³ Appellate Body Report, *Brazil – Desiccated Coconut*, p. 14 (“As the Panel has said ... the question for consideration is ... whether Article VI of the *GATT 1994* and the *SCM Agreement* represent an inseparable package of rights and disciplines that must be considered in conjunction”) and p. 16 (“The ordinary meaning of these provisions taken in their context leads us to the conclusion that the negotiators of the *SCM Agreement* clearly intended that, under the integrated *WTO Agreement*, countervailing duties may only be imposed in accordance with the provisions of Part V of the *SCM Agreement* and Article VI of the *GATT 1994*, taken together.”) (original underline emphasis); Panel Report, *US – FSC*, para. 7.82 opining that the above statements of the Appellate Body in *Brazil – Desiccated Coconut* are “equally applicable to the relationship between Part II of the *SCM Agreement* and Article XVI of the *GATT 1994*. Thus, we agree

must search for and prefer an harmonious interpretation and application of relevant provisions.²⁴ It is only in case of conflict that the provisions of the SCM Agreement prevail.²⁵

So what actually happened in the move from the GATT 1994 (via the 1979 Subsidies Code) to the SCM Agreement? Did the baby (neutrality, the possibility of impacting location and the balance or compromise of necessity – including Article XX) go out with the bath water (the relatively ineffective language of Article XVI of the GATT)?

The absence of any reference in the SCM Agreement to Article XX of the GATT 1994 and the lapse of Part IV of the SCM Agreement on non-actionable subsidies after five years, pursuant to Article 31,²⁶ are sometimes taken to support such a view. The argument, however, is flawed. Article 31 in fact provides for the lapse of *two* sets of provisions, one being the *quid pro quo* for the other.

The first set of provisions, directed *against* subsidies, is contained in Article 6.1 of the SCM Agreement, and provides for certain circumstances in which serious prejudice may be "deemed" to exist. The lapse of Article 6.1 does not mean that serious prejudice can no longer exist in the circumstances set out in Article 6.1. It only means that serious prejudice can no longer be "deemed" to exist in those circumstances, but must rather be demonstrated to exist.

The second set of provisions, designed to *permit* certain types of subsidies, is contained in Part IV of the SCM Agreement. Consistent with the conclusion with respect to the lapse of Article 6.1, the lapse of Part IV does not mean that such subsidies automatically cause serious prejudice. It only means that, in such circumstances, serious prejudice must be demonstrated to have been caused. In this respect, the SCM Agreement expressly recognises that government assistance for various purposes is

(Contd.)

with the United States that 'the *SCM Agreement* and Article XVI are not to be construed in isolation from each other'); Appellate Body Report, *US – Anti-Dumping and Countervailing Duties (China)*, paras. 560 ("... Article 10 establishes that Part V of the *SCM Agreement* relates to the application of Article VI of the GATT 1994, and that countervailing duties must conform to the dictates of that provision as well as to the *SCM Agreement*."), 561 ("The link between the GATT 1994 and the *SCM Agreement* also figures prominently in Article 32.1 of the *SCM Agreement* ..."), 562 ("Footnote 56 to Article 32.1 reaffirms the right of Members to take action under other relevant provisions of the GATT 1994, and at the same time recognizes that not all such action will be "appropriate"."), 563 ("...the close link between the GATT 1994, in particular its Article VI, and Part V of the *SCM Agreement* ..."), 564 ("Article VI, entitled "*Anti-dumping and Countervailing Duties*", is the genesis of both the *SCM Agreement* and the *Anti-Dumping Agreement*."), and 570 ("...the provisions in the WTO covered agreements should be interpreted in a coherent and consistent manner, giving meaning to all applicable provisions harmoniously.[] Members have entered into cumulative obligations under the covered agreements and should thus be mindful of their actions under one agreement when taking action under another.")

²⁴ Appellate Body Report, *Korea – Dairy*, para. 81 ("In light of the interpretative principle of effectiveness, it is the *duty* of any treaty interpreter to 'read all applicable provisions of a treaty in a way that gives meaning to *all* of them, harmoniously'. An important corollary of this principle is that a treaty should be interpreted as a whole, and, in particular, its sections and parts should be read as a whole.") (original italic emphasis) (footnotes omitted); Appellate Body Report, *US – Continued Zeroing*, para. 268 ("The interpretative exercise is engaged so as to yield an interpretation that is harmonious and coherent and fits comfortably in the treaty as a whole so as to render the treaty provision legally effective."). See also Appellate Body Report, *Argentina – Footwear*, para. 81; Appellate Body Report, *US – Upland Cotton*, para. 549.

²⁵ The General Interpretative Note to Annex 1A of the WTO Agreement provides as follows: "In the event of conflict between a provision of the General Agreement on Tariffs and Trade 1994 and a provision of another agreement in Annex 1A to the Agreement Establishing the World Trade Organization (referred to in the agreements in Annex 1A as the 'WTO Agreement'), the provisions of the other agreement shall prevail to the extent of the conflict".

²⁶ There are four remarkable things about Article 31. First, it is positioned far away from Parts III and IV of the SCM Agreement, to which it relates, in an unrelated and apparently technical Part XI, titled "Final Provisions". Second, there is no cross-reference from Parts III or IV to Article 31. Third, Article 31 is titled "Provisional Application", a term usually used to refer to a situation that may arise prior to a treaty's ratification and entry into force. Fourth, Article 31 passes in silence over the fact that the SCM Committee will decide by consensus. Hence, given that the Members could not agree from the outset, it is clear that the 5 year period would never be extended. It is pertinent to ask why things were done in this manner. To which it is reasonable to answer that it was done for the same reasons that there is no preamble. In an effort at "constructive ambiguity", disagreements on difficult issues were being consigned to obscure provisions and/or passed over in silence.

widely provided by Members and that the mere fact that such assistance might not benefit from Part IV (whether because it falls outside the scope of Part IV or because Part IV has lapsed) does not in itself restrict the ability of Members to provide such assistance.²⁷ Furthermore, just like the SPS Agreement and the TBT Agreement, which cross-reference other international fora and documents for the purposes of assessing what is a legitimate objective and what is necessary,²⁸ the SCM Agreement also expressly directs Members, at least with respect to certain matters, to carefully take into consideration the work in other relevant international institutions.²⁹

Thus, the overall design and architecture reflected in the GATT 1994 – including the core principle of compromise itself – is preserved by the rule on *conditionality* for prohibited subsidies³⁰ and the rule on *causation* for actionable subsidies,³¹ ***provided that these rules are properly understood and applied.***

The rule on conditionality for prohibited subsidies is founded on a logical link between conditionality and prohibition. That is because export or import conditionality, by definition, partitions markets. That is, it creates, in different countries, and by means of a legal mechanism, different conditions for the operation of the forces of supply and demand. This strikes at a key objective of the WTO, which is to create the conditions for the development and exploitation of absolute and comparative advantages. It is inconceivable that such conditionality would be necessary for the purposes of ensuring a common good. There would always be less trade restrictive alternatives. Hence, in order to preserve the overall balance in the design of the WTO Agreement, the GATT 1994 and the SCM Agreement, it is of fundamental importance that prohibited subsidies are not misconstrued to extend to subsidies that merely have effects in export markets; or that merely benefit domestic producers.

The rule on causation for actionable subsidies is, in effect, a necessity test. If a subsidy is limited to what is necessary in order to ensure a common good it will not generally cause volume or price effects for other firms. This helps us to understand why adverse impact is generally presumed pursuant to Article 3.8 of the Dispute Settlement Understanding (DSU),³² but not in the special case of actionable subsidies. It is because the SCM Agreement rules on causation perform a very similar function to Article XX of the GATT 1994. It similarly helps us to understand why the imposition of countervailing duties requires a showing that subsidies have caused material injury.

The subsidy might have *some* effect. For example, consumers might prefer the green product. However, the concept of a "genuine and substantial relationship of cause and effect" cannot be construed – and should not be construed – as capturing such effect. Another way of saying the same thing is that, if a subsidy is limited to what is necessary in order to ensure a common good, there is no

²⁷ SCM Agreement, footnote 23: ("It is recognized that government assistance for various purposes is widely provided by Members and that the mere fact that such assistance may not qualify for non-actionable treatment under the provisions of this Article does not in itself restrict the ability of Members to provide such assistance.")

²⁸ SPS Agreement, particularly Article 3 and Annex A.3; TBT Agreement, particularly Articles 2.4-2.5 and Annex 1, paragraph 4.

²⁹ SCM Agreement, footnote 25: ("... the Committee shall carefully review the definitions of the categories set forth in this subparagraph in the light of the experience of Members in the operation of research programmes and the work in other relevant international institutions.")

³⁰ In particular, SCM Agreement, Articles 3.1(a) and 3.1(b).

³¹ In particular, SCM Agreement, Article 5.

³² DSU, Article 3.8: ("In cases where there is an infringement of the obligations assumed under a covered agreement, the action is considered prima facie to constitute a case of nullification or impairment. This means that there is normally a presumption that a breach of the rules has an adverse impact on other Members parties to that covered agreement, and in such cases, it shall be up to the Member against whom the complaint has been brought to rebut the charge.")

serious prejudice or significant effect that is caused to the interests of other Members.³³ **Otherwise, Members would be denied the freedom to choose between regulation, fiscal measures and subsidies having equivalent economic effects when pursuing legitimate objectives. That would be a fundamentally irrational thing for the WTO to do. The WTO is concerned with substance, not form.** The Appellate Body Reports in *Canada – Renewable Energy/Feed-In Tariff Program* may be seen as confirming the need to preserve a balance between the trade interest and the non-trade interest, and the principles of neutrality, potential locational impact and necessity, as they result from the WTO Agreement and the GATT 1994 – in the specific context of a benefit analysis. They confirm that the market benchmark must take a WTO-consistent regulatory framework as a given.³⁴ Accordingly, if a measure ensures the provision of a common good in the least discriminatory and trade-restrictive manner possible, for example through the use of a price discovery mechanism,³⁵ it will be consistent with the SCM Agreement.³⁶ It is possible or even likely that a similar element of balancing is, in effect, embedded in the rules related to specificity.³⁷

The foregoing analysis aligns with EU State aid law, which provides a solid basis for a systemic comparison, because the issues under consideration flow, as a matter of logic and necessity, from first principles. The WTO balancing element is reflected in the rules of EU State aid law that permit a determination that a State aid is compatible with the internal market.³⁸ The analogue of the rule in Article III:8(b) of the GATT 1994 is to be found in the *Iannelli* case.³⁹ Analogues of the *Canada – Renewable Energy/Feed-In Tariff* case may be found in the *PreussenElektra*⁴⁰ and *Altmark*⁴¹ cases.

³³ Articles XVI:1 and XVI:5 of the GATT 1994 refer to "serious prejudice" and "seriously prejudicial". Article 5(c) of the SCM Agreement refers to "serious prejudice". Article 6.3 of the SCM Agreement states that serious prejudice "may arise" if what follows is the case; and Article 6.3(c) uses the term "significant" to refer to price effects, which arguably are a pre-condition for volume effects. (underline emphasis added)

³⁴ Appellate Body Reports, *Canada – Renewable Energy/Feed-In Tariff Program*, para. 5.175 ("... the definition of a certain supply-mix by the government cannot *in and of itself* be considered as conferring a benefit within the meaning of Article 1.1(b) of the SCM Agreement."). See also, para. 5.178.

³⁵ Appellate Body Reports, *Canada – Renewable Energy/Feed-In Tariff Program*, paras. 5.225 ("... the market based, price-discovery mechanism ..."); 5.228 ("... a price-setting mechanism that ensures a market outcome ... price discovery mechanisms ..."); 5.233 ("... a market-based, price-discovery process ..."); and 5.243 ("... price-discovery mechanism ...").

³⁶ J. Flett, *How to Get Fit in Eight Easy Steps*, Fourteenth Annual WTO Conference, British Institute of International and Comparative Law, Institute of International Economic Law at Georgetown Law, Society of International Economic Law, 14/15 May 2014.

³⁷ SCM Agreement, Article 2 and Article 8.1(a).

³⁸ Notably, Treaty on the Functioning of the European Union, Article 107.

³⁹ Case 74/76 *Iannelli v Meroni* European Court Reports 1977, p. 557, para. 10 ("... that a system of aids ... may, simply because it benefits ... national undertakings or products, hinder ... the importation of similar or competing products ... is not in itself sufficient to put [it] ... on the same footing as a measure having an effect equivalent to a quantitative restriction [on imports] ...").

⁴⁰ Case C-379/98, *PreussenElektra* [2001] ECR I-2099.

⁴¹ Case C-280/00, *Altmark* [2003] ECR I-7747.

Annex: Draft Preamble for the Agreement on Subsidies and Countervailing Measures

Members

Desiring to further the objectives of the WTO Agreement and of the GATT 1994 and to elaborate rules for the application of the provisions of GATT 1994 that relate to subsidies, in particular the provisions of Articles III:8(b), XVI and XX, and the relevant provisions of Article VI,

Committed to reaching an Agreement on Agriculture, including specific provisions relating to agricultural subsidies, which, in case of conflict, should prevail over the provisions of this Agreement,

Recognising that Members may have recourse to regulations, fiscal measures, subsidies, or other measures, in order to pursue legitimate objectives, provided that they comply with the relevant provisions of the GATT 1994 and other applicable WTO agreements,

Recognising in particular that, pursuant to Article III:8(b) of the GATT 1994, the provisions of Article III of the GATT 1994 do not apply to subsidies,

Recognising that Article XX of the GATT 1994 provides that nothing in that Agreement shall be construed to prevent the application or enforcement by any Member of certain measures, subject to the requirement that such measures are necessary and are not applied in a manner that would constitute a means of arbitrary or unjustifiable discrimination or a disguised restriction on international trade,

Desiring to elaborate a definition of a subsidy as consisting of a financial contribution or any form of income or price support, that confers a benefit, and that is specific to certain enterprises,

Desiring to prohibit subsidies contingent upon export or upon the use of domestic over imported goods, which, by definition, by partitioning markets along national lines, contradict important economic objectives of the WTO Agreement and of the GATT 1994, and which, in light of alternative means of action, could never be justified pursuant to Article XX of the GATT 1994,

Recognising that no Member should cause, through the use of subsidies, and particularly subsidies that are not necessary in order to achieve a legitimate objective, adverse effects, including serious prejudice, to the domestic industry of another Member, in particular through significant volume or price effects in any market, and desiring to elaborate more detailed rules in that respect,

Recognising that certain subsidies, such as subsidies benefiting products in excess of 5 per cent or to cover operating losses or in the form of debt forgiveness, are susceptible to cause serious prejudice, whilst certain other subsidies, such as for research or to disadvantaged regions or with respect to the environment, are rather susceptible not to cause serious prejudice, such categories being open to the possibility of review,

Desiring to elaborate rules for the application of countervailing duties, pursuant to the relevant provisions of Article VI of the GATT 1994, including rules relating to the causation of material injury,

Recognising that subsidies may play an important role in economic development programmes of developing countries, and that in this respect special and differential treatment should be provided for,

Recalling that, in the event of conflict between a provision of the GATT 1994 and a provision of this Agreement, whether such provisions are prescriptive or permissive, the provision of this Agreement prevails to the extent of the conflict,

Hereby *agree* as follows:

State Aid Control in the EU: The System in Action

The Forces Shaping State Aid Control in the EU

Massimo Merola¹

The Historical Roots of State Aid Control

One possible starting point for understanding how EU primary law concerning State aid is *shaped* would be to dust down the Havana Charter of 1947. The reason for this is that the Havana Charter was the closest model of the European Treaties and both the GATT rules on subsidies and the Treaties' rules on State aid were initially conceived in response to the numerous subsidies put in place in the 1930s and again in the immediate aftermath of the Second World War, which were considered to significantly interfere with the free circulation of goods.

In the Europe of the late 1940s and early 1950s, the new-mercantilism was still the dominant economic doctrine, and State aid to undertakings was one of the basic instruments used by governments to intervene in the economy. Lobby organisations (both industrial and social) strengthened their position by defending special interests and trying to obtain various benefits from the government, which in turn used subsidies to help them reach their objectives.² In addition, a strict link existed between subsidies and dumping: governments and national industries joined forces to take up new markets and strengthen commercial surplus. This, in a nutshell, is the reality that the authors of the Treaties had in mind when modelling State aid rules. But they were also looking at the link between State aid and the rules on antitrust, based on the model of the Sherman Act (US) and German ordoliberalist theories. Indeed, Member States' unilateral measures ought not to interfere with the level playing field that antitrust rules aimed to ensure.

The Start-Up Phase and Some Initial Difficulties

A **European** regulation on State aid was adopted for the first time in the **Treaty of Paris** of 1951, which established the European Coal and Steel Community (ECSC). Pursuant to Article 4(c) "subsidies and state assistance" were abolished and prohibited within the common market for the coal and steel market. This prohibition was designed around the drafters' view that ECSC aid could replace the national assistance provided at that time to the coal and steel industries. However, this idea proved to be unfeasible.

Some years after the establishment of the European Coal and Steel Community, the same founding states introduced a similar, but far more flexible, regulation in the **Treaty of Rome** of 1957. State aid policy was tied to the objective of European integration, and it was for this reason that Member States restricted their sovereignty and assigned surveillance powers to the European Commission: the principle that underpins State aid control is that State aid is "incompatible" with the common market rather than "prohibited" in the strict sense of the word.

Another factor that played a fundamental role in *shaping* the relevant provisions of the Treaty Establishing the European Economic Community (the EEC Treaty) was the political orientation of the six founding states and the fact that they were all mixed economy states with a very strong publicly-owned industrial sector at the core of their economic system. Although this feature was acknowledged and preserved through Article 222 of the EEC Treaty, the Commission was given power to exert

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² In this context, the UK adopted the Customs Duties Act in 1957 and France introduced Article 9-*bis* of the Customs Code.

special surveillance on public undertakings to prevent them being used to distort competition or restrict trade.

State aid control and the rules on public undertakings have always been the most “anomalous” of the EU’s competition policies in that they: (a) complement both competition and internal market rules; and (b) involve both governments and undertakings. Consequently, political pressure from Member States has always been a major influence in *shaping* the Commission’s control and implementation of State aid policy.

Another key influence is the pressure from lobbyists,³ particularly for some industries (e.g. shipbuilding, steel, cars and electronics) and with regard to environmental protection and other substantive issues. However, private stakeholders have clearly been unable to impact significantly on procedural rules, as shown by the marginalisation of undertakings in State aid proceedings, which is at odds with the twofold objective of State aid rules. The Commission and some Member States (especially those interested in promoting national champions) have often joined forces in modelling procedural rules (first by deferring the adoption of procedural regulations and, more recently, by limiting the modernisation of procedural rules to a minimum).

The European Court of Justice (ECJ)⁴ has proven to be another major driving force in *shaping* the State aid control system. The ECJ has always maintained a rigorous approach to preserving the role of State aid control, being conscious that aid policies that Member States implement or, even worse, individual aid to specific undertakings, result in an uneven playing field, capable of hindering the free competition the founding fathers were aiming for.

When reading Articles 92 and 93 of the EEC Treaty, I am struck by the audacity of the founding fathers, which is especially reflected in the wide definition of aid, which made of it a multi-purpose provision capable of adapting to changing markets and, even more, to evolving goals. To paraphrase Jean Monnet, audacity *shaped* these rules more than cautiousness. Observing the various phases of implementation of State aid control will help to illustrate this feature. This is the object of the following remarks.

From the outset, State aid rules provided for the prevention of misallocation of resources as they were meant to avoid supporting undertakings that would not be rewarded by the market. Subsidies can lead to inefficiencies, and this means a waste of public money to the detriment of the Community’s welfare. Surveillance is meant to lead to the best allocation of resources within single Member States and, indirectly, to serve the goal of economic integration and Europe-wide welfare.

The control system is designed around a wide notion of aid,⁵ only limited by the requirements of distortion of competition⁶ and effect on trade. Article 92 of the EEC Treaty was worded to include all subsidies and measures with similar effect and every aid regardless of its form. Moreover, the wording “granted by a Member State or through State resources” included aid granted by both the Member

³ Especially since the beginning of the 1980s, the European landscape platform has been characterised by a dynamic presence of private players such as industrial groups, such as the European Roundtable of Industrialists (ERT) and Business Europe (formerly Union of Industrial and Employers’ Confederations of Europe (UNICE)). Their role in the State aid regulation has been fundamental as they have been a source of information for the Commission and have established strong alliances with national governments.

⁴ Judgment in *European Commission v France*, C-18/84, EU:C:1985:175.

⁵ Among others, see W. Mederer., N. Pesaresi, M. Van Hoof (eds), *EU Competition Law, State Aid* (Leuven: Claeys & Casteels, 2008), Volume IV, Book I, p. 30; R. Quadri, R. Monaco, A. Trabucchi, *Commentario al Trattato CEE* (Milan : Giuffrè, 1965); C. Quigley, *European State Aid Law and Policy* (3rd edn, Oxford : Hart Publishing, 2009).

⁶ The scope of the prohibition was broadened following an input of the Dutch delegation which wanted it to also encompass the threat to distort competition. See S. Neri, H. Sperl, *Traité instituant la CEE, Travaux préparatoires*, Luxembourg, 1960 p. 229.

State and by entities depending *latu sensu* on the Member State.⁷ The ECJ's broad interpretation of the requirements of competition distortion and effect on trade was therefore the ideal complement to this approach.

The audacity of the founding fathers also determined two additional features of State aid control: 1) as to the institution in charge of control, the founding states agreed that this should be the Commission which, as an independent and impartial institution, they considered to be the best solution;⁸ and 2) following input from the Italian delegation,⁹ an *ex-ante* control procedure was introduced whereby new aid is made subject to a standstill obligation until the Commission issues a decision.

Until the late 1960s the Commission was hesitant to make full use of its State aid authority, trying mostly to clarify the concept of State aid itself. Indeed, during that period only two negative decisions¹⁰ were issued; however, with the establishment of a true customs union in **1968**, it became increasingly apparent to the Commission that State aid control was becoming ever more relevant. Following a drive from the European Parliament, the Commission began publishing its *Report on Competition Policy* in 1971, as a means to provide information on its policy. This approach was brought to a halt by the financial crisis, which shook the world economy between the **1970s** and **early 1980s**. As we all know, the world economy suffered one of the most severe recessions in history, caused, among other things, by the breakdown of the Bretton Woods' monetary system and two consecutive oil shocks; consequently, European governments started to deliberately use public subsidies to promote national undertakings and raise employment levels. Additionally, the fact that Japanese and American companies started locating their plants in Europe led some Member States to offer subsidies in order to attract them in their country.¹¹ All this created conflict between European control over State aid and national public aid policies.¹² European governments were unable to agree on any common policy and simply applied their own economic policy to recover from the crisis.¹³ Moreover, undertakings began pressuring Member States to grant aid when they saw that their competitors were receiving subsidies in other Member States. The Commission felt that it was necessary to avoid a subsidy race which would have had a negative impact from both budgetary, competition and internal market perspectives.

⁷ Belgian authorities wanted to make sure that aid granted by entities depending on the State would also be included. See *supra* footnote 6, p. 229.

⁸ The Treaty established a ring-fenced window for unanimous Council decisions in cases that the Commission had opened investigations under Article 93(2) of the EEC Treaty. The Council has always played a limited role in developing State aid policy and its legislation, based on Article 94 of the EEC Treaty, which proved to be a failure during the 1960s when many proposals were withdrawn.

⁹ See *supra* footnote 6, p. 234.

¹⁰ The first in 1964 (the Ford Tractor Ltd Antwerpen case) and the second in 1969 (the Recherche et rénovation des structures industrielles et commerciales dans le secteur textile case).

¹¹ See European Commission/Netherlands Economic Institute, *New Location Factors for Mobile Investment in Europe: Final Report* (Luxembourg: Office of the Official Publications of the EC 1993).

¹² See the Commission, *Tenth Report on Competition Policy* (Luxembourg: Office of the Official Publications of the EC 1981), p. 111 *et seq.*; *Eleventh Report on Competition Policy* (Luxembourg: Office of the Official Publications of the EC 1982), p. 111 *et seq.*; *Twelfth Report on Competition Policy* (Luxembourg: Office of the Official Publications of the EC 1983), p. 109 *et seq.* The Commission's action was "imperative and impossible". Imperative because the level of aid activity was rising due to recession and rising unemployment, which led governments to rely on public resources. Impossible because it was politically risky, as governments were intolerant of interference with national industrial and employment policies. As the Commission realised, its role was becoming increasingly complex as it had to reconcile the need for aid with the objectives of Community policy (see *Eleventh Report on Competition Policy*).

¹³ France, for example, adopted a series of micro-economic measures to grant contracts and financial aid to the national leading industries, and the UK enforced some macroeconomic strategies through taxes, interest rates and subsidies. In almost all Member States, undertakings operating in specific industrial sectors (such as shipbuilding, steel production, car manufacturing and electronics) received national industrial subsidies.

This trend lasted until the **mid-1980s** when Member States finally agreed on a Common Policy for the development of the Single European Market. Until then, the Commission had Members States comply with EU State aid law, without being aggressive. This approach, whereby the Commission simply reacted to successive national initiatives rather than by implementing proper action at a Community level, was not effective, and the amount of State aid being granted continued to rise even when economic issues began subsiding. Although the Commission had increased its enforcement efforts in the early 1980s in reacting against political pressures by States, it had undeniably maintained a tenuous position *vis-à-vis* Member States. One indicator of the initial lenient approach is the fact that the Commission waited almost ten years following the landmark *Kohlegesetz* judgment¹⁴ before issuing the first recovery decisions. This delay was partially due to the lack of a strong support to the Commission from Member States.

The Mid-1980s and the 1990s: A New Beginning Following the Single Market Project and Liberalisation

One of the first key turning points in the *reshaping* of the EU State control system was indeed the Commission's new policy ordering the recovery of illegally granted aid.¹⁵ Without this instrument, which was not included in the Treaty, Member States would have had nothing to fear in implementing illegal aid (the possibility of pecuniary sanctions for failing to implement a judgment following an infringement procedure was introduced only later on with the Maastricht Treaty). At the same time, the risk of recovering aid made State aid less attractive for undertakings. Given the limited resources available, the Commission started then to focus its recovery policy on large cases in order to maximise overall cost-effectiveness. Additionally, focusing on large cases allowed the Commission to attract more attention on its policy.¹⁶

A second turning point was the Member States' and the Commission's belief that greater control of State aid was a necessary concomitant of further **liberalisation and the Single Market**: as remaining non-tariff barriers came down, subsidies and other forms of State aid were some of the few remaining tools available to governments to protect politically-sensitive and economically-threatened undertakings.

The Commission started paying more attention to State aid issues, and the ECJ developed the scope of judicial reviews of State aid decisions. In **1984**, the decision in the *Intermills* case¹⁷ gave the Commission more confidence, and from that time the Commission started using Article 93(2) of the EEC Treaty more frequently. **A new phase** started with the establishment in **1985** of a Task Force on State aid, which was tasked with reviewing all aid granted in the Community, to help Member States identify aid that posed a risk to the achievements of the single market. During the European summit in Milan in **1985**, the white paper on *Completing the Internal Market*¹⁸ (White Paper) was presented to the European Council, which contained a detailed programme of hundreds of measures. The internal market programme, also called the *1992 initiative*, was supported by the ERT's extensive lobbying to undecided national governments and became the legal basis for the **1986 Single European Act**. In accordance with the White Paper, the Commission underlined the importance of reinforcing the "Community discipline on state aids" and emphasised the link between a strong competition policy

¹⁴ Judgment in *Commission v Federal Republic of Germany*, C-70/72, EU:C:1973:87.

¹⁵ It was only in 1982 that the first decision ordering a recovery was issued (Decision No. 1982/312/EEC of 19 May 1982, OJ 1982 L 138/18).

¹⁶ A. Umut, *State Aid, Issue Framing and the Politics of Expertise*, Presentation at the ECPR Joint Session, Lisbon, 14-19 April 2009, available at <https://ecpr.eu/Filestore/PaperProposal/8ac220a8-b4a2-4d0a-8469-525a85f1ea08.pdf>.

¹⁷ Judgment in *SA Intermills v Commission of the European Communities*, C-323/82, EU:C:1984:345.

¹⁸ European Commission, *Completing the Internal Market*, COM(85) 310, http://europa.eu/documents/comm/white_papers/pdf/com1985_0310_f_en.pdf

and the accomplishment of the internal market. The Community's efforts to complete a single unified internal market by 1992 added more importance to the enforcement of competition rules, particularly the rules on State aid,¹⁹ and helped the Commission *shape* new legislation and screening tools.

Thanks to the Single European Act, which introduced the principle of economic and social cohesion that helped refine the approach to regional aid, the Commission acquired more powers to promote State aid control as a tool to orientate industrial and economic policies.²⁰ Indeed, following the Iberian enlargement, the Commission started to enforce more control over public aid, as policy measures were necessary to minimise the disparity between wealthier and poorer regions. The control of State aid therefore also became a necessary tool of **cohesion policy**.²¹

In **1987** the Padoa-Schioppa Report considered whether there was a need for stricter control over public measures distorting competition, including State aid. The report stated that the answer to this question must be nuanced, but at the same time stressed the need for a stricter control of subsidies during the completion of the Single Market, as State aid would be one of the few protectionist measures still available. In **1988** the First Survey of State Aids in the European Community, carried out by the Task Force established in 1985, demonstrated that, on average, aid represented 3% of the GDP and 10% of government expenditures. Additionally, those findings showed that state aid to enterprises exceeded the revenue generated from the direct taxation of companies.

As underlined in some literature,²² by the end of the **1980s** pressure for a stricter State aid policy also came from some Member States, such as the UK, the Netherlands and Denmark, in particular with regard to the granting of State aid to failing companies. Additionally, the UK and the Netherlands were facing budgetary pressures and economically conservative ideologies which pushed for a far stricter State aid policy.

In the **1990s**, State aid control followed the implementation of the Single Market programme. With the liberalisation, the scope of State aid control widened, for at least two reasons: first, the liberalisation process changed the tools available to the States, obliging them to use state-owned industries less and less to address political needs; second, it expanded the field of application of State aid control to new sectors and required increased transparency of the financial relations between the States and the undertakings.

The Treaty of Maastricht, which entered into force in 1993, provided very strict convergence criteria that EU Member States were required to fulfil to enter the Eurozone. These criteria imposed, among other things, public debt and deficit targets which obliged Member States to reduce public expenditure and take more care with budget discipline. This led Member States to decrease their spending on general economic support measures, which were excluded as such from the ban on State aid, but also to resort to new forms of aid.

During this period, the Commission encouraged private actors to submit complaints against competitors in order to collect more information and national courts to help control non-notified aid, too.

¹⁹ See Commission, *XV Report on Competition Policy* (Luxembourg: Office of the Official Publications of the EC 1986).

²⁰ E. Poli, *Financial Crisis Effect on Governance in the EU: The Development of State Aid Regulation Beyond the Oil Crisis and the Credit Crunch*, Draft Paper - Conference on The Financial Crisis, EMU and the Stability of Currencies and the Financial System University of Victoria Canada 30 September-2 October 2010, http://web.uvic.ca/jmc/events/sep2010-aug2011/2010-09-financial-crisis/pdf/Oct1,2010-Panel_B-Eleonora_Poli-Uvic-Financial_Crisis.pdf.

²¹ As stated in the Commission's Ninth Survey on State Aid in the European Union, COM/2001/0403 final, State aid control is essential "to the reduction in the disparities between prosperous regions and regions where there is either a concentration of crisis-ridden sectors or indeed no jobs at all".

²² See *supra* footnote 16.

As the **markets opened up**, State aid policy also became increasingly important in the field of services of general economic interests (SGEI). The main force that *shaped* the policy in this field was the case law. It helped the Commission to overcome an impasse in its policy on SGEI with landmark rulings in the early 2000s in cases such as *FFSA*, *Ferring*, and *Altmark*.²³ It was in the wake of the *Altmark* decision, in particular, that in 2005 the Commission adopted the first comprehensive set of new legislation in this field called the *Altmark package* (later followed by the 2011 *Almunia package*).

At the **end of the 1990s**, the Council adopted important pieces of legislation on the grounds of Article 94 of the EEC Treaty (now Article 109 of the TFEU): (a) Regulation No. 994/1998²⁴ enabling the Commission to introduce exemption regulations for categories of horizontal aid and to provide a legal basis for the *de minimis* rule; and (b) Regulation No. 659/1999 (known as the “Procedural Regulation”).²⁵ This Regulation, whose purpose was to provide more legal certainty for both the Commission and Member States, codified in one single binding text the Commission practice and the case law of the ECJ²⁶. This codification launched a first wave of modernisation of State aid rules and clearly confirmed the huge impact of the ECJ’s decisions in the making and *shaping* of the State aid control system. However, it also left the Commission sufficient freedom to organise the administrative proceedings to its needs.

The Economic Monetary Union, the Lisbon Strategy and the 2004 Enlargement: A Drive for Better-Targeted Aid and Better Public Spending

Starting from the **late-1990s** and until the mid-2000s, three important factors *shaped* State aid policy: first, the completion of the **Economic Monetary Union (EMU)**; second, the preparation and implementation of the **Lisbon Strategy**; and third, **the enlargement of the EU**.

The completion of the EMU required the use of State aid rules for the first time as a tool for Member States to **control public spending**. This trend was later exacerbated by the 2007-2008 financial crisis, which obliged several Member States to implement massive rescue measures to ensure the stability of their economic system and exposed others to the risk of default.

The emphasis placed on the new principle of “less and better targeted aid” showed the Commission’s willingness not only to reduce aid but mostly to divert aid to reasonable objectives of common interest.

The **2004** enlargement represented a challenge as it required the application of State aid rules in very different economies from those of the other Member States.

The **Lisbon Strategy** contributed to *shaping* a more pro-active competition policy for a more competitive EU, urging a better control over State aid by building a real partnership with Member

²³ Judgment of 27 February 1997, *FFSA and Others v Commission*, T-106/95, EU:T:1997:23, confirmed by the Court in Judgment in *FFSA and Others v Commission*, C-174/97 P, EU:C:1998:130; Judgment in *Ferring SA v Agence centrale des organismes de sécurité sociale (ACOSS)*, C-53/00, EU:C:2001:627; Judgment in *Altmark Trans GmbH and Regierungspräsidium Magdeburg v Nahverkehrsgesellschaft Altmark GmbH, and Oberbundesanwalt beim Bundesverwaltungsgericht*, C-280/00, EU:C:2003:415

²⁴ Council Regulation (EC) No. 994/98 of 7 May 1998 on the application of Articles 92 and 93 of the Treaty establishing the European Community to certain categories of horizontal State aid, OJ 1998 L 142.

²⁵ Council Regulation (EC) No. 659/1999 of 22 March 1999 setting out detailed rules for the application of Article 93 of the EC Treaty, OJ 1999 L 83/1.

²⁶ An example of the case law which *shaped* the Procedural Regulation is the *Lorenz* case, in which the ECJ established that the aid was tacitly authorised if the Commission issues no decisions within two months of the notification. Another example can be found in the *Cook* and *Matra* judgments, in which the ECJ has clarified the notion of interested parties and their rights. See Judgment in *Lorenz v Germany*, C-120/73, EU:C:1973:152; Judgment in *Cook v European Commission*, C-198/91, EU:C:1993:197; and Judgment in *Matra v European Commission*, C-225/91, EU:C:1993:239.

States and stakeholders, to ensure State aid rules better contribute to sustainable growth, competitiveness, social and regional cohesion, and environmental protection. The **2005 State Aid Action Plan** was launched with this very objective in mind: to provide more focused State aid rules and, thus, promote better-targeted aid and better public spending.

These three factors converge and play as a single *shaping* force in the current stage of development of EU State aid rules: they all lead to the consolidation of a monetary and economic union with common monetary policies and a strong coordination of economic policies, rather than a political union, as originally envisaged by the founding states. Such a major change in the driving force of EU State aid control requires further review and considerable changes to the “older” tools, which were not originally intended for this purpose.

Thus, over the last few years, the Commission has promoted a move from a purely form-based approach towards an effects-based and efficiency-based approach which emphasises the economic implications of State aid.

During this period, in order to increase the level of transparency and to identify which Member States were granting the highest level of State aid, the Commission introduced the on-line *State Aid Scoreboard* presenting all data on the volume and objectives of State aid in the various countries. This also encouraged policy makers to discuss State aid issues more freely.²⁷

From a procedural perspective, the Commission’s new approach generated more incentives to strengthen surveillance on the one hand, and raise the level of protection of individuals on the other hand. This has led, to give just one example, to a systematic application of the *Deggendorf* case law,²⁸ whereby the Commission requires Member States to suspend the payment of new aid (even if compatible) to undertakings that have not repaid previous illegal and incompatible aid. This has effectively increased pressure on Member States to enforce recovery decisions in a more diligent manner, so as to be able to implement new State aid measures.

Until **2007**, the use of State aid decreased across Member States because the Commission acquired many more powers to promote State aid control and its role strengthened as part of the EMU, the Lisbon Strategy and the enlargement. Moreover, since the 1990s, the reinforcement of the Single Market Programme has allowed a major coordination in the use of State subsidies by *shaping* Member States’ interests.

The 2007 Economic Downturn and Its Impact on the Shaping of EU State Aid Policy and Law

By the **end of 2007**, this positive trend changed when the worst financial crisis since 1930 struck the global economy. This crisis once again underlined the highly political dimension of State aid. Indeed, the first political reaction of Britain, France, Germany and many other European countries was to foster their national economic recovery through subsidy measures. State aid within the EU-27 rose sharply from less than 1% of EU GDP in 2007 to around 13% in 2011.²⁹

The need to guarantee a level playing field for European businesses, but also to avoid a subsidy war among Member States by preventing them from adopting unilateral measures to react to the crisis, forced the Commission to respond to the crisis with a set of new coordinated policies and the enactment of new important pieces of soft law (“Temporary Framework”).

²⁷ See above n 16.

²⁸ Judgment of 13 September 1995, *TWD v European Commission*, Joined cases T-244/93 and T-486/93, EU:T:1995:160; Judgment in *TWD v European Commission*, C-355/95 P, EU:C:1997:241.

²⁹ European Commission Staff Working Document, *Facts and Figures on State Aid in EU Member States, 2012 Update*, SEC(2012) 443 final of 21 December 2012.

When financial problems started subsiding, the “Exit Strategy” *shaped* State aid rules as deeply as the Temporary Framework had done. Indeed, following the Commission Communication of May 2012 on State Aid Modernisation (SAM), two major factors once more *reshaped* the enforcement of State aid rules: first, the need to contribute to a stronger financial discipline of the Member States, whilst at the same time avoiding increasing the gap, through State aid policy, between the deep-pocket States and the others; and second, the need to streamline the enforcement of State aid rules, allowing the Commission to focus on the most distortive cases, but at the same time guaranteeing a qualitative assessment of aid schemes and individual aid through the General Block Exemption Regulation (GBER).

From a procedural perspective, in view of the Commission’s increased powers, stakeholders more acutely felt the need for greater transparency in State aid procedures. However, the Commission and Member States failed to address this need when amending the Procedural Regulation.³⁰ The ECJ’s case law once again significantly contributed to this trend, especially regarding the position of claimants. In this respect, cases such as *Athinaiki*, *NDSHT* and *Ryanair* have had a strong impact on enforcement practice.³¹ Similarly, case law has strengthened parties’ defence rights by: (a) imposing limits on the Commission’s control of the correct execution of its recovery decisions (*Mediaset*);³² and (b) maintaining access to justice for all undertakings receiving a recovery order.

It is indeed thanks to the ECJ³³ that the actual beneficiaries of individual aid granted under an aid scheme can challenge the Commission’s decision before the EU courts, declaring an aid scheme incompatible with the common market and seeking recovery of the aid paid out. After a ten-year battle and despite the Commission’s efforts to persuade the EU courts that these claims should be dealt with at a domestic level, the ECJ has refused to accept the Commission’s view that this solution was in the best interest of the EU’s legal system. Without such a strong stance by the EU courts, the *shape* of EU State aid control would have been very different from the current one.

In spite of this, the ECJ has been too conservative in defending the bilateral characterisation of State aid proceedings. As a consequence, transparency and procedural rights for third parties are still the two main unresolved issues in State aid control.

Conclusion

Undoubtedly, the founding fathers demonstrated extraordinary perspicacity and vision in including State aid rules in the Treaty from the outset. These rules have always played a vital role in the EU preventing State-driven distortions of competition and hidden protectionism; improving cohesion between the regions in the EU;³⁴ and promoting solidarity and a level-playing field. In this sense, these rules have played a pivotal bridging role between guaranteeing undistorted competition and strengthening market integration and Europe-wide welfare.

Primary law in this field has proved to be as flexible as it needed to be and made it possible to quickly translate new political guidelines into instruments for action. Soft law and secondary

³⁰ Council Regulation No. 734/2013 of 22 July 2013 amending Regulation No. 659/1999, setting out detailed rules for the application of Article 93 of the EC Treaty, OJ 2013 L 204/15.

³¹ Judgment in *Athinaiki Techniki v Commission*, C-521, EU:C:2008:422; Judgment in *NDSHT Nya Destination Stockholm Hotell & Teaterpaket AB v European Commission*, C-322/09 P, EU:C:2010:701; Judgment of 19 May 2011, *Ryanair v Commission*, T-423/07, EU:T:2011:226.

³² **Judgment** in *Mediaset SpA v European Commission*, C-403/10 P, EU:C:2011:533.

³³ Judgments in *Comitato “Venezia vuole vivere” and Hotel Cipriani Srl and Società Italiana per il gas SpA (Italgas) v European Commission*, Joined cases C-71/09 P, C-73/09 P and C-76/09 P, EU:C:2011:368.

³⁴ G.E. Luengo Hernandez De Madrid, “Conflicts Between the Disciplines of EC State Aids and WTO Subsidies: Of Books, Ships and Aircraft”, *European Foreign Affairs Review* 13 (2008), 1-31.

legislation rules have been constantly inspired by these political guidelines and, broadly speaking, have fulfilled their role adequately.

However, State aid control presents some unique aspects which still have to be entirely explored. After three waves of modernisation, State aid substantive rules (secondary law and soft-law) have reached a level of sophistication, coherence and stability never attained before. By contrast, the need to deeply *reshape* the rules is still very strongly and widely felt by stakeholders as far as the procedure is concerned. Enforcement has proved to be less consistent, persuasive and effective due to procedures which progressed too slowly and behind the times. The distinction between substantive and procedural rules is crucial for describing the forces which have *shaped* State aid rules. Historically and until relatively recently, procedural rules *have been shaped* by less worthy forces and objectives such as a quite conservative approach by the administration, unwilling to accept any changes when it comes to its consolidated internal practice. In the administrative practice, many general principles of State aid control (such as, for example, the bilateral character of the administrative procedure before the Commission) have been almost invariably interpreted and applied as “dogmatic” rules and, therefore, incapable of substantial development or reform. In this sense, only a change in the approach of the Commission and the Member States at law-making level – i.e. pursuing the general interest and not their own goals – can lead to a satisfactory *reshaping* of State aid procedural rules and bring them to a level of maturity comparable to that achieved by substantive rules.³⁵

³⁵ Member States’ interests and policies always play a pivotal role in *shaping* the rules on State aid according to C.D. Ehlermann, “State Aids Under European Community Competition Law”, *Fordham International Law Journal* 18/2 (1994).

Changes and What Drives them Evolution of State Aid Control

Koen Van de Castele¹

The genesis of State aid rules in the European legal order is well known. From the outset there was recognition that a common market as it was then called could not function properly if competition would be distorted through State interventions.

ECSC-Treaty

The first Community organisation was created in the aftermath of the Second World War when reconstructing the economy of the European continent and ensuring a lasting peace appeared necessary.

Thus the idea of pooling Franco-German coal and steel production came about and the European Coal and Steel Community (ECSC) was formed. This choice was not only economic but also political, as these two raw materials were the basis of the industry and power of the two countries. The underlying political objective was to strengthen Franco-German solidarity, banish the spectre of war and open the way to European integration.

The Treaty establishing the European Coal and Steel Community was signed in Paris on 18 April 1951 and entered into force on 23 July 1952, with a validity period limited to 50 years. The Treaty expired on 23 July 2002.

The ECSC Treaty contains an absolute prohibition of “subsidies or aid”:

Article 4

The following are recognized as incompatible with the common market for coal and steel and shall accordingly be abolished and prohibited within the Community, as provided in this Treaty:

(a) import and export duties, or charges having equivalent effect, and quantitative restrictions on the movement of products;

(b) measures or practices which discriminate between producers, between purchasers or between consumers, especially in prices and delivery terms or transport rates and conditions, and measures or practices which interfere with the purchaser's free choice of supplier;

(c) subsidies or aid granted by States, or special charges imposed by States, in any form whatsoever;

(d) restrictive practices which tend towards the sharing or exploiting of markets or the exploitation of the consumer.

This absolute prohibition was in practice modulated through decisions adopted by the High Authority under Article 95 of the ECSC Treaty.

Spaak Report

The report on the common market prepared by the Intergovernmental Committee on European Integration (so-called Spaak Report)² which prepared the grounds for the EEC Treaty was clearly

¹ The views expressed are purely those of the writer and may not in any circumstances be regarded as stating an official position of the European Commission. Contact: Koen.Van-De-Castele@ec.europa.eu. Thanks to V. Tesna for her assistance with this contribution.

inspired by the GATT rules (to which reference was made in the part on the customs tariff for the customs union).

However, from the beginning, there are differences built in, most markedly the fact that GATT 1947 focuses on products while the Spaak report looks at undertakings (and hence has a broader scope, including e.g. services).³

Also noteworthy is that the absolute prohibition of the ECSC Treaty became a prohibition in principle with various compatibility grounds.

Règles concernant les aides accordées par les Etats: Une des garanties essentielles qui doivent être données aux entreprises, c'est que le jeu ne risque pas d'être faussé par les avantages artificiels dont bénéficieraient leurs concurrents.

Les aides accordées par les Etats doivent donc être examinées de très près, indépendamment de la forme extérieure qu'elles revêtent: l'exemption accordée à une catégorie d'entreprises ou à une branche d'industrie au regard des charges de droit commun comporte les mêmes effets et relève des mêmes critères d'examen qu'une subvention sur fonds publics.

Il est nécessaire de fixer les principes généraux qui doivent être retenus dans ce domaine, les exceptions temporaires qui peuvent être admises, les procédures appropriées.

La règle générale est que sont incompatibles avec le marché commun les aides, sous quelque forme qu'elles soient accordées, qui faussent la concurrence et la répartition des activités en favorisant certaines entreprises ou certaines productions.

Ce critère permet immédiatement de mettre hors de cause une importante part des aides accordées par les Etats:

- *des subventions bénéficiant aux consommateurs individuels, qui n'entrent pas dans le circuit de la production et qui ne sont pas en concurrence entre eux, sont un instrument de politique sociale et une méthode de redistribution des revenus qui restent entièrement aux mains des Etats à la condition d'être accordées sans discrimination liée à l'origine des produits, elles n'ont pas d'incidence sur le marché commun. La même considération vaut pour les aides aux établissements désintéressés: écoles, hôpitaux, centres de recherche, institutions charitables;*
- *la politique générale peut attacher une importance essentielle au développement de certaines régions pour éviter des concentrations urbaines excessives ou au maintien d'équilibre entre différents groupes sociaux. Les subventions dont elle userait à cet effet ne tendent qu'à compenser, pour les activités intéressées, les désavantages qui leur sont imposés en vue de l'avantage collectif. C'est sous cet angle il conviendra en particulier de considérer les aides données à l'agriculture de certaines régions spéciales, telles que les montagnes ou les sols pauvres, aussi bien qu'au développement d'activités décentralisées susceptibles de réabsorber des agriculteurs en surnombre ou de leur offrir un emploi de complément.*

En dehors même de ces exceptions de caractère durable, l'intervention des subventions comporte des exceptions temporaires :

- *au cours de la période de transition, il peut y avoir avantage à conserver ou même à créer des aides directes à certaines exploitations marginales pour leur permettre de subsister et de s'adapter; cette méthode, surtout si elle est assortie de conditions concernant l'emploi productif des fonds, évite que les prix ne s'établissent au niveau des coûts de ces exploitations, ou que la réduction des protections ne doive être ralentie pour l'ensemble de l'industrie à laquelle elles appartiennent;*

(Contd.) _____

² Intergovernmental Committee on European Integration, *The Brussels Report on the General Common Market* (the Spaak Report), 1956. English summary available at http://aei.pitt.edu/995/1/Spaak_report.pdf.

³ L. Rubini, "The International Context of EC State Aid Law and Policy: The Regulation of Subsidies in the WTO" in A. Biondi, P. Eeckhout and J. Flynn (eds), *The Law of State Aid in the European Union* (New York: Oxford University Press 2004), p. 149. M. Slotboom, "Subsidies in WTO Law and in EC Law, Broad and Narrow Definitions", *Journal of World Trade Law* 36/3 (2002), p. 517. K. Van de Castele, "The International Dimension of State Aid", in M. Sanchez Rydelski (ed.), *The EC State Aid Regime* (London: Cameron May 2006), p. 789.

- *les aides peuvent être admises à titre temporaire si elles ont pour effet, non de favoriser des entreprises, mais de compenser des distorsions qui agiraient à leur détriment.*

Le discernement entre les diverses formes d'aides, suivant leur effet économique et leur opportunité pour la réalisation progressive et sans heurts du marché commun, doit être confié à la Commission européenne à laquelle elles devront être notifiées par l'Etat intéressé, mais qui pourra aussi entreprendre l'examen approprié sur la base des informations qu'elle se procurera elle-même ou sur demande un autre Etat.

Il lui appartiendra, après consultation du Conseil, et sous réserve de recours devant la Cour, des Etats affectés par la décision, de statuer sur la compatibilité des aides publiques avec le marché commun, ou sur les conditions et délais qui s'attacheront aux autorisations temporaires. Toutefois il y a lieu de noter que certains régimes d'intervention qui formellement sont des aides ou des subventions ne s'adressent pas spécifiquement à des entreprises ou à des secteurs, mais affectent l'économie générale. Dans ce cas la Commission n'a pas compétence pour décider par elle seule de l'incompatibilité, mais a besoin de l'accord du Conseil à l'unanimité dans la première étape, à la majorité qualifiée par la suite.⁴

Treaty-Provisions

The Treaty provision is currently laid down in Article 107 of the Treaty on the Functioning of the European Union. It is basically identical to the original Article 92 of EEC Treaty and very much follows the wording in the Spaak Report, in particular as regards the prohibition in principle.

1. Save as otherwise provided in the Treaties, 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 internal market.
2. The following shall be compatible with the internal 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. Five years after the entry into force of the Treaty of Lisbon, the Council, acting on a proposal from the Commission, may adopt a decision repealing this point.
3. The following may be considered to be compatible with the internal market:
 - (a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment, and of the regions referred to in Article 349, in view of their structural, economic and social situation;
 - (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 Union 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 on a proposal from the Commission.

⁴ Intergovernmental Committee on European Integration, *The Brussels Report on the General Common Market* (the Spaak Report), 1956, available in French, <http://www.unizar.es/euroconstitucion/library/historic%20documents/Rome/preparation/Spaak%20report%20fr.pdf>

Evolution

Although the Treaty provision has not changed, its application has clearly evolved, partially linked to the expansion of the internal market (e.g. liberalisation of the energy markets, which created the pre-condition for having measures which could potentially impact competition and trade between Member States), partially through an expansionist reading by the Union Courts.⁵

This expansionist reading went largely parallel to the broad interpretation given more generally by the Commission and especially by the Union Courts to rules to help shaping the internal market. After a first expansionist phase, there was a backlash during the years of eurosclerosis in the 1970s and the early 1980s, until the adoption of the Single European Act in 1986, which gave a new impetus to the process.

In the period starting from 1998, under Commissioners Van Miert and Monti the Commission became much more active in a legislative role (part together with the Council), with the adoption of Enabling Regulation, Procedural Regulation, the first block exemption regulations and the first more comprehensive “guidelines”, which are soft law instruments akin to hard law. Commissioner Kroes initiated in 2005 a modernisation plan for State aid control with SAAP, the State Aid Action Plan, which took in particular a more economic approach.⁶

Commissioner Almunia went further down this reform road with the State Aid Modernisation, which went much further than the SAAP as it also entailed a widening of the Enabling Regulation and a revision of the Procedural Regulation.

Research Project

The proposed research project is very ambitious.

In the above very sketchy overview, the three main forces shaping the subsidies rules have been the Member States/Council, Commission and Union Courts. That is not to say that these are the only ones, e.g. the European Parliament has played a rather active role in the preparation and adoption of the SGEI-package. Also more granular approaches would be possible, e.g. differentiating between the General Court and the Court of Justice or looking at the role played by individual European Commissioners (e.g. someone like Mario Monti).

Focusing on two of the main actors, the Union Courts and the European Commission, there are many instances one may want to examine more closely. There are maybe three in particular I would tentatively put forward.

Shaping of Rules: “Insofar as it Affects Trade between Member States”

Very striking is the different development as regards impact on trade and competition, where the Union Courts in cases like Philip Morris,⁷ Tubemeuse,⁸ Altmark⁹ or Heiser¹⁰ went very far so that

⁵ A. Biondi and E. Righini, “An Evolutionary Theory of State Aid Control”, King's College London Dickson Poon School of Law, Legal Studies Research Paper Series, Paper No. 2014-41.

⁶ See T. Kleiner, “The State Aid Action Plan”, in W. Mederer., N. Pesaresi, M. Van Hoof (eds), *EU Competition Law, State Aid* (Leuven: Claeys & Casteels 2008), Volume IV, Book I, p. 65; for a more sceptical view, see J.L. Buendia Sierra and B. Smulders, “The Limited Role of the ‘Refined Economic Approach’ in Achieving the Objectives of State Aid Control: Time for Some Realism”, *EC State Aid Law: Liber Amicorum Francisco Santaolalla* (Alphen aan den Rijn: Kluwer 2008), Chapter 1.

⁷ *Philip Morris v Commission*, C-730/79, EU:C:1980:209.

⁸ *Belgium v Commission*, C-142/87, EU:C:1990:125.

⁹ *Altmark Trans and Regierungspräsidium Magdeburg*, C-280/00, EU:C:2003:415.

¹⁰ *Heiser*, C-172/03, EU:C:2005:130.

impact on trade and competition has become nearly a given. That case law went against the developments in other parts of competition policy, notwithstanding the near identical provisions in the Treaty provisions.

Article 107(1): ... which distorts or threatens to distort competition by favouring ..., in so far as it affects trade between Member States,...

Article 101(1): ... which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular

Article 102: Any abuse by one or more undertakings of a dominant position within the common market or in a substantial part of it ... in so far as it may affect trade between Member States.¹¹

Although the Commission generally seems to have supported such broad interpretation by the Union Courts,¹² there have been attempts to at least limit somewhat the scope and give more meaning to the notions effect on trade/impact on competition.¹³ In 2003 the Commission came forward with a significant impact test, composed of two parts, the LASA (lesser amounts of State aid) and LET (limited effect on trade), project which was eventually abandoned.¹⁴ The draft Communication explicitly stated that it did not seek to reinterpret the case law of the Community Courts, or to call into question the concept of effect on trade. “Rather, as part of its discretion to assess the economic effects of aid, the Commission is seeking to identify those characteristics of aid measures which make it possible to consider that the measures will produce only limited effects on trade, and which may therefore be subject to a simplified assessment procedure.”¹⁵ LET could only apply to a limited number of activities that, by their nature, do not produce significant cross-border effects. The measures qualified as State aid, but in view of their limited impact could be subject to a light assessment, normally leading to a compatibility conclusion.

Even if the LET-project was abandoned, it is interesting to note that the Commission still considers that certain sectors/activities are inherently less prone to affect trade between Member States. Indeed, several of the sectors included in the LASA/LET reappear in a Commission decision regarding aid for the reduction of social security contributions in Sweden, be it as compatible aid: “Although the measure concerns service activities, which are normally provided

¹¹ Commission Notice, Guidelines on the Effect on Trade Concept Contained in Articles 81 and 82 of the Treaty, OJ C 101, 27 April 2004, pp. 81-96.

¹² See e.g. for a rather extreme case, Commission Decision of 11 May 2011, *State aid to the Danish Shellfish Centre*, OJ C 215, 21 July 2011, p. 21.

¹³ Based on K. Van de Castele, “Effect on Trade” in W. Mederer, N. Pesaresi, M. Van Hoof (eds) *EU Competition Law, State Aid* (Leuven: Claeys & Casteels. 2008), Volume IV, p. 403ff.

¹⁴ The history is summarised in the impact assessment to the SAAP (State aid Action Plan):

In 2003, DG COMP put forward some proposals in order to improve the prioritisation of State aid policy, through a significant impact test. DG Competition has consulted other services and Member States and comments have been taken into account to the largest possible extent. More specifically, on 17 October 2003 (ref D/56595) an inter service consultation on two Communications, LASA and LET was launched and at the “réunion bimensuelle des chefs de cabinet” on 20 November 2003, a summary was circulated and the drafts were presented to the other Cabinets. On 4 February 2004 the Commission services had a multilateral meeting with experts of the Member States about the LASA/LET Communications. Subsequently, the two Communications were merged and a second inter service consultation was launched on 12 May 2004 and a discussion was held in the “réunion bimensuelle des chefs de cabinet” on 1 July 2004. Other stakeholders also communicated their views on these texts, and notably the industry.

While there was a generally positive reaction in favour of an instrument allowing Member States more flexibility to design and implement aid measures, which do not pose significant risks to trade and competition, it appeared that the proposals under LASA/LET were not a viable option for the Commission, notably due to legal uncertainty in their implementation.

¹⁵ Draft Communication from the Commission, A new framework for the assessment of State aid which has limited effects on intra-Community trade, http://ec.europa.eu/competition/state_aid/reform/sit_let_en.pdf

at the local level, the Commission is not able to exclude the possibility, particularly as regards sectors such as boat repairs or hotels and catering, that the scheme may involve services provided on a cross-border basis, or undertakings involved in trade between Member States”.¹⁶

On 7 November 2012, the Commission adopted a package of no aid decisions,¹⁷ to which it gave some prominence.¹⁸

As recently as 29 April 2015, the Commission has adopted another package of cases which it actively advertised as cases having a local impact only because they are unlikely to have “a significant effect on trade between Member States”.¹⁹

Shaping of Rules: Commission’s Response to the Financial Crisis

The turmoil in the financial markets which was triggered by the financial crisis in 2008 called for the intervention by European governments in order to limit the adverse effects of the shock. State aid to financial institutions was crucial as a means of restoring confidence in the financial sector with the aim of avoiding a systemic crisis.

The control of these aids by the Commission ensured these measures did not destroy the level playing field between aid recipients and their competitors. State aid rules were the main instrument that the European Commission had at its disposal to avoid subsidy races, protectionist measures and unfair damage to healthier companies. State aid rules also limit the amount of taxpayers’ money going into failed financial institutions.

The existing rules had to be revised to allow for more flexibility and faster procedural processes were required. The Commission had to have recourse to the near obsolete legal basis of Article 107(3)(b) of the TFEU (“aid to remedy a serious disturbance in the economy of a Member State”). Very quickly the European Commission adopted a set of new rules which were still inspired by the traditional rescue and restructuring guidelines for firms in difficulty²⁰ but much more tailor-made to take account of the specificities of financial institutions and the gravity of the crisis.

Generally, the action of the European Commission has been welcomed.²¹ Certainly the response to the financial crisis has shown the adaptability of State aid control.

The genesis of these new rules to address the financial crisis and the interaction with new actors like the ECB in the process presents another promising area for further research.

¹⁶ Commission Decision N 581/2007 of 11 December 2007, *Sweden - Scheme for reduced social security contributions in certain service sectors*, OJ C 59, 4 March 2008, p. 3.

¹⁷ SA.34466 – Cyprus – Centre for Visual Arts and Research; SA.34576 – Portugal – Jean Piaget/Northeast medium- and long-term continuing care unit; SA.33243 – Portugal – Jornal de Madeira, SA.34404 – The Netherlands – Purchase of land for relocating riding school.

¹⁸ See e.g. Commission Staff Working Document, *Guide to the Application of the European Union rules on State Aid, Public Procurement and the Internal Market to Services of General Economic Interest, and in Particular to Social Services of General Interest*, SWD(2013) 53 final/2, 29 April 2014, p. 38, http://ec.europa.eu/competition/state_aid/overview/new_guide_eu_rules_procurement_en.pdf.

¹⁹ See European Commission - Press release, *State Aid: Commission Gives Guidance on Local Public Support Measures that can be Granted Without Prior Commission Approval*, available at http://europa.eu/rapid/press-release_IP-15-4889_en.htm. (emphasis added)

²⁰ At the time the: Communication from the Commission, *Community Guidelines on State Aid for Rescuing and Restructuring Firms in Difficulty*, OJ L C 244, 1 October 2004, pp. 2-17. Those guidelines are now replaced by Communication from the Commission, *Guidelines on State Aid for Rescuing and Restructuring Non-Financial Undertakings in Difficulty*, OJ C 249, 31 July 2014, p. 1.

²¹ See e.g. ECON Report, *State Aid Crisis Rules for the Financial Sector and the Real Economy*, 2011, <http://www.europarl.europa.eu/document/activities/cont/201107/20110714ATT24010/20110714ATT24010EN.pdf>

SAM

A last (and certainly not the least) area of interest is the new State Aid Modernisation package. The modernisation has three main, closely linked objectives:²²

- i) Foster growth in a strengthened, dynamic and competitive internal market
- ii) Focus enforcement on cases with the biggest impact on the internal market
- iii) Streamlined rules and faster decisions

Now, one of the questions would be whether those changes actually lead to changes in State aid control. In particular fostering growth enhancing measures seem at least *prima facie* at a variance with the more traditional perceived primary role for State aid control of ensuring a competitive internal market. More generally, SAM conveys the message that not all compatible State aid is equal. The strong insistence on using the General Block Exemption Regulation rather than notifying measures could suggest that the Commission moves beyond State aid control into the direction of State aid policy (a traditional competence for Member States).

The first comments trying to evaluate the impact of the new rules vary from moderately positive²³ to the rather negative.²⁴

Tentative Submission: Limitations of Enforcement Agency As a Driver for Change?

The two main policy changes in the last ten years have been the State Aid Action Plan²⁵ and State Aid Modernisation.

It is submitted that an important driver for the reform process is countering the European Commission's limitations as an enforcement agency.

The European Union has itself gone through very important changes in that period – first and foremost, enlargement, which implied that a union of 15 Member States expanded to 25 in 2004, 27 in 2007 and 28 Member States in 2013, operating in 24 official languages²⁶ (as opposed to the 11 languages before the 2004 accessions).

The fact that the Union Courts have taken a different direction than in antitrust regarding impact on trade and competition, notwithstanding the very similar language²⁷ may have contributed to an “imperial overstretch”, whereby the resources of the European Commission are too thinly spread to adequately deal with all cases, while dealing with economically insignificant

²² See Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *EU State Aid Modernisation*, COM(2012) 209 final, 8 May 2012, <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0209&from=EN>.

²³ L. Idot, “Regards sur la modernisation du contrôle des aides d'Etat”, *Concurrences*, n. 4, 2014, p. 83.

²⁴ A. Sanchez-Graells, “Digging Itself Out of the Hole? A Critical Assessment of the European Commission's Attempt to Revitalise State Aid Enforcement After the Crisis”, University of Leicester School of Law Research Paper No. 15-15.

²⁵ See State aid action plan - Less and better targeted state aid : a roadmap for state aid reform 2005-2009, <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=CELEX:52005DC0107>

²⁶ Note that Irish (Gaeilge) has been an official language of the European Union since 1 January 2007 following an agreement within the Committee of Permanent Representatives of EU Member States on 13 June 2005 to amend Council Regulation 1/19581 (Article 2 of Council Regulation 920/05). However, there was a derogation from the obligation to draft and publish all acts in Irish until 1 January 2012 – this applies to both legislation and decisions. This derogation has been extended for a period of five years (until 31 December 2016) by Council Regulation (EU) No 1257/2010.

²⁷ Article 107(1) of the TFEU: “... which distorts or threatens to distort competition by favouring ...”, in so far as it affects trade between Member States, ...” vs. Article 101(1) of the TFEU: “... which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the internal market, and in particular ...”

cases, which seem to have at most a purely theoretical impact.²⁸ It is also noteworthy that in both stages of the reform there was a lot of attention for the need to adopt decisions in “business relevant timelines”.

Lastly, State aid policy was seen as a constituent element for the Lisbon Strategy and Europe 2020, aiming at supporting growth through a renewed focus on the internal market.

In light of those considerations, it is easier to grasp the reform steps undertaken

- iv) Extension of the General Block Exemption Regulation – a whole range of less problematic cases no longer need to be notified *ex ante* to the European Commission, but Member States can start implementing those measures immediately.
- v) Reform of the Procedural Regulation, which introduced new tools to collect information (e.g., market information tools, sector inquiries) and at the same time allowed reigning in sometimes frivolous complaints.
- vi) Focus on cases that really matter: that implies identifying “good aid” and “bad aid” – this objective ties in with the strong emphasis on economics in both reform stages.²⁹

Although “it is exceedingly difficult to make predictions, particularly about the future”, to quote Danish physicist Niels Bohr, I will still try.

First, I would expect that there will be in some shape or form a closer involvement of Member States – some may even call it decentralisation.³⁰ Even if the general block exemption regulation has a much wider scope, there will always be cases which may still not be covered, while they actually have a very limited impact on competition. One could envisage a sort of first screening by an entity at national level, followed by a simplified, confirmatory process at Commission level.

Secondly, calls to extend third party rights in State aid proceedings will only increase.³¹ As mentioned, the Commission has received new tools to collect better information, and the cases it is currently dealing with are often very high profile³² (as they should be - one of mantras of the State aid reform process was that the Commission should focus particularly on the cases which really matter, rather than the Dorsten swimming pool or Brighton Piers of this world).³³ I see however no reason why such extension of third party rights should take place. The case law of the Union Courts has clearly defined the rights that third parties enjoy,³⁴ which is now further cemented in the Procedural Regulation.³⁵

²⁸ See e.g. SA.30649 State aid to the Danish Shellfish Centre, above n 12.

²⁹ In that respect, I refer to the contribution by V. Verouden, ‘EU State Aid Control: The Quest for Effectiveness’.

³⁰ Legally, that terminology is wrong – the Commission cannot delegate its competences in the area of State aid control.

³¹ See e.g. M. Merola and L. Aramati, “Complainants’ Rights in State Aid Matters: Lost in Modernisation?”, GCLC Working Paper 01/13; F. Laprévote, “A Missed Opportunity? State Aid Modernization and Effective Third Parties Rights in State aid Proceedings”, *European State Aid Law Quarterly* 3 (2014), pp. 426-439; J. Temple Lang, “The Charter and EU State Aid Procedure”, conference paper available at <http://uksala.org/state-aid-modernisation-seminar-slides/>.

³² See, e.g., tax investigations with regard to Apple, Amazon, Starbucks and Fiat.

³³ See e.g. speech of Commissioner Kroes on 14 July 2005, “The State Aid Action Plan – Delivering Less and Better Targeted Aid”, available at http://europa.eu/rapid/press-release_SPEECH-05-440_en.htm?locale=en.

³⁴ *Commission v Sytraval and Brink's France* C-367/95P, EU:C:1998:154; *Athinaiki Techniki v Commission* C-521/06P, EU:C:2008:422.

³⁵ A similar prediction was made regarding WTO procedures, see, e.g., the essay of Professor Davey, ‘Subsidy Control in the GATT/WTO: Surveillance and Litigation’.

Thirdly, the quest for identifying “good aid” will continue. I don’t dare to speculate whether that is a quest “to boldly go where no man has gone before” or rather “there and back again”; I’ll leave that question to my friends, the economists, to answer.

EU State Aid Control: Competition Between Undertakings or Between Member States?

Jose Luis Buendia Sierra¹

I. Introduction

The substance of State aid rules in the Treaty has never been modified. However, the actual implementation of EU State aid rules has changed a lot over time. This short essay will try to identify some of the forces shaping these changes and will try to explain some of the reasons behind them.

I will focus in particular on one specific point of contention. Everybody agrees that EU State aid rules are part of the EU competition rules. It is however much more difficult to agree on the kind of competition that these rules are about. Is State aid about competition between undertakings (like antitrust) or is it rather about the competition between Member States in attracting and keeping economic activities on their territory? As we will explain later, this is far from a purely abstract debate but one with profound practical consequences. Despite this, it has not attracted much explicit attention. I will try to explain now my view on how the different actors have played their roles with regard to this specific issue.

Let's first have a look to the original rationale of State aid rules, as designed in the Treaty of Rome. Articles 92 and 93 have been renumbered and are now Articles 107 and 108 of the TFEU, but their content has barely been modified. Article 107(1) is the key provision and reads as follows:

Save as otherwise provided in the Treaties, 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 internal market.

Look also to the Spaak Report,² page 57:

La règle générale est que sont incompatibles avec le marché commun les aides (...) **qui faussent la concurrence et la répartition des activités** en favorisant certaines entreprises ou certaines productions.

EU State aid rules are placed between internal market rules addressed to the Member States and antitrust rules addressed to undertakings. They are also competition rules albeit addressed to the Member States. The key question is who are these competitors involved in the competition to which the different rules refer.

It is essential to understand that the Treaty is speaking here of two very different kinds of "competition": competition between undertakings and competition between Member States. Lip service is regularly paid to both objectives in the context of State aid, but the implications are rarely understood. Indeed, the logic of both objectives is rather different: while the Treaty wants to preserve competition between companies, it also wants to limit competition between Member States. The problem is that the Treaty is supposed to cover both objectives with the same set of rules! It is obviously an uneasy coexistence. As this essay will try to show, this internal tension may contribute to explain some of the changes undertaken by State aid control over the years.

Let us now briefly summarise the key Treaty rules on State aid. The prohibition of State aid appears in the current Article 107(1) of the TFEU. State aid was meant to be a large (but not

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² Intergovernmental Committee on European Integration, The Brussels Report on the General Common Market (the Spaak Report), 1956.

unlimited) notion from the beginning. The exceptions to the prohibition foreseen in Article 107 were based on what we now call “equity reasons”, while efficiency considerations and “market failures” were entirely absent. The main characteristics of the procedure as foreseen by the Treaty are as follows. Member States must notify *ex ante* their projects to grant aid, while the Commission – under its exclusive competence – decides on its compatibility. The dialogue occurs exclusively between the Commission and the Member State; undertakings are almost entirely absent, at least legally speaking. Member States may request the judicial review of the decisions if they don’t agree with the Commission analysis. Undertakings may do so too, albeit with more difficulties.

II. The Names of the Actors

It would be useful to present briefly the different “actors” that play in the drama. We can distinguish three major roles: the Member States, the undertakings and the European Commission. We will also briefly refer to the judiciary, both at EU and national level. None of these categories is entirely homogeneous, but will give us a simplified idea of the interactions that may occur. Indeed, these actors could also be seen as the “forces” shaping the evolution of EU State aid control.

The Member States

The Member States have different attitudes and capabilities as regards the idea of granting aid. Some have both the willingness and the resources to grant aid, while others lack at least one of both elements (more often the resources). As a result, the undertakings may have greater or fewer possibilities to receive aid depending on the Member State in which they are located.³

Originally, that asymmetry was the main reason for the establishment of State aid control in the EU.⁴ State aid control was introduced at the time in order to avoid distortions of competition between companies and also in order to avoid subsidies races between Member States trying to attract companies to their territories. However, this later idea is no longer so fashionable. Indeed, in the day to day, Member States currently tend to look more to their own interest in giving aid and do not really care very much about the aid granted by other Member States. With some exceptions, Member States do not feel the aid granted by its fellows as a major competitive threat to them. They tend to see it as a problem for the undertakings. They let the undertakings go to the Commission by themselves. At most they do some lobbying in their support, but normally not too openly.

Generally speaking, Member States tend to care more about their own possibilities of granting “their aid”. As a consequence, they develop a kind of tacit neutrality – if not solidarity – towards their fellow Member States’ actions in this field. Sadly, the Commission may be seen more as a common obstacle than as a neutral arbiter. Exceptions occur when delocalisation appears as an obvious consequence of the aid, such as the granting of aid to carmakers or to bank deposits during the crisis. Those were rather brutal reminders of the importance of State aid as an instrument of competition between Member States.

Member States with fewer resources often do not realise that other (richer) Member States may use State aid as an antidote against its lower costs and other internal market economic effects. Or perhaps

³ Former commissioner Kroes stated that “some Member States have deeper pockets than others” and recalled that “one Member State spent 20 billion Euro of State aid in 2005, compared to 64 billion for the entire EU 27”: Neelie Kroes, *The Law and Economics of State aid control – a Commission Perspective*, SPEECH/07/60, speech delivered in Berlin on 8 October 2007 at Joint EStALI/ESMT Conference on “The Law and Economics of European State Aid Control”, p. 4.

⁴ This was explained by Baron Snoy et D’Oppuers, member of the Belgian delegation during the *travaux préparatoires* for the Treaty, in an interesting article, “La notion de l’intérêt de la Communauté à l’article 90 du Traité de Rome sur le marché Commun—rapport international” in *Concorrenza tra settore pubblico e privato nella CEE*, Colloquio di Bruxelles della “Ligue Internationale contre la concurrence déloyale” 5–6 March [1963] RDI anno XII 252.

they do realise but do not dare to oppose it, since the same Member States are also the main contributors to the structural funds that they benefit from. This is perhaps politically understandable but also rather regrettable from the point of view of the internal market.

The interest in limiting competition between Member States is often a very diffuse interest without any strong advocate. By contrast, the interest of the Member State in attracting investment on its territory is very intense. The Commission is put in a difficult position. The problem is the State aid procedures are based on the assumption that Member States will actively play their role and the reality is that they normally don't. As we will see, undertakings can only replace Member States up to a point.

The Undertakings

The position of undertakings as regards State aid can be summarised as follows: virtually all undertakings like State aid granted to them and almost all undertakings are against State aid granted to their competitors. This implies that there are two categories of undertakings playing different roles as forces in State aid procedures: the beneficiaries of aid and their competitors. However, neither beneficiaries nor their competitors have a really important role in the area of State aid. They are just considered as "third parties" or "sources of information" by the Commission, with very few "rights".

The beneficiaries of aid very often support the position of the Member State granting the aid, but they must rely on its willingness to involve it in the procedures. It is only when the formal procedure is opened that they (like anybody else) have the right to express their opinion formally before the Commission. This is rather odd, since the interests of both parties are not exactly identical. It is enough to notice that, in case of a negative decision, the undertaking would have to pay back the money... to the Member State. It is therefore unrealistic to assume that Member States would in all cases undertake a heroic defence of the beneficiaries' interest.

The situation of the competitors of the beneficiaries is not much better. Surely they can complain before the Commission about the aid allegedly granted to their competitors. The Commission however considers them as little more than "sources of information" without real rights. The complainant has no right to say anything during the preliminary phase. It is only if and when the formal procedure is opened (and this is a big "if") that they would have the right to express their opinion formally before the Commission.

The case law on *locus standi* of the complainants against positive decisions also speaks volumes. If the Commission approves the aid without opening the formal phase, the complainant can only attack this formal infringement, but cannot oppose the substance of the Commission decision. If the Commission has adopted the positive decision at the end of the formal procedure, it is very difficult to prove that the competitor/complainant is directly and individually affected by the aid that has been approved. As a consequence, if the Commission opens the formal procedure, it is rather difficult for an undertaking to be able to attack a positive Commission decision on an aid granted to a competitor. Since Member States very rarely attack positive decisions concerning other Member States' aid, this means that such decisions are more likely to survive judicial review than negative decisions (which are more easily attacked by beneficiaries and very often attacked by the granting Member States).

Said situation suggests that the State aid procedure is not entirely coherent with its declared aims. If it was really true that State aid control is about competition between undertakings and not just between Member States, then the undertakings should have a role in the procedure similar to that of Member States. This is obviously not at all the case and neither the Commission nor the Member States have showed any willingness to change it.

The European Commission

The Treaty places the Commission at the centre of State aid control. It is the Commission more than any other EU institution (certainly more than the Council or the Parliament) that drives State aid policy. This means that any “force” that wants to influence State aid policy must exercise its influence primarily, and above all, over the Commission.

Legally speaking, the Commission is entirely independent from the Member States and even more so from other entities. It is also actually quite independent in its behaviour and day-to-day action. However, it cannot act entirely in a vacuum but often has to reckon with the different interests at stake. Member States, some of them more than others, have an interest in influencing Commission decisions as much as possible. It would be entirely naïve to forget it in a context as politically sensitive as State aid. One cannot rely only on the (admittedly very good) sense and self-discipline of the Commission officials in order to achieve a balanced application of the rules. The best guarantee for the independence of the Commission would be that the different influences balance each other.

For that, it is essential that all the stakeholders play their part. If only some do, the result is likely to be structurally biased. This unfortunately seems to be the case right now: Member States have much more weight than undertakings. Giving more procedural rights to the latter and facilitating their *locus standi* is likely to result in the long term in a more efficient judicial review and a more predictable State aid law.

The Commission decided from the beginning to entrust State aid enforcement to the same DG in charge of antitrust enforcement, what we now call DG COMP and was previously called DG IV. For a long time this coincidence was little more than nominal, since there was limited circulation between both sides. The Commission later increased the circulation of officials, know how and ideas between both sides. This had obvious positive effects but – as we will explain later – also led to some misunderstandings as regards the role of State aid control.

The administrative convenience of the Commission also plays a role in shaping the content and direction of State aid enforcement. In theory Member States are obliged to notify all their planned State aid and the Commission is obliged to act whenever it learns of any State aid. In reality, the Commission lacks resources to efficiently fulfil such task. At the same time, it would be impossible to decentralise State aid control to National Competition Authorities, due to the very nature of State aid as linked to competition between Member States. State aid control requires a supra-national arbiter. There is a very different situation in antitrust, which is only about competition between undertakings.

The Commission therefore has acted in order to reduce the input of cases by enlarging enormously the scope of the block exemptions, thereby increasing the theoretical possibilities for all Member States to grant aid. This has been justified on the allegedly limited impact on competition between undertakings. The problem is that this theoretical increase for all can only be actually used by those Member States with resources. This new trend may have therefore actually increased the distortions of competition between Member States.

The Judges

The European Court of Justice is the other EU Institution with an important role in State aid law. It controls the legality of Commission decisions, in particular on the notion of aid, but cannot decide on compatibility. In general the ECJ can only react to Commission decisions and only when somebody with *locus standi* brings the case before it. The ECJ does not see the many cases that never lead to decisions or the many decisions that were not attacked by someone with *locus standi*. This in itself restricts its action to only a small portion of the real State aid cases. It can also act through preliminary rulings, some of them landmark cases (as *Altmark* or *Preussen Elektra*). These cases refer to the notion of Aid and normally not to compatibility. The ECJ is normally seen as pro-integration, but this has not always been the case in this particular field.

In principle, national courts have a modest role due to a reluctance – for good reason – in the design of the Treaties to give too much room to national authorities (national competition authorities or judges). However, national courts can rely on the direct effect of Articles 107(1) and 108(3) of the TFEU and submit preliminary questions to the ECJ. Although often struggling with the limits of the notion of aid, they have an important role in recovery issues (undertakings challenging national acts following Commission decisions).

III. Recent Developments: From Competition between Member States to Competition between Undertakings

Let us now take a brief look at the recent history of State aid control: what is its core *raison d'être* after all? Is State aid control mainly about restricting competition between Member States or about preserving competition between undertakings?

It is submitted that, at its origins, the main objective was rather to put limits on the competition between Member States and to prevent subsidy wars between them in order to attract economic activity to their territory. The similarities between State aid and infringements of other Treaty rules addressed to the Member States were underlined. The rules were basic, simple and “legalistic” even if those applying them were mainly economists. In general there was no need for profound economic analysis (an exception was the “market investor principle”). The exceptions foreseen in the Treaty were all “equity based” – in particular regional development – and no reference whatsoever was made to “efficiency” or “market failures”. This is of course an oversimplified view, but gives a general sense of things at the time.

Then the emphasis started to change as from 2000. The Commission began to speak more and more of “competition between undertakings” as the core mission of State aid control, only paying lip service to the other dimension. Furthermore, some techniques began to be imported from antitrust which had just experienced a modernisation. This was encouraged and reinforced by staff movements between both parts of DG COMP.

We witnessed two waves of State aid modernisation, in 2003 and 2005, respectively: “Lesser Amounts of State Aid” and “Less Effects on Trade” (LASA & LET), and “State Aid Action Plan” (SAAP).⁵ A “refined economic approach” was advocated for State aid too (probably without much thinking about its actual implications).⁶ “Solving a market failure” suddenly became the main reason to declare compatible State aid and “equity reasons” were discretely downgraded, having implications

⁵ Commission of the European Communities, *State Aid Action Plan – Less and Better Targeted State Aid – a Roadmap for State Aid Reform 2005-2009*, Document COM(2005)107 final of 7 June 2005.

⁶ Some of the most illustrative literature following the tendency were the following: J. Derenne and M. Merola (Eds.) *Economic Analysis of State Aid Rules – Contributions and Limits, Proceedings of the Third Annual Conference of the Global Competition Law Centre (GCLC), College of Europe, 21-22 September 2006*, Lexxion, Berlin, 2007; D. Hildebrand and A. Schweinsberh, “Refined Economic Approach in European State Aid Control- Will it Gain Momentum?”, *World Competition* 30/3 (2007), pp. 449-462; P. Heidhues and R. Nitsche, “Comments on State Aid Reform – Some Implications of an Effects-Based Approach”, *European State Aid Law Quarterly* 1 (2006), pp. 23-34; L. Hancher, “Towards an Economic Analysis of State Aids”, *European State Aid Law Quarterly* 3 (2005), p. 425; D. Spector, “The Economic Policy of State Aids: The Assessment Criteria”, *Concurrences*, n. 2, 2006; P. Crocioni, “Can State Aid Policy Become More Economic Friendly”, *World Competition* 29/1 (2006), pp. 89-108.

Among the studies it is worth mentioning the report by the Office of Fair Trading of the UK, “*Public Subsidies*”, November 2004, OFT 750, and the study made for the Directorate general of Economic affairs of the European Commission, Nitsche, R. and Heidhues, P., “*Study on methods to analyse the impact of State aid on competition*”, February 2006.

on the kind of aid approved. Efficiency enhancing aid was labelled as “good aid”, implying that equity driven aid was “not so good”.⁷

The effects of the new approach could be seen in two of the main compatibility fields: regional aid, and research and development and innovation aid (R&D&I).⁸ Regional aid lost its original glamour, becoming something that was to be more and more limited. Intensities of regional aid were generally reduced and big regional aid projects became subject to an even stricter regime. The only exception was telling: more intensity was allowed for small and medium-sized enterprises in the richer regions of Europe! At the same time, R&D&I became the paradigm of “good aid”. Intensities increased, scope was expanded, incentive effects were easily presumed, and big projects were not penalised.

These changes – justified under the logic of “competition between undertakings” and “efficiency” – had, however, rather perverse implications for the “competition between Member States”. Certain Member States, who had more resources to spend on aid, could now support more R&D&I, while others, who wanted to support regional projects, were unable to do so to the same extent as in the past. The result was more aid granted and in the richer zones of the EU. Calling it “good aid” entirely missed the point; “good aid” may be as distorting of competition as “bad aid”, or even more. So, the Member States with resources and willingness to grant aid preferred that State aid policy focused on competition between undertakings and not so much on competition between Member States.

The above changes were policy choices, perfectly legitimate if the consequences are understood and assumed. The problem was that the changes were, rather, presented as logical consequences of economic science and the implications were not openly discussed or even entirely understood.

Following the SAAP some people started advocating for the “economic approach” to also be applied to the notion of aid, based on the idea of “competition between undertakings”.⁹ The Commission realised that this would severely undermine State aid control and tried to apply the brakes.¹⁰

Then the crisis arrived, first in the banking sector and then spreading to the rest of the economy. The aid granted to the banks in one year equalled the total aid previously granted to the whole European economy since the origins of the Communities. With aid to banks, State aid control suffered a massive “stress test” that put it on the edge of collapse, with the dimension of competition between Member States emerging as a major issue (see the example of Irish guarantees for deposits). It probably persuaded many Member States of the need to preserve State aid control after all. State aid policy emerged from the crisis alive and even reinforced, but the Commission learned the importance of competition between Member States.

⁷ For a more nuanced discussion of the issues see H.W. Friederiszick, L.H. Röller and V. Verouden, “European State Aid Control: An Economic Framework”, in Buccrossi (ed.), *Handbook of Antitrust Economics* (Cambridge Massachusetts, MIT Press 2008). For a more critical view, see J.L. Buendía Sierra and B. Smulders, “The Limited Role of the ‘Refined Economic Approach’ in Achieving the Objectives of State Aid Control: Time for Some Realism”, in *EC State Aid Law: Liber Amicorum Francisco Santaolalla*, Chapter 1 (Alphen aan den Rijn, Kluwer 2008); J.Y. Chérot, “Le plan d’action de la Commission dans le domaine des aides d’État, Progrès et limites de l’analyse économique dans le contrôle communautaire des aides d’État”, 44 *L’Actualité Juridique. Droit Administratif*, 24 décembre 2007, p. 2412; J.L. Buendía Sierra, “Not Like This: Some Sceptical Remarks on the Refined Economic Approach in State Aid”, in *New Developments in European State Aid Law 2006 – Proceedings of the 4th Experts’ Forum held in Brussels on 18 and 19 May 2006*, EStALQ, Lexion, Berlin, 2006, pp. 59-64.

⁸ This duality is further analysed in J.L. Buendía Sierra & B. Smulders, *ibid.*

⁹ S. Martin and C. Strasse, “La politique communautaire des aides d’Etat est-elle une politique de concurrence?”, *Concurrences*, n. 3, 2005, p. 52.

¹⁰ See the interesting reply given to the above article by T. Kleiner and A. Alexis, “Politique des aides d’Etat: Une analyse économique plus fine au service de l’intérêt commun”, *Concurrences*, n. 4, 2005, p. 45.

The very recent “State Aid Modernisation” (SAM, 2014)¹¹ is more pragmatic than its two predecessors and apparently less focused on the economic approach. The main change is a very big expansion of the categories of aid exempted from notification. Again, this may make some sense from the point of view of State aid policy (increasing R&D, environmental investments, etc.) but much less from the point of view of State aid control. The latter is particularly true if we think of competition between Member States. It is indeed obvious that the level of resources that the different Member States may use for State aid is tremendously different, much more so after the crisis. Increasing the theoretical possibilities for all of granting aid without Commission control may actually mean that only some Member States will use such possibilities.

The EC argues that a reduction in the number of notifications would allow DG COMP to concentrate on the “*cases most distortive of competition*”. It obviously means distortive of “competition between undertakings”. However, even if this proved to be true (it is too soon to judge), it would not at all solve the problem created by SAM to the other form of competition: competition between Member States.

Another problem with SAM is that, while increasing the theoretical emphasis on competition between undertakings, it does absolutely nothing to increase the rights of undertakings in State aid procedures. The paradox is blatant: despite the latest “modernisation”, the undertakings have no real say in a system whose main aim is supposed to be protecting competition between them. Instead, Member States remain the only counterparts of the Commission. It is hard to explain such a contradiction.

IV. Some Conclusions

State aid provisions do not only relate to competition between undertakings but also to competition between Member States. In other words, State aid rules are not just competition rules but also internal market rules.¹² This internal market character of State aid explains, for instance, why even measures that apply equally to all undertakings present in a relevant market are nevertheless prohibited. A case in point is the aid given by a Member State to all the undertakings in one sector when the relevant market has a national dimension. For some commentators such measures should not be prohibited since they do not distort competition between undertakings. However, such measures have always been prohibited as selective because they distort competition between Member States by artificially attracting certain economic activities to certain Member States.

It is therefore essential to understand that State aid policy is not just about competition between undertakings in the relevant market but also about competition between Member States in the internal market.¹³ Failure to understand that basic principle would lead to big misconceptions as regards the basic meaning of State aid policy.

To sum up, EU State aid rules have a mother and a father. The father is the internal market, also known as competition between Member States. The mother is competition between undertakings. “*Who do you love more, mum or dad?*” is obviously the wrong question. I submit that the same is true

¹¹ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions, *State Aid Modernisation SAM*, Document COM(2012)209 final.

¹² This point is rightly underlined by A. Biondi and P. Eeckhout, “State Aid and Obstacles to Trade”, in A. Biondi, P. Eeckhout and J. Flynn, *The Law of State Aid in the European Union* (Oxford, Oxford University Press, 2003), p. 103. See also D. Spector, “The Economic Policy of State Aids: The Assessment Criteria”, *Concurrences*, n. 2, 2006, para. 28, who, on the basis of these considerations concludes that community state aid control policy must not be exclusively a competition policy. (“[L]a politique communautaire de contrôle des aides d’État ne doit pas être seulement une politique de concurrence”).

¹³ H.W. Friederiszick, L.H. Röller and V. Verouden, above n 7, p. 652.

as regards State aid. A proper enforcement of State aid rules requires one to have both objectives in view simultaneously when designing guidelines and adopting decisions.

I have already made clear my view that State aid is not only about competition between undertakings. I must underline also that State aid is not only about competition between Member States either. Insisting on just one of both dimensions would be a mistake. Both form an essential ingredient of EU State aid. Finally, as previously explained, a greater role for undertakings in State aid procedures would greatly benefit the system in the long run.

EU State Aid Control: The Quest for Effectiveness

Vincent Verouden¹

Subsidies to firms present us with something of a dilemma. On the one hand, subsidies are given by public authorities – so one would hope - for sound public policy reasons. For instance, subsidies are given to promote R&D activity, foster environmental protection, or to improve the fate of certain disadvantaged regions. On the other hand, subsidies that are given to some firms but not to others may distort competition between these firms and may negatively affect, in a wider context, trade between countries.

Already in 1956, the authors of the Spaak report² (the report which prepared the ground for the 1957 EEC Treaty) saw the need to control the extent to which the individual Member States of the future European Economic Community would be able to financially support their firms. Precisely in a deeply integrated trade zone as the common market was soon to become, the authors saw State aid control as an integral part of EU competition policy and a natural companion to the rules governing the internal market. The Spaak Report thus proposed a rather strict principle of prohibition of State aid. However, it also foresaw the need to allow for certain grounds for exemption.

Accordingly, in the present constellation, measures which constitute State aid within the meaning of Article 107(1) of the TFEU are subject to EU State aid control and such State aid is in principle prohibited. State aid can however be declared “compatible” under Article 107(3) of the TFEU when it is deemed (by the European Commission) to be in the common interest.

The general principle behind the Commission’s compatibility assessment is to balance the positive impact of the aid measure (pursuing an objective of common interest) against its potential negative effects (distortions of trade and competition). In most cases, however, such a balancing is not carried out explicitly, but rather by reference to predetermined criteria or proxies. The traditional approach taken in the General Block Exemption Regulation³ as well as in most enforcement guidelines is to define a set of objectives (e.g. fostering R&D) and eligible costs (the costs of an R&D project) on the basis of which companies may receive State aid. The amount of subsidy allowed is specified in terms of maximum aid intensities of the eligible costs. The implicit balancing inherent in this approach is to obtain the positive impact of the aid measure by declaring expenses eligible for aid while restricting the possible distortions of competition by limiting the aid intensity.

The amounts of State aid given in the EU are considerable. According to Eurostat data, in 2013, approximately EUR 63 billion in aid was spent in the EU as a whole, or 0.5% of EU GDP.⁴ These aggregate numbers conceal considerable differences among countries, with some countries achieving aid levels exceeding 1.5% of their GDP.⁵

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² The report was itself influenced by the earlier General Agreement on Tariffs and Trade. See, K. Van de Castele’s essay in this volume, ‘Changes and What Drives them: Evolution of State Aid Control’.

³ The GBER authorises broad categories of aid without the need for Member States to notify the measure to the Commission.

⁴ See http://ec.europa.eu/competition/state_aid/scoreboard/non_crisis_en.html. The number reported refers to the so-called non-crisis related State aid (excluding subsidies to railways).

⁵ That group includes Greece (EUR 2.9 billion in 2013), Malta (EUR 0.1 billion), Hungary (EUR 1.5 billion) and Slovenia (EUR 0.6 billion). In absolute numbers, the Member States spending most on State aid are France (EUR 13.0 billion), Germany (EUR 12.0 billion) and the UK (EUR 4.6 billion).

The Quest for Effectiveness: The 2005 State Aid Action Plan

Over the years, there has been a growing willingness at the level of the EU and the Member States to consider the effectiveness of state subsidies in pursuing public policy objectives, and to look more closely at the costs and benefits of State aid. Both at the national and the European level, the objective has been to achieve “less and better targeted State aid”.⁶

A notable step in this regard was taken in June 2005, when the Commission published its *State Aid Action Plan*,⁷ setting out a roadmap for State aid reform. The State Aid Action Plan formulated a “balancing test” as a conceptual framework for analysing State aid cases.⁸ The balancing test has subsequently been introduced in the 2008 GBER (in the design of the compatibility criteria) and in a number of enforcement guidelines, and it has been applied in numerous notified cases.

In essence, the balancing test asked:

- (i) whether the State aid pursues an objective of common interest, e.g. by addressing a market failure or equity concern;
- (ii) whether there is an incentive effect (i.e. whether the aid affects the behaviour of the recipient in a way which meets the objective);
- (iii) whether the aid leads to distortions of competition and trade; and
- (iv) whether, given the magnitude of the positive and negative effects, the overall balance is positive.

The first limb of the balancing test led the Commission to more systematically ask Member States the question: Why is there a need for aid? Why does the market not deliver itself the expected outcome? In a sense, one can see this part of the test as a first check on the potential effectiveness of the aid. After all, if there is no market failure to begin with (or none that remains taking into account other forms of state intervention such as sector regulation or taxation), the market in question already operates efficiently and it is hard to see how State aid can improve upon the market outcome (other than by redistributive effects).

Following this diagnostic check, the test moved on to the analysis of the incentive effect. While the incentive effect test was in itself not new – it is an essential limb of the necessity test which in turn is a well-established European legal device⁹ - the increasing emphasis placed on this requirement was new. In many Guidelines adopted prior to the SAAP, the Commission had merely required a “formal” (if not formalistic) check of the incentive effect.¹⁰ The only requirement was that the project to be supported should not have commenced prior to the recipient's application for aid to the public authorities. If the application had been made in time, the incentive effect of the aid was assumed. The SAAP led to the introduction of a “substantive” check of the incentive effect, demonstrating on the basis of counterfactual analysis that the project(s) in question would not have gone ahead without the aid. The substantive incentive effect test was incorporated into various sets of guidelines that were

⁶ The political mandate for an approach towards “less and better targeted State aid” has been expressed in various conclusions of the European Council since the launch of the so-called Lisbon agenda for growth and jobs in 2000.

⁷ *State Aid Action Plan, Less and Better Targeted State Aid: A Roadmap for State Aid Reform 2005 to 2009*, available at ec.europa.eu/comm/competition/State_aid/reform/saap_en.pdf.

⁸ For a more detailed description of the balancing test, see also H.W. Friederiszick, L.-H. Röller and V. Verouden, “European State Aid Control: an Economic Framework” in P. Buccirossi (ed.) *Handbook of Antitrust Economics* (Cambridge, Massachusetts: MIT Press, 2008).

⁹ Cf. L. Hancher and P. Nicolaidis, “Article 107(3) TFEU: General Principles” in P. Werner and V. Verouden *EU State Aid Control: Law and Economics* (London: Kluwer Law International 2016, forthcoming). See further Advocate General Bot in Joined Cases C-630/11P to C-633/11P, 21 March 2013.

¹⁰ This applied for instance to the *Framework for State Aid for Research and Development* (1996, prolonged in 2002), OJ C 045 , 17 February 1996, pp. 5-16; and the *Guidelines on National Regional Aid* (1998), OJ C 74, 10 March 1998, pp. 9-31.

revised as part of the SAAP exercise,¹¹ as well as into the 2008 GBER (in relation to aid given to larger enterprises).

The check on the incentive effect has been described as the “fighting sword” of the Commission in its attempts to make sure that aid was only granted when it was motivated by a change in the beneficiary’s behaviour in order to achieve a common legitimate interest.¹²

Why all this emphasis on the incentive effect? Of course, one can certainly argue that when aid has no incentive effect, it is not effective in achieving what it is meant to achieve. The economic literature is rich in studies assessing to what extent subsidies induce additional activity by firms. There is a strong body of evidence, especially in the domains of R&D support and regional investment aid, showing that subsidies may lead to a significant crowding out (i.e. replacement) of private investment. Furthermore, several studies find that aid granted to larger firms is often less effective than that granted to SMEs.¹³

It is a laudable goal of the Commission to avoid public money being wasted. However, it can hardly be called a “legitimate” goal, in the sense that the Commission does not have a mandate from the Member States to control the effectiveness of their public spending. The mandate of the Commission is to control State aid that leads to distortions of competition, and only insofar as there is an impact on intra-EU trade. However, there are a number of logical connections between the analysis of the incentive effect and the analysis of the distortions to competition and trade.

The Nexus Between the Incentive Effect and Distortions of Competition and Trade

In order to understand the impact that a subsidy can have in terms of competition and trade, one first needs to form an understanding of what would have happened in the absence of the subsidy. In other words, one needs to build an understanding of the counterfactual. This brings us closely to the question of incentive effect: does the aid change the behaviour of the company compared to the no-aid situation and, if so, in what way?

Consider a state subsidy to a company to invest in a new, environmentally friendly and efficient production technology. Suppose, first, that the aid has an incentive effect. This means that the company will now invest in the green technology, whereas otherwise it would not. This is likely to have an impact on competition in the relevant product market, as the new technology allows the company to save on the use of inputs and thereby obtain lower marginal costs of production. The increased efficiency will normally allow it to increase market share at the expense of rivals, including rivals in other Member States.

¹¹ See e.g. the *Guidelines on National Regional Aid for 2007-2013*, OJ C 54, 4 March 2006, pp. 13-45 (for a subset of large investment projects); *Framework for State Aid for Research and Development and Innovation*, OJ C 323, 30 December 2006, pp. 1–26; *Guidelines on State aid for Environmental Protection*, OJ C 82, 1 April 2008, pp. 1-33. For a full review, see P. Nicolaides, “The Incentive Effect”, *World Competition Law and Economic Review* 32/4 (2009), pp. 571-591.

¹² Cf. M. Ortiz Vilela, “Two Europes and a Single SAM”, State Aid Hub (2014), available at: stateaidhub.eu/blogs/stateaid/post/1055.

¹³ For regional aid, see in particular C. Criscuolo, R. Martin, H. Overman and J. Van Reenen, “The Causal Effects of an Industrial Policy”, LSE, Centre for Economic Performance Discussion Paper No 1113, January 2012; Bondonio and Martini, “Counterfactual Impact of Cohesion Policy: Impact and Cost-Effectiveness of Investment Subsidies in Italy”, Report for DG REGIO (2012). For R&D aid, see González, Jamandreu and Pazó, “Barriers to Innovation and Subsidy Effectiveness” *RAND Journal of Economics* 36 (2005), pp. 930-50; Bronzini and Lachini, “Are Incentives for R&D Effective? Evidence from a Regression Discontinuity Approach”, mimeo Bank of Italy (2010); Gorg and Strobl, “The Effect of R&D Subsidies on Private R&D” *Economica* 74/294 (2007), pp. 215-234; E. Einiö, “R&D Subsidies and Company Performance: Evidence from Geographic Variation in Government Funding Based on the ERDF Population-Density Rule”, *The Review of Economics and Statistics* 96/4 (2014), pp. 710–728.

Suppose now that the aid has no incentive effect. In other words, the company would have invested in the green technology anyway. Logically, it would seem that the aid can have no direct impact on product market competition in the relevant market concerned in the sense that, both *with* and *without* the aid, the company would have made the investment in green technology and would have become more efficient. Nonetheless, competition might still be influenced in the two following ways:

First, there is an effect on product market competition because the aid amounts to a windfall profit for the company (“free money”). Effects on product market competition may arise when the company faces some finance constraints and the aid allows the company to execute other (profitable) projects that it was unable to finance before the aid.¹⁴

Second, it is possible that the aid does not have an incentive effect in the proper sense of the word (i.e. it does not change the company’s behaviour in line with the objective of the subsidy), but is meant to induce the company to take other steps than the one directly targeted by the subsidy. In particular, in cases where investments are mobile (in the sense that they could be undertaken in one of several locations), the aid may distort location decisions across Member States. Think of a pharmaceutical company setting up a research project in order to develop a new medicine. Suppose that the company would undertake the research project anyway given that it wants to bring the medicine to the market, but that the only question is in what location the research project is undertaken. In that case, R&D aid given to this company would not have an incentive effect (given that the company would have done the research anyway), but might persuade the company to do the research project in the country that gives the aid instead of another country. In that case the aid exerts a negative externality on the latter country,¹⁵ and may set off a wasteful subsidy race among Member States.

Other examples would be aid given under the banner of environmental aid or training aid, but in reality meant to persuade a company not to lay off employees at a given production site, or to buy supplies from domestic suppliers. Even if anecdotal, there are indications that politicians tend to see the granting of aid for a purpose such as R&D as a *quid pro quo* for the firm in question maintaining employment in the country or region.¹⁶ Indeed, there have been several State aid cases where it has been established that the aid, instead of giving a proper incentive effect, merely served to attract economic activity to the region concerned.¹⁷

Summarising, by screening cases on the presence or absence of incentive effect, one is better able to understand (and control) the distortive effects of State aid. It is a means to identify which potential distortive effects are at play in any given case.

¹⁴ Note that the effect of aid may in this case well arise in markets which are fully unrelated to the market directly concerned by the environmental subsidy.

¹⁵ In the EU, there is one setting where state support to investment is specifically allowed, even if this means that the investment is thereby attracted away from other regions. This is the case of regional aid given by Member States (at any level) to attract investment into the most disadvantaged regions (so-called assisted regions).

¹⁶ For instance, when in 2012 the Belgian company Bekaert, a large industrial firm active in steel wire transformation and coatings, announced that it would shed a large number of employees in response to worsening economic conditions, questions were asked in the Flemish parliament as to whether previously given innovation aid (amounting to EUR 16 million) could be recovered from the firm. Opposition leader Van Malderen was quoted as saying: “Companies do not get these subsidies merely as a present. We expect these firms to make an effort as regards employment and job security” (author translation). Source: De Standaard, *Peeters onderzoekt teruggordering steun aan Bekaert*, 2 February 2012.

¹⁷ See e.g. Commission Decision of 4 July 2006 in case C-40/2005, *Ford Genk*; Commission Decision of 4 April 2007 in case C-14/2006, *General Motors Antwerp*.

From SAAP to SAM

In 2012, the Commission launched the State Aid Modernisation.¹⁸ According to the Commission, a modernisation of State aid control “is needed to strengthen the quality of the Commission’s scrutiny and to shape that instrument into a tool promoting a sound use of public resources for growth-oriented policies and limiting competition distortions that would undermine a level playing field in the internal market. The current complexity of the substantive rules as well as of the procedural framework, applying equally to smaller and bigger cases, are challenges to State aid control”.¹⁹

The objectives of modernisation of State aid control were therefore threefold:

- (i) to foster sustainable, smart and inclusive growth²⁰ in a competitive internal market;
- (ii) to focus Commission *ex ante* scrutiny on cases with the biggest impact on the internal market whilst strengthening the Member States’ cooperation in State aid enforcement; and
- (iii) to streamline the rules and provide for faster decisions.

The policy document with which the Commission announced its modernisation (the SAM Communication) signalled a clear intention to further emphasise the (substantive) incentive effect as a requirement of compatibility: “Modernised State aid control should facilitate the treatment of aid which is well-designed, targeted at identified market failures and objectives of common interest, and least distortive (‘good aid’). (...) State aid will be effective in achieving the desired public policy objective only when it has an incentive effect, i.e. it induces the aid beneficiary to undertake activities it would not have done without the aid. (...) State aid which does not target market failures and has no incentive effect is not only a waste of public resources but it acts as a brake to growth by worsening competitive conditions in the internal market.”²¹

For the various guidelines to assess the compatibility of State aid, one can observe that the substantive check of the incentive effect has indeed been given more prominence. This applies in particular for the new Regional Aid Guidelines,²² where the substantive check of the incentive effect has now become one of the common assessment principles applicable to all notified cases, but also for the new R&D&I Framework²³ and the Energy and Environmental Aid Guidelines.²⁴

By contrast, the new GBER of 2014 has a longer list of types of aid for which the incentive effect is presumed to exist than before. Whereas the 2008 GBER included, next to a “formal” incentive effect test (the basic timing requirement), also a “substantive” incentive effect test for larger companies, this latter requirement has now been dropped.²⁵ At first sight, this would seem to be at odds with one of the main aims of SAM, i.e. to improve the effectiveness of State aid. Especially so, if one considers that the Commission expects that in the future, three-quarters of today’s State aid measures and some two-thirds of aid amounts could be covered by the new GBER (a proportion that could increase to even 90% of all aid measures provided Member States use the GBER to the full

¹⁸ Communication, *State Aid Modernisation*, 8 May 2012, COM(2012)0209 final (hereafter: SAM Communication).

¹⁹ SAM Communication, para 6.

²⁰ In line with the so-called EU2020 objectives, the Commission’s growth strategy for the period up to 2020.

²¹ SAM Communication, para 12.

²² *Guidelines on Regional State Aid for 2014-2020*, OJ C209, 23 July 2013.

²³ *Framework for State Aid for Research and Development and Innovation*, OJ C 198, 27 June 2014.

²⁴ *Guidelines on State Aid for Environmental Protection and Energy 2014-2020*, OJ C 200, 28 June 2014.

²⁵ With the exception for *ad hoc* aid given to large enterprises (i.e. aid to large enterprises not part of an aid scheme).

extent).²⁶ This means that only cases with the biggest potential to distort competition in the EU common market will remain subject to *ex-ante* scrutiny (via notification).²⁷

While the SAM Communication underlined the importance of the substantive incentive effect, it is also true that it proposed simplification (“to streamline the rules”) as one of its other main objectives. Inevitably, a certain trade-off arises between keeping the rules simple (which calls for e.g. clear *per se* rules or, at most, a simple compatibility requirement) and trying to achieve the “correct” outcome on a case-by-case basis (which would call for strengthened conditions on checking the incentive effect and the negative effects of aid).

It would appear that the simplification objective has indeed carried the day in GBER. In part, this may be explained by the Commission’s desire to create a sharper distinction in terms of requirements between GBER and the Guidelines, so as to make sure Member States indeed only notify large or complex cases for which they think these can pass the (increased) test of the Guidelines and adapt the remainder of their measures to GBER. When GBER is endowed with too many complexities and uncertainties, this would likely not happen, Member States might self-select away from GBER.²⁸

It is also possible that relaxing the requirements on the incentive effect in GBER has been, politically speaking, the *quid pro quo* for the Commission to be able to tighten the rules for a number of specific aid categories (notably regional aid and aid in the field of energy) and to make other requirements in GBER stricter. The Commission has introduced significantly stricter rules in those domains where it thought that there was sufficient evidence suggesting that aid was either not effective, or even harmful. A notable example is that of regional investment aid given to large firms. Whereas under the previous GBER and Regional Aid Guidelines, it was possible for public authorities in the so-called “c” areas (moderately disadvantaged areas)²⁹ to grant such aid to all firms, the new rules leave very little scope to grant such aid to large firms.³⁰

In this context, one can also refer to the new criteria as to when firms are deemed to be in financial difficulty and, hence, ineligible for aid. This rule should be beneficial in making sure that aid for specific purposes such as R&D or training does not end up with firms that more or less need the aid to stay in business.³¹ Furthermore, there is the newly introduced requirement that Member States must in

²⁶ European Commission, “State Aid Modernisation – a Major Revamp of EU State Aid Control”, *Competition Policy Brief*, Issue 11, November 2014.

²⁷ The notification thresholds for individual regional aid are in the range of EUR 18,75 – 37,5 million per project (in so-called “a-areas”), for R&D&I aid they are in the range of EUR 15 – 40 million per project, and for environmental aid they are in the range EUR 7.5 – 10 million. It would seem difficult to characterise all aid below these thresholds as “small aid”. Having said this, when the overall budget of the aid scheme exceeds EUR 150 million, the scheme is no longer automatically covered by GBER and is subject to the requirement of ex-post evaluation (see further below). This should act as a counterbalance.

²⁸ Cf. L. Hancher and P. Nicolaidis, “Article 107(3) TFEU: General Principles” in P. Werner and V. Verouden (eds) *EU State Aid Control: Law and Economics* (London: Kluwer Law International 2016, forthcoming).

²⁹ Areas eligible for regional aid under Article 107(3)(a) of the Treaty, commonly referred to as “a” areas, tend to be the more disadvantaged within the Union in terms of economic development. Areas eligible under Article 107(3)(c) of the Treaty, referred to as “c” areas, also tend to be disadvantaged but to a lesser extent.

³⁰ With the exception of aid for pure “greenfield” investments. The significant change in policy was not only motivated by concerns relating to a lack of effectiveness of regional aid. The Commission also considered that, even where there was an incentive effect in ‘c’-areas, it might well be of the ‘wrong’ kind, i.e. aid serving to draw away investment from (even more disadvantaged) ‘a’-areas.

³¹ It is well documented in the economic literature that many successful sectors witness productivity growth not because all firms present in the market gain in productivity, but rather because the more efficient and technologically advanced firms grow at the expense of the less efficient or innovative ones. To the extent that this process of exit, entry and expansion is disturbed by aid given to ailing firms, industry-wide productivity improvements are likely to be slowed down. See e.g. Economic Advisory Group on Competition Policy (B. Lyons, J. Van Reenen, F. Verboven, X. Vives), *Commentary on EU Rescue and Restructuring Aid Guidelines* (2008), available at ec.europa.eu/dgs/competition/economist/eagcp.html.

the future publish the names of the aid beneficiaries and the individual aid amounts, in order to increase the transparency of aid.

More specifically in relation to the effectiveness of the aid, one can point at the new ex-post evaluation requirements in GBER (and several guidelines) for large aid schemes. In view of the greater potential impact of such schemes on trade and competition, aid schemes with an average annual budget exceeding EUR 150 million are in principle subject to State aid evaluation. The evaluation should aim at verifying the effectiveness of the aid measure in the light of its general and specific objectives.³² In essence, therefore, the SAM has resulted in a shift from an *ex ante* check of the effectiveness of aid (of the incentive effect) to an *ex post* check.

Time will tell whether relaxing the GBER rules on the incentive effect was indeed a bright idea or rather represented a weakening of State aid control with respect to a large (and increasing) proportion of aid measures.³³ But as most evaluators will be able tell: without some experimentation there is little that one can learn.

Conclusion

Over the past decade, the European Commission has paid increasing attention to the effectiveness of State aid. By and large it has tightened the criteria under which Member States can grant State aid and it has, notably, imposed the need to carefully assess the incentive effect/effectiveness of state subsidies in pursuing public policy objectives.

In 2014, the Commission completed the State Aid Modernisation process, with the aim of better targeting State aid and making the award process for public authorities simpler and clearer. This has led to an increase in the requirements on the incentive effect for notified cases and, for larger aid schemes under GBER, to a shift away from the *ex ante* incentive effect check towards the *ex post* evaluation of the effectiveness of the aid.

The Commission has given itself a set of new rules for the years to come. But, as times are changing, its “quest for effectiveness” is likely to continue.

³² The Commission has published a Staff Working Document *Common Methodology for State Aid Evaluation*, SWD(2014) 179 final, setting out suitable evaluation methods. The results of the evaluations are to be made public, but will not have an impact on the compatibility of aid granted under an approved aid scheme. In other words, lessons learned will only serve the future schemes or the renewal of existing schemes, where appropriate.

³³ Cf. Cf. L. Hancher and P. Nicolaides, above n 9; M. Ortiz Vilela above n 12.

State Aid Control: An Evolutionary Theory of Resilience and Adaptation¹

Elisabetta Righini²

The Treaty articles dealing with State aid – now numbered 107 and 108 by the Lisbon Treaty – are among the very few that have remained unchanged since the Treaty of Rome came into force on 1 January 1958.

The Spaak Report³, published the year before, identified State aid control as one of the key policies for the creation of a single market. The abolition of tariffs and non-tariff barriers, the demolition of borders and the ability for firms and workers to operate freely in this newly created market, would have been of little use if Member States were allowed to interfere in the economy by benefitting one production or undertaking through subsidies or other forms of intervention. The idea had already been developed in the two sectors that were key for their project of lasting peace: no subsidy was possible for coal and steel under the 1951 ECSC Treaty.

In the Treaty of Rome, the founding fathers introduced the principle that any aid should in principle be prohibited. Such prohibition became, together with antitrust control, the second pillar of the internal market next to regulation. The first dichotomy of State aid was born: taken from the realm of free trade, State aid became the little (and often neglected) sister of competition law.

But, as in the case of the fundamental freedoms of the internal market, the State aid discipline had also to come to terms with the fact that there were other objectives beyond a free market that had to be protected, objectives that could justify an exception to the absolute prohibition of State intervention in the economy. This is why, still today, the analysis of State aid takes place in two steps:

- Whether a measure can be considered aid in the meaning of Article 107(1) of the Treaty on the Functioning of the European Union (TFEU) and therefore, in principle, be incompatible with the establishment of an internal market; and
- Whether it can be declared compatible, as it falls in line with one of the objectives indicated in Article 107(2) and (3) of the TFEU.

Albeit these Treaty provisions governing State aid policy have remained formally immutable since 1958, State aid control is, however, often perceived as a rather obscure and technocratic kind of policy: a system for insiders based on few Treaty articles and affected by a constant struggle between the various actors on a battleground immersed in thick political fog.

In reality, the life story of State aid law can be “humanised” as one of resilience and adaptation.

Over almost six decades, State aid control has been constantly evolving and adapting to keep pace with the profound changes undergone by the European venture.

It has grown “spatially” as, with the progressive integration of new countries into the Union, the system has been horizontally and territorially stretched, and has also become more complex, as each of the now 28 Member States has very different levels of government, and thus aid granting authorities.

¹ This contribution is inspired by a more extensive work published as A. Biondi and E. Righini, “An Evolutionary Theory of EU State Aid Control”, in D. Chalmers and A. Arnall (eds) *The Oxford Handbook of European Union Law* (Oxford:Oxford University Press 2015).

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³ Intergovernmental Committee on European Integration, *The Brussels Report on the General Common Market (the Spaak Report)*, 1956, Title II, Chapter 2.

And it has had to adapt “substantially” to adjust to the ever variable size and functions of the public sector and the market, as well as to the ensuing endless varieties of government interventions, through subsidies or other forms of aid.

Sixty years from the Treaty of Rome, the rules on State aid now cover a market of five hundred million people and a number of sectors unthinkable when the founding fathers conceived the very idea of an internal market. Similarly, the assessment of the positive contribution to the common European objectives that makes an aid measure compatible has become more and more sophisticated in order to accommodate the ever-growing needs of the complex European social economy.

Last but not least, in recent times companies and governments have had to cope with the impact of an unfortunately long and serious crisis, which has multiplied the need for public support while cutting the budgets of many Member States. Consequently, State aid policy has changed “focus” to become also an important tool to target public resources towards objectives of common interest, and thus avoid a waste of public resources, as well as to respond to the growing disparities in the fiscal capacities of different EU countries – what have been called the “deep pocket distortions”.

A shift in focus that may finally allow recognising the initial internal-market vs. competition dichotomy as fallacious and inadequate and allow State aid control to be considered more appropriately as a tool of economic coordination, which would - at the same time – cover macro and micro considerations.

Following this latter angle of analysis, it is easy to see how the process of resilience and adaptation has shaped not only the definition of undertaking, both temporarily and spatially, and the very concept of what constitutes an “aid”, but also the criteria that are exclusively set by the European Commission in order to establish the compatibility with the internal market of the State intervention. In particular, this latter balancing of interests, built over the years into a core of common objectives that Member States are lawfully entitled to pursue, can be used as a map into a journey through the history of the European model of social economy.

An excursus through the history of State aid control reveals that the main variables pushing its evolution are the same macro-economic forces that have driven, and still are driving, Member States’ politics and policies and the European Commission’s agenda.

Unfortunately, the legal, policy and economic analysis of this field of EU action is still in its infancy. A pity because, after such a long and harsh economic crisis, Europe can only benefit from a full understanding and use of this instrument of macro- and micro-economic coordination.

But the strength of this hard-wearing yet flexible instrument still shows. Recently, two sectors of the economy that remain completely uncoordinated and uncontrolled, such as energy and fiscal policy, have fallen under the State aid sword.⁴ Where regulation has failed, as in the former, or has never been able to happen, as in the latter, the magic relentless force of European integration is still able to push public spending towards common interests, such as sustainable growth and social responsibility, under the supervision and assistance of an independent controller.

So, sixty years after, State aid control is still about ensuring “that resources are channelled to industries which contribute to growth and competitiveness, that State intervention does not permit any company or sector to gain an unfair advantage over its competitors in another Member State and that State aid policy is consistent with other Community policies”.⁵ And this is even truer at a time when more efficient and targeted European action is considered essential both in terms of fiscal governance,

⁴ See Communication from the Commission, *Guidelines on State Aid for Environmental Protection and Energy 2014-2020*, OJ C 200/1, 28 June 2014; and Commission’s enquiry on tax rulings practice in all Member States.

⁵ P. Sutherland, “Foreword”, in *Competition Rules in the EEC and the ECSC Applicable to State Aids* (Brussels-Luxembourg: Commission of the European Communities 1987), p. 6.

to control “the negative externalities that unsound public finances in a Member State can generate for its neighbours”⁶ and of structural policies.

⁶ Mario Draghi, *Memorial Lecture in Honour of Tommaso Padoa-Schioppa*, speech delivered in London on 9 July 2014.

“A policy made in Brussels that clearly works”

Malcolm Harbour CBE¹

Shortly after the announcement of two European Commission investigations into Google’s activities, the Financial Times published a lead article by Professor Mario Monti.² Under the headline “*The bold Brussels ‘eurocrats’ who command the world’s respect*” he used the Google case as the central pillar of his argument that the Commission, through its competition policy, has become “one of the world’s most formidable defenders of free markets”. It was, he suggested “a policy made in Brussels that clearly works”.

Professor Monti was a very well respected Commissioner for Competition from 1999-2004 (my first mandate as an MEP) so his views command respect. During his time there were significant developments in the area of State aid control. My perspective is that the current policy has widespread support across the spectrum, its principles have remained largely unchallenged, and discussion has largely been focused on effective implementation. On that basis, it has to be considered a success.

However, I was frustrated, as an elected politician, that there was rarely much debate about competition and State aid policy issues. This was probably because implementing rules on competition policy cannot be amended by the Parliament and so were rarely scrutinised in detail. However, many changes in the rules, or new guidelines, were actively creating new policy. Because the Competition Directorate has sweeping powers of investigation, judgement and enforcement, its engagement with elected politicians is far more remote and measured than for other areas of the Commission.

In State aid, EU level political issues are complicated by national interests in each Member State. The need to minimise distorting State aid, to ensure fair competition and avoid market foreclosure, is now broadly accepted as an integral part of achieving an EU Single Market. On the other hand, the role of State aid in building a more competitive EU, post enlargement, is also undisputed. The State aid rules came under intense pressure during the sharp move into recession in 2008. There are now new rules on rescuing and restructuring aid³, so that the EU will be better prepared in future.

Post recession, there is already an increase in companies active across the Single Market, especially those deploying digital technologies. These are already bringing new challenges for competition and State aid policy. The Digital Single Market programme,⁴ a flagship project of the new Commission, has been accompanied by the launch of a wide ranging competition enquiry⁵ into restrictions on cross border sales. It has also required new guidelines on the State aid provided to subvent high investment costs of rolling out super fast networks to all communities.

Alongside the integration of competition policy into a broader policy framework, it still remains a major challenge, at the operational level in Member State authorities, to apply consistent rules and ensure compliance. As the European Representative of a large UK region, I worked with many councils and agencies on projects where meeting EU State aid criteria was an issue. On the one hand, it is an indication of the success of State aid control measures that they are so widely known. On the

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² Financial Times, 24 April 2015.

³ European Commission, Competition Policy Brief, *New Rules on Rescue and Restructuring Aid for Industry: The Right Incentives for Innovation and Growth*, Issue 9, June 2014. Available at: http://ec.europa.eu/competition/publications/cpb/2014/009_en.pdf

⁴ DSM Communication 2015. Available at: http://ec.europa.eu/priorities/digital-single-market/docs/dsm-communication_en.pdf.

⁵ European Commission, Press Release, *Antitrust: Commission Launches E-Commerce Sector Inquiry*, 6 May 2015. Available at: http://europa.eu/rapid/press-release_IP-15-4921_en.htm.

other hand, they are seen by many as yet another example of unnecessary EU “interference”, a complicating and delaying mechanism. Managing project design around the rules or below *de minimis* thresholds is widespread.

The Commission has taken action to address these concerns with the 2012 State Aid Modernisation programme.⁶ This was widely welcomed and gained the full approval of the European Parliament. These new provisions are now coming into operation.⁷ They envisage that a high proportion of State aid programmes will fall under General Block Exemption rules that enable authorisation without prior notification. There are specific aid categories now included in the exemption provisions, notably in energy, environmental and research infrastructure projects. The thresholds for interventions exempted from notification, based on the level of support and aid intensity, have also been raised. The Commission expects that 90% of aid measured could potentially be exempt under the new rules.

The trade off for Member States is that they will have to be more transparent over aid awards, they will be expected to observe the criteria for funding and also to introduce more competitive bidding processes where aid supported projects are being awarded. The Commission proposes to focus its attention on a smaller number of large aid submissions while at the same time intensifying evaluation of unnotified projects.

This new regime could mark a significant change in the way the State aid is viewed, balancing both positive and negative perceptions. Certainly, the New Commissioner, Margrethe Vestager, is taking a much higher public profile and has already been the subject of favourable articles in the business pages⁸ across Europe. In a recent speech the Commissioner provided a very clear and helpful definition of the reasons why State aid needs to be controlled:

[T]oo much State aid is still badly designed and **hinders growth**. By preventing inefficient companies from leaving the market or awarding tax breaks to multinationals, it **disadvantages the young, innovative companies** that could revolutionise our economy. By providing conditions that the private sector cannot match, it **crowds out** private investment. By benefiting domestic companies over rivals in other Member States, it **fragments** the single market, the cornerstone of our prosperity.⁹

I hope that State aid, and competition issues more generally, will take a higher profile in the current European Parliament. They also need more research attention in documenting successes and failures, and collecting information on the trends following the new modernisation initiative. As the Commission itself has noted “you can’t improve what you can’t measure”.¹⁰

⁶ European Commission, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: EU State Aid Modernisation (SAM), COM(2012) 209 final, May 2012. Available at: <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52012DC0209&from=EN>.

⁷ Policy Brief November 2014. Available at: http://ec.europa.eu/competition/publications/cpb/2014/011_en.pdf.

⁸ See an interview with Vestager in *The Sunday Times*, *After Danish Politics, Taking on Google and Gazprom is a Doodle*, 29 March 2015. Available at: http://www.thesundaytimes.co.uk/sto/business/business_interviews/article1537110.ece.

⁹ Speech at High Level Forum of Member States by Margrethe Vestager, Commissioner for Competition, 18 December 2014. Available at: http://ec.europa.eu/commission/2014-2019/vestager/announcements/speech-high-level-forum-member-states-margrethe-vestager-commissioner-competition-18-december-2014_en. Emphasis added.

¹⁰ Policy Brief June 2014. Available at: http://ec.europa.eu/competition/publications/cpb/2014/007_en.pdf.



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