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**TOWARDS DEVELOPING SUBSIDY DISCIPLINES UNDER GATS**

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## **Foreword**

The next major boost to world trade is expected to come from greater trade in services. And this is possible only when greater liberalization in services is achieved which in turn depends on the progress that WTO members make in terms of higher commitments in different rounds of WTO negotiations. As this happens, subsidy practices of various member countries will increasingly come under sharp public scanner.

Unlike agricultural and manufactured goods for which subsidy rules or disciplines are already well developed in the WTO, in services these rules/disciplines are yet to be developed. Developing subsidy rules in services pose a major challenge because of the various channels through which trade in services takes place and also because of basic framework of trade in services (General Agreement of Trade in Services (GATS)) already developed in the WTO.

This paper brings out the complexity of issues that come up while developing subsidy disciplines for services. What adds to this complexity is almost non-availability of information about the various subsidy practices of member countries

This paper discusses whatever limited evidence is available in this regard and draws some broad guidelines that can help in the development of subsidies framework. The finding of this paper is very much in the spirit of early thinking on the subject.

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## **Executive Summary**

According to the guidelines and procedures for the negotiations on trade in services, among other things, negotiations on subsidies should conclude before negotiations concerning specific commitments are completed. However, progress on developing subsidy discipline is tardy. Most member countries have not yet even furnished information on the subsidy programs that they maintain in service sectors. Whatever limited evidence that is available suggests that subsidies to various services sectors are fairly widespread, and so are the forms that such subsidies take. At present there are no effective subsidy disciplines in the general agreement on trade in services (GATS). Subsidy disciplines are necessary to encourage members from making greater commitments, which in turn is necessary for achieving higher trade in services. Subsidy disciplines in services would be particularly beneficial to developing countries that have considerable benefits to reap from trade in services, have limited capacity to subsidise, and would anyway stand to gain exemptions from certain subsidy provisions as and when these provisions are developed.

The basic difference between trading in goods and trading in services on the one hand and the difference in the design of goods agreement (GATT) and services agreement (GATS) on the other limit the scope of applying subsidy provisions developed in goods case. Further, certain peculiarities of and complexities in trade in services give rise to additional complications that a subsidy framework needs to grapple with.

While GATS provide considerable flexibility to member countries in liberalizing their services sectors, the national treatment obligation (which restricts ability of member countries from treating foreign service providers differently from the domestic service suppliers) discourages member countries from providing subsidies. Nevertheless, there is a need to develop subsidy disciplines. Subsidy disciplines, as and when they are developed, should address only those measures that qualify as subsidies. Public measures such as regulatory policies and/or practices of monopolies and exclusive service providers that generate subsidy-like effect need to be addressed separately from those arising due to subsidies. Therefore, any attempt to develop subsidies framework needs to focus on distortions due to subsidies alone.

In thinking about subsidies framework in GATS, it is useful to examine the applicability of agreement on subsidies and countervailing measures (ASCM) to services case. The subsidy definition in ASCM (namely, financial contribution by the government leading to conferral of benefit) seems useful in services case as well; so is the definition of specificity. The idea that non-specific subsidies i.e., subsidies available more generally, are non-trade distortionary is valid in services too.

However, disciplines on specific subsidies based on their trade distortionary effect would differ in services. Unlike goods case where trade takes place only through cross border movement (i.e., Mode 1), trade in services can additionally take place when consumers move abroad (Mode 2) or when service supplier sets up a base in foreign market (Mode 3) or when labour, both skilled and semi-skilled, temporarily move abroad (Mode 4). This has some implications: one, trade flows become relatively complex; and, the link between trade distortion and competition distortion is no longer clear cut, two, trade within the domestic territory of a member country can occur much more than in case of goods; and so is the possibility of subsidy-induced trade distortion within the domestic territory of subsidizing country than in other member countries. As a result, the distinction between export subsidy and production subsidy becomes difficult, even if it is still useful. Furthermore, given considerable cross-linkages across services sectors, invisibility of many types of service transactions, practical difficulties involved in calculating subsidy margins, and limited scope of remedy by way of countervailing duties, it is prudent, as a general principal, to ban on all subsidy practices. At the same time, the need for achieving public policy goals call for having a “positive list approach” that provides certain derogations from the general principal of ban or prohibition. These derogations or exceptions could be to achieve certain well defined social and cultural, environmental, and development goals. Such an approach can take care of many of the challenges that come up in the design of subsidy provisions in services such as competition distortion across modes or across sub-sectors or a service supplier located abroad and supplying service through cross border movement facing unfair competition in the market where domestic suppliers are subsidized. There is strong relationship between public services provided in exercise of

governmental authority (i.e., Article I:3(b)) and public policy goals for which subsidies are allowed.

One possible way to dealing with the issue is to leave the scope of public services open, and let the members decide what services they would treat as basic services, which should eventually get reflected in their commitments in GATS, and then treat the issue of subsidies to social sectors not very different from other service sectors in the subsidies agreement. Another possible way is to tighten the scope of I:3(b), and then leave large enough room in subsidies agreement to enable member countries achieve their legitimate social objectives through subsidies in these sectors.

Indeed, the European community has adopted the “positive list approach” that has been tested for the past several years. While this “positive list approach” would be possible in a full blown subsidy framework which would take some time to develop, in the meantime it is probably a good idea to identify and limit those subsidies that are viewed to be the most trade distortionary. One type of trade distortion that has necessitated the need for having some subsidy disciplines is the undermining of market access commitments especially in a “third country market” due to subsidy practices of member countries.

All discretionary and ad hoc subsidies given to the infrastructure services (telecommunications, financial and transport sectors) that go as input into the production of other goods and services need to be disciplined as priority. So are certain sector specific subsidies given, for example, to tourism sector that is known to receive significant financial support from governments, and has a clearer bearing on trade. Similarly, subsidies that encourage the use of domestic inputs (both goods and services) over imported inputs must be taken up on a priority basis. Also subsidies that are specifically targeted at firms/sectors known for their foreign exchange potential ought to be zeroed in first. Likewise, consumption subsidies that are linked to purchase decision could also be focused in the initial disciplines. Sectors in which member countries have made greater commitment can be targeted first. Whether the subsidy disciplines developed in the interim need to be applied only to the sectors and the members that have made commitments or whether

subsidy disciplines need to be applied more generally even to those sectors and members that have not been committed remains an open issue. In the absence of good information on various subsidy practices of member countries, it is difficult to make progress on subsidy disciplines even on a limited scale.

## **Introduction \***

As in goods case, subsidy can be an important source of distortion of trade in services. But subsidy is not the only source of distortion. Domestic regulatory policies as well as practices of monopolies and exclusive service providers can have subsidy-like effect. Ideally, subsidy disciplines should form a part of broader system of controls over all forms of intervention including regulation and direct public provision in the economy (OECD 2001). But given the GATS reality, distortions due to regulatory policies and monopoly practices need to be addressed separately from those arising due to subsidies. Therefore, any attempt to develop subsidies framework needs to focus on distortions due to subsidies alone.

The basic motivation behind subsidy disciplines in service is to provide level playing field for all service providers, irrespective of where they are located, and in all modes of supply. Subsidy disciplines under GATS are needed to make progress on service negotiations which are necessary for achieving greater liberalization of trade in services that is expected to be even more beneficial than (further) liberalization of merchandise trade. Subsidy agreement would be particularly beneficial to developing countries, as Sauve (2001) notes, “Developing countries should be active demandeurs of subsidy disciplines in services negotiations given their limited capacity to provide subsidy compared to the developed countries.” Developing countries may not have a big share of services today except perhaps in certain sectors such as tourism and transportation. But they are moving up the value-added chain in services supply (UNCTAD 1999). As developing countries progress on this, they may gradually overtake developed countries in certain lines of services, depending on their comparative advantages---the trend observed in goods trade. Absence of subsidy disciplines can be a major stumbling block to achieving such a trend.

Before thinking through the issues in subsidies in services, it is instructive to examine how trade in goods is different from trade in services. Unlike trade in goods that

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mostly occurs through cross border movement (i.e., Mode 1), trade in services can additionally occur through three other modes: consumption abroad (Mode 2), commercial presence (Mode 3), and movement of natural persons (Mode 4). Because trade in services can occur through other channels or modes, trade flows become a bit more complicated (see Figure 1 and 2). One major implication of this is that the possibility of subsidy-induced trade distortions in the domestic market of subsidizing member country is much more in services than in the goods case. Moreover, the GATS architecture itself is quite different from that of GATT. Therefore, subsidy disciplines in services have to be different from those in case of goods. Before discussing subsidies, let's examine the main differences between the GATT and GATS.

Although the basic objective and the principles behind both these agreements (GATT and GATS) are the same namely to reduce trade barriers and to practice non-discrimination, the two agreements are framed quite differently. The difference in the two frameworks partly reflects the fact that trading in goods is different from trading in services, and is partly conditioned by the necessity of making the services agreement agreeable to the member countries, some of whom were reluctant to the inclusion of trade in services during the Uruguay Round. There are, of course, many differences between the two agreements. The main differences of interest here are outlined below.

Merchandise trade involves only one type of transaction i.e., cross border movement and only one legitimate instrument of protection i.e., tariffs. Trade in services, on the other hand, involve four different types of transactions (categorized in terms of four different modes) and two different sets of negotiable trade obligations, namely, 'market access' and 'national treatment'. The negotiable trade obligations include six different types of market access restrictions and a virtually unlimited range of conceivable departures from national treatment.

The fact that these two different sets of trade obligations are negotiable, implies that GATS allow member countries considerable flexibility in terms of undertaking sector-specific access obligations as well as scheduling commitments that can be inscribed mode-

wise and to which broad range of limitations over and above existing market conditions can be applied. The 'bottom-up' approach to the undertaking of sector-specific access obligations in GATS implies that nothing is bound that is not included in commitments. This feature allows considerable flexibility to member countries in comparison to GATT where a negative-list approach is adopted, implying everything is bound unless explicitly excluded (for other differences see Adlung 2004, Adlung and Roy 2005).

These two basic features of GATS agreement pose considerable challenge to framing subsidies discipline in services. Besides, there are other issues in services trade that add complexity and challenge to designing a subsidies framework. The fact that trade in services can take place through four different modes gives rise to the issue of subsidy-induced distortion in any one mode affecting competition in the same service provided through another mode. Moreover, given the nature of certain services, the role of public policy is much more pronounced in services than in case of goods. Furthermore, diverse service sectors in GATS<sup>1</sup>, with each sector having some sectoral specificities, considerable cross-linkages, and the issues of transparency add considerable complexity to developing subsidy disciplines in services. Before discussing these complexities in some detail, let's examine the potential reach of the existing disciplines in matters of subsidies.

### **Existing GATS Disciplines**

While the need for having subsidy disciplines in services is well recognized, the GATS rules currently have minimal disciplines on subsidies. GATS article on subsidies (Article XV), as it stands today, is more of an expression of the collective thinking of member countries on the subject rather than an attempt to impose disciplines. For example, GATS recognises that in certain circumstances subsidies may have distortive effects on trade in services. Accordingly, GATS mandates that members shall enter into negotiations with a view to developing the necessary multilateral disciplines to avoid such trade-distortive effects. At the same time, GATS recognizes subsidies to be important policy tool for achieving national development goals. Hence, the subsidy disciplines in services, as and when they are developed, should seek to control trade related subsidy measures, and in case

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<sup>1</sup> GATS categorize all kinds of services into 12 broad sectors (see WTO classification list W/120).

of non-trade related measures, the subsidy disciplines should only cover their incidental effects on trade. It also makes it incumbent upon members to share information on the subsidies that are being given to services sectors. If a subsidy practice of any member country adversely affects any other member, the affected member can seek consultation under Article XV. However, this provision does not specify what the consulted member is required to do in case the country requesting the consultations is able to show that it is adversely affected. Hence, the consultative process under GATS is more or less ineffective.

Besides Article XV, five other GATS articles that have a bearing on subsidy practices are: the MFN clause (Article II), the NT clause (Article XVII), market access (Article XVI), additional commitments (Article XVIII), consultations on subsidies (Article XV (2)), and non-violation nullification or impairment (Article XXIII (3)).<sup>2</sup> We briefly discuss the relevant portion of these articles below.

The MFN clause that deals with most favoured nation treatment tends to discipline subsidies by making it mandatory for a member country giving subsidies to foreign service suppliers from some countries to extend such subsidies to foreign suppliers from all countries. However, diluting measures such as the option not to grant subsidies to foreign service suppliers at all, or to schedule MFN exemption, partially offset these potential disciplining effects.

Similarly, national treatment obligation makes it mandatory for a member country to extend subsidy to all foreign suppliers located in the domestic territory of a member country if such subsidies are available to domestic service suppliers and the country has not sought subsidy limitation under national treatment. The obligation to grant service subsidy to foreign like firms inhibits the desire to grant the subsidy to national service firms. Most members have included limitations on national treatment that apply horizontally to all services subsidies.

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<sup>2</sup> For these GATS Articles refer Benitah (2004) from which we have drawn heavily.

Market access commitments are the necessary condition for the existence of previous disciplining effects through MFN and NT clauses. Thus, the disciplining effect of the NT and MFN clauses on services subsidies is de facto toothless in all sectors not included in the schedule of commitments.

GATS Article XX(1)(c) allows members to make additional commitments in sectors where specific commitments have been made. According to Benitah 2004, “This provision could theoretically allow the request and offer of commitments to bind, reduce, remove or otherwise discipline services subsidies in the additional commitments column of members’ schedules. In practice, no country has used this option.”

Another GATS Article that has a bearing on subsidy practices is Article XXIII (3) which stipulates that if a member considers that any benefit it could reasonably expect to accrue (from specific commitment of another member) is being nullified or impaired as a result, for example, of a particular subsidy, it may have recourse to the dispute settlement process. According to Benitah 2004, “Since information on services subsidies is at this moment opaque for most countries, it would be surprising to see a WTO panel take seriously the argument that such a subsidy was really unexpected at the time when specific commitments were made.”

Furthermore, Benitah 2004 notes, “All current tools offered by the GATS for disciplining subsidies are inherently limited as their bite is largely dependent on individual members’ foresight and bargaining power.”

### **Complexities in Developing Subsidy Framework**

Since the current GATS provisions have limited effect on subsidies a need for full blown subsidy framework is felt. There is already a significant body of literature that brings out the range and complexity of issues involved in developing subsidy and also sheds some light on what the essential elements could be in any modest beginning towards developing subsidy disciplines. We discuss some of these complexities below:

*Modal distinction:* While members make commitments under different modes, trade distortion in one mode where a member has not made any commitment can easily alter conditions of competition under another mode in which the member has actually made commitments. Difficulty in handling this issue has given rise to what is called likeness of service and likeness of service providers. The definition of likeness cuts across different modes and poses a challenge when dealing with subsidies.<sup>3</sup> The issue here is well summed up in Mattoo (1997): “If “likeness” of a service were defined independent of the mode of supply, then there would be built-in protection within the Agreement for foreign suppliers of services through all modes against national subsidization. In effect, if a Member were to subsidize its own service or service supplier, the national treatment obligation would make it necessary to provide an “equivalent” subsidy to the services of other Members supplied within its territory, irrespective of the mode of supply. Otherwise, it could be argued that the subsidy had modified the conditions of competition in favour of services or service suppliers of the Member. On the other hand, if likeness were held to depend on the mode of supply (as the structure of schedules suggests), then foreign suppliers through a particular mode may not be protected against national subsidization. In this case, there would be a gap in the current disciplines which may need to be remedied.”

*Public policy objectives:* Public services provided in exercise of governmental authority, not on a commercial basis and not in competition with other service suppliers, is excluded from GATS disciplines under Article I:3 (b). However, the understanding on what constitutes a basic public service has not been reached among member countries. The reason for this is not difficult to see. In any country the range and level of public services is the result of history, varying social and political values, and differing notions of appropriate role of the state (Krajewski 2001). Hence, the extent of public services varies from country to country. In healthcare service, for example, Europe has a strong tradition of public health systems which is financed through taxes or through mandatory insurance while in the US private provision of healthcare is fairly strong. What is observed in healthcare is also

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<sup>3</sup> The Canada autopact case suggests that the concept of like service can cross mode. If so, then it might become arguable whether a member who scheduled an NT limitation in mode 3 for subsidies granted to its domestic supplier but committed full NT in mode 1 and 2, might be in breach of its NT obligation if the subsidies changed the conditions for competition for foreign suppliers supplying services in mode 1 and 2.

observed in other services such as education, water, environmental services, energy supply and so forth. Therefore, the scope of GATS agreement depends on whether or not a particular service constitutes a basic public service. This in turn depends on how the notion of “a service supplied in the exercise of governmental authority” is understood. At present, for a service to qualify as basic public service it must meet two conditions: it must neither be supplied on a commercial basis nor in competition with one or more service suppliers. If a service is provided on non-commercial basis but in competition with one or more service suppliers or on a commercial basis but without competition, it is not a service supplied in exercise of governmental authority. The scope of the GATS thus depends on an understanding of the notions “supplied on a commercial basis” and “supplied in competition with one or more services suppliers”.

The scope of the agreement is also relevant if the member has made specific commitments concerning market access and national treatment. If a service is covered under the scope of GATS all horizontal disciplines (such as Article II, MFN, or Article III, transparency) apply to it.

Although, the discussions in the WTO have brought greater clarity on this issue, the final decision is yet to be reached. For example, the background note on *postal and courier services* prepared by the council for trade in services, the secretariat stated “There might be a relation between postal services provided by wholly government entities and the GATS Article I provision excluding government functions. Postal services of a member, whatever the status of the postal supplier, would be services covered by the GATS as long as, and which his usually the case, they are supplied on a commercial basis.”

In case of *legal services* the secretariat held that “the administration of justice (judges, court, clerks, public prosecutors, state advocates, etc.) (...) is effectively excluded from the scope of the GATS as in most countries it is considered a ‘service supplied in exercise of governmental authority’ according to Article I:3 (b) of the Agreement.”

In the background note on *health and social services* the secretariat concludes “that the hospital sector in many countries, however, is made up of government-and-privately-owned entities which both operate on a commercial basis, charging the patient or his insurance for the treatment provided. Supplementary subsidies may be granted for social, regional and similar policy purposes. It seems unrealistic in such cases to argue for continued application of Article 1:3 and/or maintain that no competitive relationship exists between the two groups of suppliers or services.”

As we shall see later, social services typically receive considerable government support that would easily qualify as subsidies. Whether subsidy discipline should be applicable to these services would depend on their scope in the GATS as well as their treatment in the subsidies agreement.<sup>4</sup>

One possible way to dealing with the issue of public policy goals is to leave the scope of basic public services open, and let the members decide what services they would treat as basic services, which should eventually get reflected in their commitments in GATS, and then treat the issue of subsidies to social sectors not very different from other service sectors in the subsidies agreement. Another possible way is to tighten the scope of I:3(b), and then leave large enough room in subsidies agreement to enable member countries achieve their legitimate social objectives through subsidies in these sectors.

*National treatment obligation:* The national treatment obligation tends to impose significant disciplines on member countries in checking against the proliferation or prevalence of subsidies in services sectors.<sup>5</sup> Although national treatment can substantially discipline trade distortion in the domestic territory of a member country, it cannot

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<sup>4</sup> Also, Article XIII exempts the application of Articles II, XVI and XVII to government procurement i.e., procurement by governmental agencies of services purchased for governmental purposes in pursuit of non-commercial goals.

<sup>5</sup> In GATT, national treatment is concerned with measures affecting products *per se* and is applied across the board. In comparison to GATT, national treatment obligation under GATS is wider in scope (as the domain of national treatment obligation in the includes not only measures affecting services products, but also measures affecting service suppliers) but it is more limited in application because it applies only to scheduled sectors, and there too may be subject to limitations. Also, in GATS, subsidies are automatically subject to national treatment disciplines in scheduled sectors unless limitations have been scheduled. GATT, however, exempts production subsidies from national treatment.

discipline all kinds of subsidy-induced trade distortions in the domestic territory of a subsidising member country or in the third country. In particular, it leaves open the following possibilities:

- (i) Service supplier located outside domestic territory
  - (ii) Consumption support linked to domestic supplier
  - (iii) Subsidizing specialized skills of nationals
- (i) Supposing a Member has bound itself to provide national treatment under *all four modes* in a particular sector, and that the member provides subsidy to all national service providers. Is the member obliged to extend the subsidy to the service suppliers located abroad who faces unfair competition in the domestic market of subsidising member country? The Explanatory Note clarifies, to an extent, the territorial scope of the national treatment obligation. Paragraph 10 of the Explanatory Note states that:

"There is no obligation in the GATS which requires a Member to take measures outside its territorial jurisdiction. It therefore follows that the national treatment obligation in Article XVII does not require a Member to extend such treatment to a service supplier located in the territory of another Member."

According to Mattoo (1997), "This would seem to imply, for example, that a Member is not obliged to extend a subsidy provided to suppliers located in its territory to suppliers located outside its territory. It should be noted, however, that the Explanatory Note addresses specifically the treatment of *suppliers* and does not deal with issues that may arise in relation to the treatment of *services* - especially with respect to the cross-border supply of a service, when the service is supplied *within* the territory of a Member while the supplier is located outside it."

Any subsidy provided under modes 3 or 4, for example, would have an impact also on competitive conditions under mode 1, because cross border suppliers would be

competing against subsidized local services. Thus, the issue here is on how to ensure non-discriminatory conditions for suppliers through all modes.

- (ii) Another issue that needs to be addressed relates to consumption subsidies. Consumption subsidies given to residents are non-trade distortionary. However, when such subsidies are linked to purchase from a national supplier, they tend to distort trade. It does not matter whether the resident is located within domestic territory or located abroad. When a subsidy is granted for consumption abroad and it is linked to purchase from a national supplier located abroad or conditional on purchase in a particular country, it once again, gives rise to the tension between the notion of territory and wider notions of jurisdiction.

There may be no obligation in the GATS which requires a Member to take measures outside its territorial jurisdiction (as paragraph 10 of the Explanatory Note states), but if a Member does take such measures, is it free to act as it chooses - or should there be an obligation to take such measures consistently with GATS principles?<sup>6</sup> Mattoo 1997 observes that in the absence of such an interpretation, there is a danger that the national treatment (and MFN) obligations would have limited value with respect to consumption abroad.

- (iii) In addition, other form of subsidy that can distort trade both within and outside domestic territory is subsidy given to residents for acquiring specialised skills. When the residents, armed with specialized skills that are subsidized by government, temporarily move abroad the subsidy causes distortion. At present this distortion is limited, if at all, since the members countries usually have strict immigration/visa regulations. But even when there is no temporary movement of natural persons, subsidized specialized skills may distort trade when, for example, outsourcing of services to the subsidizing member takes place via mode 1.

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<sup>6</sup>Unlike in GATT, *export subsidies* are not prohibited in GATS, but a Member who had committed to provide national treatment would also be obliged to provide such subsidies to all foreign producers with commercial presence in its territory. However, would the obligation affect a Member who provides the subsidy to its

Even if the above channels through which trade distortion takes place are addressed, trade distortion may still occur if one of the sub-sectors is subsidized or when any particular mode is subsidized. So a full blown subsidy disciplines should check against cross-(sub) sectoral and cross modal trade distortion, even when such subsidies in a specific mode or specific sub-sector are available to both domestic and foreign service suppliers.

Subsidy disciplines ought to address these channels of subsidy-induced trade distortions.

### **Towards developing subsidy disciplines in GATS**

Under GATS rules, member countries have full flexibility in terms of what sectors to schedule and what limitations to seek both under market access and under national treatment obligations. Any subsidy framework (whatever form it takes) should uphold this basic spirit of GATS i.e., should be applicable only to those sectors that have been scheduled and in which a member country has not sought any limitations to subsidies under national treatment. In other words, if a member country has not scheduled a sector or having scheduled a sector sought limitation to subsidies under national treatment, the subsidy disciplines should not apply to the member country in that particular sector. At any given time, the fact that the levels of commitments under different sectors vary from one member country to another imply that the extent to which subsidies disciplines would be binding on each member country may be different.

### **Applicability of ASCM**

The literature compares subsidy disciplines under General Agreement on Trade and Tariff (GATT), and the possible subsidy disciplines under GATS. It is instructive to examine the extent to which the subsidy disciplines under GATT (i.e., ASCM) can be useful in designing disciplines in the context of GATS. In understanding the applicability of ASCM provisions to subsidy disciplines under GATS, it is to be borne in mind that the GATT architect is quite different from that of GATS.

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producer located outside its territory? Could we argue that the Member, having chosen to act outside its territory, should be obliged to act in a manner consistent with its obligations under the GATS?

In case of ASCM, the definition of subsidy is generic and unrelated to the concept of trade distortion. A measure is called subsidy, under ASCM, if it takes the form of financial contribution, by the government, leading to conferral of benefit. The link between a subsidy measure and trade distortion is established by the concept of specificity i.e., only those subsidies that are specific in nature are considered to be trade distortionary and hence liable for action under certain conditions. On the contrary, subsidies that are available more generally (i.e., non-specific subsidies) are not considered troublesome from a trade perspective and, hence, are considered non-actionable. Non-specific subsidies may be given by a member country pursuing certain desirable social and/or economic goals.

Furthermore, not all specific subsidies are troublesome to the same degree. Based on the nature of specific subsidy, ASCM assumes certain subsidies to be more trade distortionary than others and for this reason has adopted traffic light approach with respect to all specific subsidies. As per this approach, export subsidies are assumed to be trade distortionary and hence are, in general, prohibited while the link between other specific subsidies and their trade distortionary role is less clear and therefore become actionable under certain circumstances. In other words, in GATT disciplines a distinction is made between (i) government actions having finality related to trade, and (ii) the effects on trade of government actions having a finality unrelated to trade. The immediate consequence of this is that only government actions falling into (i) can be in themselves subject to GATT disciplines whereas GATT rules cannot deal with government actions falling into (ii). They can only deal with their incidental effects on trade.<sup>7</sup>

The scope of actionable subsidies is well defined in the ASCM. A subsidy measure becomes actionable if it causes adverse effect to member countries. Adverse effect includes: injury to domestic industry, nullification and impairment of benefits, and serious prejudice to members' interest.

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<sup>7</sup> For more on this see Depayre and Petriccione 1991.

It is instructive as this point to compare the services case with that of goods. In goods case, because trade takes place only through cross border movement, it is possible to distinguish between export subsidies and domestic subsidies that are specifically given, and developing stricter disciplines (i.e., prohibiting) on export subsidies than on domestic subsidies (that are actionable). In case of services the distinction between export subsidies and domestic subsidies is non-tenable because trade in services can take place through other modes too. An important implication of this, as noted above, is that subsidy-induced trade distortions within domestic market of subsidizing member country can be much more than in case of goods trade. Therefore, domestic subsidies can be as much trade distortionary (if not more) than export subsidies in services. Fortunately, the design of GATS already tends to discipline subsidy distortion in the domestic territory of subsidizing member country through national treatment. Although national treatment obligation imposes considerable discipline on subsidies, it does not address all channels through which subsidy-induced trade distortion may happen. Even if national treatment is extended, there is still a need to limit subsidy because subsidy given to a sub-sector or to a service supplied through a particular mode can still distort competition across modes or sub-sectors. It is instructive here to examine the European Commission (EC) approach in this regard. The EC has developed rules to government state aid, the term used for subsidy, among the member countries.

If all subsidies, as a rule, are prohibited and alongside this prohibition rule a positive list approach is followed wherein certain exceptions to the prohibition rule are permitted, all the complications cited above can be overcome. Indeed, this is the approach followed by the EC treaty on state aid.

*EC approach to subsidy in nutshell:*

According to EC, the core issue is whether subsidy, referred to as state aid in the EC treaty, distorted competition, and not just whether it distorted trade. As a general principle subsidy is banned in EC because it distorts competition by giving some enterprises an advantage over others. The controls in the EC treaty focus only on financial assistance to firms, and only “in cases where some subset of firms is treated differently

from the way firms are treated in the country as a whole.” This approach has the advantage of focusing on distortions to competition, which are most likely to be inefficient. However, the possibility existed that certain state aids be permitted by the commission. In this regard, a number of public policy objectives were exhaustively listed in the treaty. Provision was also made to ensure that the provision of services of general interest was not prevented.

EC rules on state aid are applicable to goods and services alike. The definition of state aid is similar to that of subsidies in case of ASCM. For any measure to be regarded as state aid, it must qualify the following four conditions: (i) lead to transfer of resources from state (including national, regional or local authorities, public banks and foundations, etc.) (ii) would constitute an economic advantage that the undertaking would not have received in the normal course of business (iii) is selective and thus affect the balance between certain firms and their competitors. (iv) must have a potential effect on competition and trade between member states. Note that it is selectivity that differentiates State aid from so-called general measures (e.g. most nation-wide fiscal measures). Potential effect of small levels of state aid (de minimis level) is considered limited and therefore kept outside the scope of the definition of state aid.

State aid is in general considered incompatible with the common market. But the principle of incompatibility does not amount to a full-scale prohibition. The Treaty specifies a number of cases in which State aid could be considered acceptable (the so-called exemptions.). However, member states must notify to the Commission any plan to grant state aid before putting such plan into effect. This gives the Commission the power to decide whether the proposed aid measure qualifies for exemption.

State aid having a social character, granted to individual consumers, provided that it is granted without discrimination related to the origin of the products concerned is considered compatible. Likewise, aid to make good the damage caused by natural disasters or exceptional occurrences is considered compatible. State aid may be acceptable if it is given for regional development, for achieving certain well defined objectives to be achieved in any region/sector. Accordingly, there are rules for regional aid, horizontal rules

and sectoral rules. Regional aid is given to improve standard of living or remove underemployment problem in regions where these indicators deviate considerably in comparison to EU average. Regional aid can also be given to facilitate the development of certain economic areas which are disadvantaged compared to the national average.

On horizontal rules, the commission allows for particular categories of aid which are aimed at tackling problems which may arise in any industry and region. These categories are: Aid for small and medium-sized enterprises; Aid for research and development; Aid for environmental protection; Aid for the rescue and restructuring of firms in difficulty; Aid to employment, and Training aid.

Besides, the Commission has adopted industry-specific or sectoral rules defining its approach to State aid in particular industries. These sectoral rules are for (i) sensitive sectors (ii) agriculture and fisheries, and aquaculture (iii) transport sector.<sup>8</sup>

Member states are urged to redirect their aid towards horizontal objectives and to seek alternatives to state aid to address market failures. Prior notification of all state aid measures or schemes to the commission is required. However, the commission is authorized to adopt regulations exempting certain categories of aid without the need for notification. Firms that receive aid that has not been notified to the commission may have to repay this aid if the commission decides that the aid is incompatible with the common interest.

In WTO, subsidy rules under GATS need to follow positive list approach i.e., all subsidy to services, as a rule, should be prohibited. However, exceptions need to be made for certain well defined objectives. Here the approach suggested by Benitah 2004, sounds

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<sup>8</sup> Over the years, special rules have been adopted for a number of sectors which have experienced severe economic problems and which were therefore considered to be sensitive. As per the available report, the sensitive sectors are the coal and steel industry, synthetic fibres sector, motor vehicles industry and shipbuilding. The general state aid rules do not apply, or apply only to a limited extent in the sectors involved in the production and marketing of products of agriculture and fisheries, and aquaculture. Similarly, while in the *road transport sector*, most general State aid rules apply, these rules do not apply to other transport sectors (rail, air, inland waterways and maritime transport).

promising. Benitah 2004 lists a number of public policy objectives which are categorized in to three heads: economic development, social development, and environmental objectives. One expects some relationship between the positive list and public services under Article I:3 (b).

This approach is useful in developing full blown subsidy disciplines which may take some time to develop. Some of the contours of a full blown framework could be as follows:

- a) As in case of ASCM, it is desirable to de-link the subsidy definition from the distortionary effect of subsidy measures;
- b) The subsidy definition given ASCM can be retained as it is general enough to capture all types of government financial support: budgetary and non-budgetary and implicit and explicit. (EU treaty adopts similar definition on State Aid);
- c) Infrastructure assumes greater importance in trade in services. Under ASCM public investments in general infrastructure such as ports and airports is not considered to be a subsidy. However, in case of GATS such investments can no longer be considered as those in general infrastructure. Definition of infrastructure needs revision;
- d) In keeping with the underlying spirit of ASCM, refund of all indirect taxes and levies on goods and services at any stage of generation of services that are traded should not be treated as subsidies. But clear identification of taxes (both on goods and services) used in the production of services may pose a challenge;
- e) The disciplines imposed on subsidies to services will undergo a change. To the extent non-specific subsidies that are given more generally on economy-wide basis are least trade distortionary, the distinction between specific and non-specific subsidies is desirable. While specific subsidies are more trade distortionary than

non-specific subsidies, specific subsidies have an overwhelming role in GATS because of the need to fulfill certain public policy goals.<sup>9</sup> Under certain circumstances achieving these goals may call for giving specific subsidies. Therefore discipline on specific subsidies in services needs to be different from that in ASCM. Again, in case of services the traffic light approach of ASCM is not very helpful: one, because the distinction between export subsidies (measures contingent on export performance or on the use of domestic inputs over imported inputs) and other actionable subsidies gets blurred, and two, because of the limited scope of remedial action. That the subsidy regime should place more emphasis on disciplines to control the behaviour of members ex ante than on developing rules and procedures for ex post remedial action by members has been widely acknowledged in the literature. It is perhaps desirable to have only two kinds of subsidies: those that are permissible and those that are not;

- (f) Subsidies agreement should allow for consumption support to nationals who are not able to afford a service otherwise, provided the consumption support is not linked to purchase decision. The consumption support need not be extended to foreign nationals;
- (g) Just as subsidised goods and services that go into production of export goods and fall under the purview of ASCM, subsidised goods and services that enter into the production of exported services should be subjected to subsidy disciplines in GATS;
- (h) cross-subsidy requirement imposed by regulator to achieve universal service obligations should be kept outside the purview of subsidy disciplines. However,

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<sup>9</sup> Under ASCM, subsidies given for achieving three public policy objectives were deemed non-actionable. These public policy objectives are: research and development, development of backward regions, and achieving environmental goals.

subsidies disciplines would be applicable to a measure taken to achieve universal service obligations if that measure qualifies as subsidy;<sup>10</sup>

- (i) Special and differential treatment for developing countries. For developing countries exclusive reliance on laissez-faire is a very poor option, given the underdevelopment of market forces, institutions, and national private economic agents. According to UNCTAD 2005, "...a certain level of interventionist, proactive industrial policies, which usually entail the implementation of selective subsidy policies as a key component, is a key ingredient of any development strategy..." Given the important role subsidy often play in developing countries, it is perhaps necessary to extend some kind of special and differential treatment to these countries.

In WTO, for the present the aim of developing subsidy disciplines is not to discipline all subsidies but only those subsidies that are trade distortionary. Indeed, the link between trade distortion and competition distortion is much complex in services. Even though no good real life example has been analysed with the view to bring out trade distortionary effects of subsidies in services, it is not hard to imagine trade distortion that occurs when subsidies, say cash grants/transfers, are given to service producers or when infrastructure in a particular sector is subsidised by a government. Consider, for example, tourism sector which is one of the most commonly subsidised sector. Nobody would doubt that international tourists take account of the cost of travel and stay in deciding what country destination to travel to. Accordingly, subsidies given by a government to the different entities in its tourism industry would affect the costs and hence the number of tourist arrival in the country. Such subsidies even when available to foreign supplier under mode 3 would distort trade via mode 2 i.e., consumption abroad. To that extent there is a need to check subsidies. But such subsidies are hard to check. For example, it is quite

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<sup>10</sup> On the universal service obligation, the reference paper on telecommunications services says, "Any member has the right to define the kind of universal service obligation it wishes to maintain. Such obligations will not be regarded as anti-competitive per se, provided they are administered in a transparent, non-discriminatory and competitively neutral manner and are not more burdensome than necessary for the kind of universal service defined by the member."

difficult to de-link the benefits reaped by foreign tourist and domestic tourists. Further if subsidy takes the form of market assistance, say for publishing a country brochure that promotes tourism in the country, and if such assistance is given with the view to generate greater overall revenue to the government or generate employment in the sector it, is not clear if such subsidies at all need to be controlled/regulated. Could it be that consumption abroad is special to tourism sector alone? If that is so, should there be some sector specific subsidy disciplines? These are some of the issues that come up in thinking about subsidies disciplines in GATS.

However, many WTO members are of the view that in trying to make a small beginning in controlling subsidies, the focus initially could be on identifying a subset subsidy practices or measures that are most trade distortionary. Some guidance on this can come from empirical evidence on subsidies to which we now turn.

### **Empirical Evidence**

The developed economies are mainly services economies but services are increasingly playing important role both in its contribution to GDP and employment even in the poorest countries. In 2001, service sectors accounted for 45% of GDP in low-income economies; 57% in middle-income; and almost 71% in high-income (Marchetti 2004). With the rising incomes, services would play increasingly important role in the economies of developing countries. Trade in services is expected to be a major driver of growth in world trade in the coming years (Rashmi 2005). Therefore, various government practices affecting trade in services, including subsidies, will increasingly come under the scrutiny of member countries.

For developing limited disciplines, it is instructive to look at whatever limited evidence is available on subsidies in services sectors. There are five main sources of information on subsidies: (i) the information compiled by the WTO secretariat from the Trade Policy Reviews (ii) limitation on subsidies under national treatment sought by member countries (iii) the findings of UNCTAD study on the subject (iv) EU survey on State Aid (v) analyse information on subsidies in selected sectors and in selected countries

Additionally, we use information on the commitments made by the member countries in GATS. We turn to each of these pieces of information below.

- (i) Information on subsidies in services sectors contained in *WTO trade policy review* is compiled in the most recent WTO document (S/WPGR/W/25/Add. 4) throws some light on subsidies in services sectors.

The secretariat note indicates that the majority of subsidies took the form of tax incentives, duty-free inputs and free zone incentives as well as preferential credit, sometimes linked to exports. In the banking sector, for example, 33 member countries provided subsidies, often in the form of tax incentives. In addition, 24 member governments provided subsidies to the transport sector in general, 25 to maritime transport in particular, 14 to air transport, and 14 to rail transport. The note also listed subsidies in such sectors as energy, telecommunications, construction, software and information technology.

The note covered the 26 TPR reports issued since the last update in August 2002. In terms of the findings the note highlighted that tax incentives were the preferred tool to subsidise and that subsidies were generally found in all sectors, but mainly in tourism, transport, and banking.

To see if there is any distinct pattern in subsidies across different member countries, we group this information in 3 sets of countries: the OECD countries, developing countries (i.e., annex VII countries), and the least developed countries (LDCs). This categorization yields some interesting results which are contained in Tables 1 through 3.

Table 1 pertains to OECD countries. Along vertical axis we list different services sectors; horizontal axis lists different forms that subsidies can take. Number in each cell denotes number of member countries giving subsidies. For example, in air transport service two countries gave direct grants. Maritime transport sector

received subsidies from maximum number of countries. This is followed by tourism and then banking. Direct grants were the most common form that subsidies take and this was followed by tax incentives.

As far as developing countries are concerned the most common sector receiving subsidies is tourism; this is followed by maritime transport. Tax incentive is the most common form of subsidies (see Table 2). For least developed countries, tourism sector receives maximum subsidies and this is followed by “other and unspecified” sectors. The most common form of subsidies is duty free inputs/free zones which is followed by tax incentives (see Table 3).<sup>11</sup>

It is important to be aware of the limitations of these findings of the Secretariat note prepared from the information contained in TPR. For example, the TPR reports tend to focus on certain sectors more than on others, and to that extent it lacks comprehensive sectoral focus of subsidies. Another limitation is that TPR reports were prepared with a broader focus in mind, and therefore, information on particular subsidy programs is often quite limited and made classifications difficult. The overview provided by the secretariat should be seen as best estimate on the basis of limited information. Moreover, the note did not address the issue of trade distortive subsidy. Therefore, being listed as a donor of subsidies did not imply any wrong-doing.

- (ii) A note prepared by the WTO secretariat contains *information on limitations in members’ schedules* relating to subsidies (S/WPGR/W/13 and addenda). Information contained is not complete as only those entries that make explicit reference to subsidies, grants, financial support, aid or assistance are included in the listing of measures. Furthermore, subsidies may also be granted in cases where sectors or activities have been excluded from members’ schedules of specific

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<sup>11</sup> These broad patterns are visible in the earlier WTO compilation of information based on TPRs.

commitments, or where a particular mode of supply has not been bound with respect to market access and/or national treatment.

In the secretariat note on subsidy-related entries in schedules, while not providing much information on definition, revealed certain policy intentions. For example, in mode 3, only those companies that were present on the territory were eligible for subsidies. In mode 4, only citizens and/or residents were eligible. Things were less clear for modes 1 and 2. The entries also highlighted the sectors and areas that were of particular concern to some members, such as research and development, audiovisual, and education. Requesting detailed information from member countries on subsidies to these sectors is a good starting point.

- (iii) In the *analysis done by UNCTAD*, developing countries have potential comparative advantage, particularly through movement of natural persons, in at least six different sectors. These are: professional and business services, health services, tourism, construction, audiovisual services and transport. If trade expansion based on comparative advantage is to be advanced, subsidy disciplines in these sectors need to be developed before progress is made on developing full blown subsidy disciplines.

It would be interesting to know whether members detecting distortions caused by subsidies or proposing relevant disciplines had made use of the consultations provisions of Article XV:2, thus indicating that they considered themselves adversely affected by a subsidy of another member. This would then constitute fourth source of information that would shed some light specifically on trade distorting subsidies.

A recent UNCTAD study (2005) on subsidies to services sectors makes a number of interesting observations. For example, global subsidies are more than a trillion dollars per year or 4 percent of world GDP, and OECD countries spend twice as much on subsidies in relation to developing countries but much less in proportion to

GDP. Apart from agriculture, the three most subsidized sectors all involve services: water, energy, and road transport. These three services sectors absorb almost half of total subsidies worldwide and an even higher share in non-OECD countries. Citing other estimates, the UNCTAD study suggests R&D to be another area of public support. Total OECD expenditure on R&D (public as well as private) was over US\$551 billion in 2000. The share of US was 44 per cent, EU 28 percent, and Japan 17 per cent. The share of R&D performed directly by governments is about 10%. It is particularly low in the US (7.5 %) and higher in EU (almost 14%). Most OECD countries are increasing public funding for R&D and innovations. The EU has set a goal of earmarking 3% of GDP for R&D by 2010. South Korea is determined to increase government R&D expenditure to 5% of the total government budget. Indeed, subsidy for R&D activities is one area where most developed countries have sought limitations under national treatment.

(iv) Ninth Survey on State Aid in the European Union

The importance of the service sector in EU and state aid given to this sector is summed in the 9<sup>th</sup> survey on state aid in the EU: “The European Union is a service-driven economy. The commercial service sector accounts for a large proportion of total GDP and this proportion is even larger when social and public services are included. Given the importance of services, a growing emphasis is being put on the analysis of aid granted in this sector and contingent upon information provided by Member States, a more detailed picture of the trends and patterns in the grant of aid will be presented in future.”

In 1997-99, average annual state aid given to all sectors (including manufacturing and agriculture) by the EU was Euro 90 billion or Euro 240 per capita. State aid accounted for about 1.18 per cent of GDP and 2.44 per cent of total government expenditure.

During the same period, around 42 percent of state aid to all sectors went to transport sector (36%) and services sector (6%). In transport sector majority of aid went to railways and none to airline services.

The survey report observes, “Whilst in comparison with other sectors, the overall levels of aid [to services] are not massive, the importance of aid in this sector is due to the fact that the bulk of the aid is ad-hoc aid granted to a small number of companies. For this reason government support to this sector must be kept under constant watch and all current restructuring operations will continue to be closely monitored. This is particularly important where capital injections or equivalent forms of aid have a direct impact on the beneficiaries’ operations, and may distort competition far beyond what would be expected if only the nominal value of the aid were taken in to consideration.” In 1997-99, annual average aid given to service on ad-hoc basis was Euro 3,655 million.

Between 1995-97 and 1997-99, there has been an increase in aid to service sector from 5 billion to 5.4 billion. But restructuring of certain service industries such as airlines and finance appears to be winding down following the relatively recent liberalisation of these sectors.

(v) Subsidies in Selected Sectors<sup>12</sup>

*Tourism* is the world’s largest and one of the fastest growing sectors. It accounts for over one-third of the value of total world-wide services trade (S/C/W/51). Being labour intensive, the industry has significant employment generator and hence of great interest to developing countries. Tourism is also highly perishable commodity in the sense of unsold airline seats, hotel rooms etc. have no residual value. The industry is infrastructure intensive, and is greatly influenced by immigration and

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<sup>12</sup> The author gratefully acknowledges the help of Dr. Arpita Mukherjee and Dr. Rupa Chanda for the information on subsidies in selected sectors.

entry/exit controls. The industry is broadly divided into 4 subsectors: hotels and restaurants, travel agencies and tour operators, tourist guides and others.

Many countries provide incentives to promote the development of tourism industry. These include France, Malaysia, India, Singapore, USA and UK. Tax incentive is the most common form. But countries like Malaysia also provides variety of non-tax breaks such as export credit refinancing facility, export credit insurance guarantees, special funds to be used for specific purposes, concessional price charged for land. France, for example, provides grants to improve the accessibility of geographical regions such as Reunion. Singapore also enables cheap flights to attract business visitors to certain locations. To reduce the burden on employers' Singapore provides training grant. It also assists small and medium-sized enterprises in the sector to alleviate the short-term cash flows.

Special incentives are given in the event of any catastrophic event such as the 9/11, outbreak of SARS, tsunami and so forth. Singapore helps the industry to upgrade by assisting them to engage approved professional conference organizers to organize international association meetings. The incentives come from both federal government and provincial government. In USA each of the 50 states has established an official government-sponsored office or bureau to promote tourism. USA has Visa waiver program to enable citizens of certain countries to travel to USA for tourism or business for 90 days or less without obtaining visa.

Even in as dynamic and commercial sector as *telecommunication*, we do find some subsidy program in existence. In USA for example, a number of direct mechanisms that target both service providers and subscribers to telecommunication services. Whether these programs are consistent with the USO as outlined in the Annex to the Telecommunication sector in the WTO needs to be verified. In this sector, direct funding for Research and Development is common in many countries. Malaysia provides fiscal incentives to promote investments and reinvestments in this sector.

China provides low interest loans, discounted tax rates, makes generous provision of land in high-technology parks. India provides preferential credit and guarantees, loans to service providers like BSNL and so forth. In Singapore, government provides subsidized loans, supports training and human resource programs, reimburses trade promotion costs incurred by firms, and tax incentives to exporters.

Social services such as *healthcare*<sup>13</sup>, serve important developmental, distributional, and other objectives. Accordingly, “such services may be core instruments in pursuit of social and distributional justice or could be viewed as important contributors to, or preconditions for, economic development.” As a result, “Health and social services are subject to panoply of economic and non-economic goals, influences and constraints.”

In social sectors such as healthcare government has a strong presence in most member countries. In Canada, for example, government provides subsidies to promote public health care in less prosperous provinces, for research and innovation in health and on health information, for professional training, public health research, control of certain diseases such as cancer, to improve Canada’s readiness to deal with public emergencies.

In China, government spends on national disease prevention and control centre, local disease prevention projects etc. India spends on national disease control programs including HIV/AIDS, for implementing family planning program, for providing primary health care as well as secondary and tertiary care. In Philippines subsidy is given to implement sector reforms program, to provide universal health insurance. In South Africa government provides subsidies to facilitate primary health care, to enable lower income groups to avail of health care facilities and to facilitate medical care in remote areas.

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<sup>13</sup> In the WTO listing, the definition of health-related and social services does not include medical and dental services, veterinary services and services provided by nurses, midwives etc., which have been grouped separately under professional services.

In UK, government spends on national health service (NHS), supports primary care trusts, invests in selected projects such as tackling obesity among children etc. In USA, government supports medicaid and medicare, it encourages construction of hospitals, invests in research and development, and in certain types of ailments.

In healthcare, subsidies are given to improve both supply and demand, especially for certain income and/or age groups, and to improve supply especially in rural and remote areas. Government invests in training and research, and in collecting and disseminating health information. Government also invests in prevention and promotion of health care. It invests in control of certain diseases at national level, in family planning methods in certain developing countries facing population pressure, for capacity building in handling national emergencies/crisis and so forth.

While health and social services have long been considered as non-tradeables to be provided by public institutions there has been a change in policy perception in a number of countries. More efficient transport and communication technologies have enhanced the mobility of both professionals and consumers and enabled the use of new modes of supply, overturning traditional concepts of space and distance. A WTO publication points out the increasing importance of cross-border supply of medical services such as telemedicine. There is a significant potential for cross-border trade in healthcare (S/C/W/50). From trade perspective, the discussions are focused not on constraining the ability of government to meet equity and other social objectives but to enhance efficiency in its provision.

*Transport sector* is one of the heavily subsidised services sector both in developed and developing countries. Universal service obligation (USO) is common to rail, road, and air transport services. Rail, air, and maritime transport, however, receive more subsidies than road transport. Subsidies take variety of forms. One form of subsidy that is common to all transport sectors is creation of sector specific infrastructure. This usually takes the form of direct budgetary support by way of

grants or concessional loans. In addition, subsidy also takes the form of loan guarantees, concessional land, equity infusions, and tax incentives, and cross-subsidy between passenger and freight.

Sometimes subsidy is also given for activities like research and development, to compensate catastrophic loss arising out of unforeseen event such as terrorism strike etc, tax free allowance to encourage use of trains among people, zero taxation on fuel used in air transport or launch aid.

*Audio visual sector* is also one of the heavily subsidised sectors; and subsidies in this sector are prominent in nearly every stage of the production and distribution process. It is subsidised more in developed countries than in developing countries (Bernier 2003). The stated objectives for giving subsidies and other incentives differ from country to country. For example, in France subsidies are aimed at preservation of culture's independence and diversity, unity and prestige. In United Kingdom, tax incentives are given to promote growth, employment, and investment and also to facilitate structural change to meet global competition. In EU, subsidy is given to strengthen the competitiveness of domestic film industry. In Italy subsidies are given promote cinematographic activities, including film industry events, public institutions, and professional associations, screenplay awards, conversation of archives and publications. In Germany, subsidies are given to films that promote German culture and language. The Indian government provides subsidies to preserve and promote its rich cultural heritage. In India, subsidies are given for construction of theatre/multiplexes and for promoting and hunting national talent. Elsewhere, subsidies are given for audiovisual production and distribution, generation of employment in the industry and so forth. This is one of the two sectors that have drawn maximum number of exemption to MFN obligation by the member countries.

Subsidies are given through automatic as well as selective or discretionary way. Subsidies take variety of forms: outright grants, soft loan, indirect support by way

of making the public facilities available at concessional price, fiscal incentives, and guarantee fund, soft loans. India gives television segment and film segment. Fiscal incentives such as tax shelter on reinvestment of profits, rebate on box-office taxes, tax allowances for the purchase or restructuring of cinema theatres, facilitating transition from analogue to digital terrestrial. Subsidies are provided by national as well as by provincial government for, say promotion of regional films. In Egypt there is local content requirement in case of foreign films that are shot in Egypt.

(vi) Commitments in GATS

It might be useful to look at the commitments made by member countries in GATS.<sup>14</sup> With the exception of tourism that has drawn the highest number of commitments, the focus in sector commitments tends to be on infrastructure (producer) related sectors i.e., financial services, a diverse range of business services, and telecommunications. These services have two common characteristics: one, their exposure to rapid technical change and two, their potential impact on efficiency and competitiveness across wide range of user industries.

Developing countries have scheduled far less sectors than developed countries. The only sectors which have not been committed by a significant number of developed members are other communication services (postal and courier services, and audio visual services) as well as health and education services. These sectors have been shunned completely by a significant number of developed countries.

Other observations made about the commitments are that horizontal limitations are generally more frequent than sector specific entries. In particular, limitations relating to subsidies, tax measures, land ownership or land use tend to be horizontal, while nationality and residency requirements as well as a residual category of other financial measures are often scheduled in a sector specific context.

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<sup>14</sup> This section is drawn from Adlung and Roy (2005), Adlung, R., (2004), Marchetti (2004).

It may be argued that typically horizontal measures such as denial of land ownership or discriminatory subsidization are less trade-restrictive in practice, and thus less relevant for negotiations than many sector specific measures. As far as subsidies are concerned, it appears safe to assume that these are especially relevant in sectors such as education, health and social services which are considered public sector domains in most countries. Negotiating pressures may continue to be comparatively low in such sectors.

It is also worth noting that transport sector and audio-visual sector are also the two sectors that have drawn exemption to MFN obligation (as per first MFN review in 2000) by member countries. These are also the sectors that have drawn relatively few commitments.<sup>15</sup>

According to a WTO study, “An MFN exemption is a deviation only from the obligations in Article II, and cannot be used to escape obligations deriving from specific commitments undertaken under Articles XVI and XVII. In other words, the level of market access and national treatment bound in a schedule has to be granted as a minimum to all WTO members and commitments cannot be undercut e.g., by way of reciprocity conditions through MFN exemptions. In turn, this means that the deeper the commitments in a given sector, the more limited the discrimination potential of an MFN exemption. Viewed in this light, the distortion potential of MFN exemptions is greatest in sectors such as audiovisual and transport services, where the number of exemptions is highest relative to the number of commitments.”

The overall picture that emerges from the above empirical evidence on subsidies is that while subsidies are fairly widespread in all service sectors, some sectors are subsidised more than others. Although the subsidy information available is partial (pertaining to selected sectors, in selected countries and limited in details), it is reasonable to believe that social sectors receive more subsidies than commercial

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<sup>15</sup> New members can seek MFN exemptions at the time of accession and the current members can be granted waiver under article IX:3 of the WTO agreement.

sectors. Given a strong rationale for government support in social services, it is probably better to focus on subsidies being given in non-social sectors.

Tourism is one sector that has drawn maximum commitments by member countries and, at the same time, it is subsidized by most member countries. Financial sector is another sector that has drawn higher commitments from member countries. Banking sector, which is part of financial sector, is also subsidized especially by the developed member countries. It is common understanding that social services such as education and healthcare are also heavily subsidized sectors across developed and developing countries but these are also the sectors in which the commitments made even by developed member countries are minimal. Audio-visual and transport sectors (rail transport in particular) are also subsidised to a considerable extent. These are also the sectors on which even MFN exemption is sought by many member countries. Direct grant is the most favoured subsidy route in OECD member countries. Subsidy being a horizontal measure is less trade distortionary than sector specific limitation and hence negotiating pressures on subsidies may be comparatively weak.

### **A Case of Limited Subsidy Disciplines**

The idea behind limited disciplines is not to tackle all trade distorting public support program in services sectors but to advance discussions on only those programs that are perceived to be most trade distortionary. The literature dealing with developing subsidy disciplines in GATS deals with the whole gamut of issues that are to be dealt with in developing full-blown subsidy framework in case of services. The need for such a framework is not denied. But many members favour taking a piecemeal approach, making a modest beginning, rather than developing full framework. While subsidy disciplines in services will no doubt enable member countries to achieve greater progress under GATS by making greater commitments, the present need for having subsidy disciplines is necessitated by the undermining of market access commitments when a member country subsidise service supplied in the third country market. The need for subsidies disciplines is

also heightened by the relatively low ability of developing country members to subsidise services especially in areas in which they have a comparative advantage. Lack of information on the subsidies that are being given by different member countries to different services sector is acting as a major stumbling block in achieving even this limited objective. However, the discussion on the framework can continue alongside such modest beginning. For taking a small step, the definition of subsidies in GATT is considered to be a good starting point by the member countries.

*Limited Subsidy Disciplines and Market Access:* It is increasingly becoming clear that the issue of subsidies cannot be separated from market access issue. When a member makes full market access commitments and does not seek any limitations, member cannot offer discriminatory subsidies. Foreign suppliers established in the territory will be given the same access as domestic suppliers. To this extent competition in the home market is not distorted. But the problem is that the competition may get distorted in a third market. Domestic companies in the third market may face unfair competition from abroad. The same is true of service suppliers from any other member countries that export services to the third market. If competition in the third market is distorted by subsidized suppliers of other member countries, it would tend to diminish the value of new market access commitments. In this sense the subsidy disciplines and market access commitments are interlinked. The subsidy disciplines should seek to address all trade distortive effects, including those in the third country market. However, as a priority the members want the third market effect to be tackled before all trade distortive effects of subsidies are eventually addressed. Even regional or bilateral trade agreements cannot effectively deal with issues such as effects in third markets.

The piecemeal approach could be one that addresses certain forms of subsidies to certain sectors and under certain modes only, depending on who the beneficiaries are, and what are the effects on trade. The process then reduces to identifying these forms, sectors, and modes. With the present level of information, one can make the following points:

- (i) All firm specific subsidies in basic infrastructure sectors especially in financial and telecommunications sectors could be targeted initially;
- (ii) Some discipline on subsidy practices in sectors in which higher commitments have been made such as tourism (financial and telecommunication also happens to be sectors in which higher commitments have been made);
- (iii) Subsidy measures specifically targeted at firms engaged in earning foreign exchange through services export;
- (iv) Consumption support that is tied to a service supplier could be disciplined;
- (v) Certain kinds of subsidies that take the form of export guarantees and export credit/loans extended to any service sector would most certainly be trade distortionary and should be restricted; likewise benefits accorded to outbound foreign direct investment could be disciplined;
- (vi) Transport sector receives significant level of support from government but its trade distortionary potential remains to be established;
- (vii) Social sectors such as health and education that have attracted minimal commitments and in which there is a strong public policy rationale can be ignored initially.

Whether these limited subsidy disciplines, which would focus on the most trade distorting subsidy practices, be applied only to sectors in which commitments have been made or should these be also applicable to sectors in which members have not made any commitments remains an open issue. If the latter is followed, it would tend to go against the basic spirit of GATS that accords almost full flexibility with respect to commitments that member countries make.

### **Other observations**

Since the extent of trade distortion in a given sector would also depend on secondary effects of a subsidy program, which could be different in different sectors, it may be advisable to start with a sub-sector that feeds into other services sectors. In this

context, any subsidy given to essentially intermediate sectors---financial, transport and telecommunication services--- would trickle down to many other sectors and sub-sectors. For example, a subsidy to the banking sector would indirectly benefit other sectors by reducing interest rates on credit. Categorizing services sectors into main sub-groups and having a study done on trade impacts on each sub-group might help to advance discussions. The level of restrictions could then be determined for each sub-group. The use of sub-groups could also be useful for considering public policy objectives, which are more prominent in some sub-sectors. Likewise, certain types of infrastructure created for the broad societal welfare of a country, region, state or municipality should not be subject to subsidy disciplines. This category includes, for example, interstate highways, schools, health care facilities, sewage systems or police protection, assuming they were provided for the public good and where available to all citizens on the same terms.

Sharing of information on ad hoc subsidy programs and sector specific program must be made obligatory. The GATS mandate clearly entails an obligation to exchange information concerning all subsidies related to trade in services. Since information on subsidies programs maintained by member countries is not forthcoming, many member countries (Switzerland, Hong Kong, Chile and others) have suggested that the only practical way to progress on this matter is to set a concrete time frame for exchange of information. As for the difficulty cited by member countries that absence of a clear definition of subsidy is coming in the way in furnishing information on subsidy programs, some members believe that the subsidy definition as given in ASCM agreement could be a good starting point.<sup>16</sup>

In the absence of information no generalized subsidy control by either prohibiting any new subsidy or expansion of existing subsidies is possible. Such a generalized control, for example, is included in subsidy disciplines relating to services in the Australia-New Zealand Closer Economic Relations Agreement (ANZCERTA). Article 11 of the protocol

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<sup>16</sup> It is interesting to note that more than 35 members had entered limitations regarding subsidies. The fact that absence of an agreed definition of subsidy did not seem to pose problems for the scheduling and implementation of these limitations, gives an impression that absence of definition is only being used as an excuse.

on trade in services under the agreement prohibited members from introducing new or expanding existing export subsidies, export incentives and other assistance measures having a direct distorting effect on trade. Action under the subsidy disciplines in the ANZCERTA had never been invoked.

To begin with, having an illustrative list along the lines of that in ASCM is not a bad idea. In fact, even in goods case, during the Tokyo Round, an illustrative list of export subsidies was developed, without having a definition of subsidies and other disciplines on subsidies.

Policy goals notwithstanding, subsidies alter the conditions of competition and interfere with price signals. Nevertheless, the effects depend on the form of subsidy, the market structure, the eligibility conditions, and how they interact with other policies. For example, trade distortions seem more likely when the recipient of a subsidy was a significant player in the market. At present, the scope of services sectors defined in GATS included a wide range of enterprises, from small-sized firms to multinational companies. In case of limited subsidy disciplines, its scope can be reduced to cases where the recipient of a subsidy is a significant player in the market.

Tax regimes within a sector or sub-sector should be harmonized. For example, same tax treatment of road transport and transport by rail. Differential tax treatment tends to distort supply of services at a sub-sector level. It could also distort trade under certain conditions, for example, when domestic suppliers have a strong presence in a favoured sub-sector even when the sector is open to competition.

Given the complexity of issues, one possible approach, similar to the EC approach, is to define subsidies and then, assuming that subsidies in general alter conditions of competition, impose a general prohibition on the use of subsidies while allowing for their use for certain well defined policy objectives. For this an exhaustive list of policy objectives may be prepared which may then be linked with the instruments in such a way

that the instruments used to achieve policy goals are least competition distortionary. This, of course, is possible in a full blown subsidy agreement in services.

Any subsidy disciplines would by definition limit the ability of member countries to provide subsidies. An important issue here is whether the limited disciplines should be applicable only to those sectors in which members have made commitment and not sought subsidy limitation or should it also be applicable to sectors in which members have not scheduled commitments. In developing limited disciplines, it is probably a good idea to include certain identified measures.

## **Conclusions**

Based on foregone analysis certain points are quite revealing: subsidies are quite widespread in a range of service sectors both in developed and developing countries. Subsidy definition given in ASCM can be extended to services. Furthermore, to the extent non-specific subsidies that are available on an economy wide basis are least trade distortionary, the distinction between specific and non-specific subsidy is desirable even in case of services. But further disciplines on subsidies would undergo necessary modification. The need for modification is due to the fact that trade in services can occur through other channels/modes and also the fact that scope of countervailing duties as a remedy is quite limited in services as compared to the goods case. A 2-way classification of subsidies (classified as prohibited and non-prohibited) would be more relevant compared to 3-way classification (prohibited, actionable and non-actionable) of subsidies in case of goods. While national treatment imposes significant discipline on subsidy practices of member countries in service sector, there are a few channels through which subsidies can still distort trade and competition. There is a need to make progress on the scope of article I:3(b) i.e., on the services provided in exercise of governmental authority. Owing to the strong government presence in certain social sectors, a clearer understanding on the scope of GATS is needed if subsidies in such sectors are to be brought within subsidies framework in GATS.

Subsidy disciplines should continue to uphold the flexibility given to member countries in GATS. There is a need to discipline subsidies given to service sector even after a member countries have extended national treatment to foreign suppliers as such subsidies can potentially distort trade/competition across subsectors as also across modes. Here EU approach appears useful. The EU allows subsidies to achieve certain well defined objectives. Even then, we find EU member countries provide significant level of subsidy to transport and other services sectors. Of course, EU approach is relevant for developing full blown subsidy disciplines. A limited progress in developing subsidy disciplines suggested in the paper could includes steps such as prohibition of firm specific subsidy in infrastructure services, especially in financial and telecommunications; allowing sector specific subsidies in sectors in which higher commitments have been made by member countries, control over consumption subsidies that are linked to purchase decisions. It is prudent to restrict selected most trade distorting subsidies and gradually move towards developing full scale subsidy disciplines.

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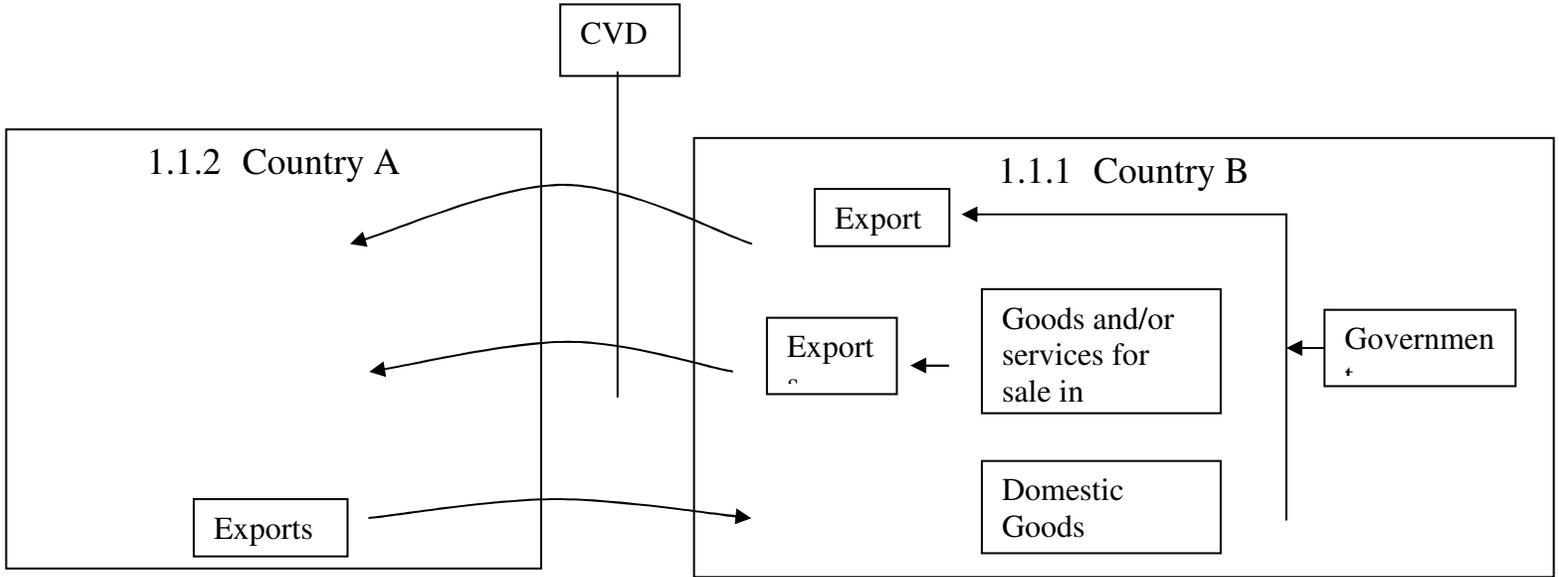
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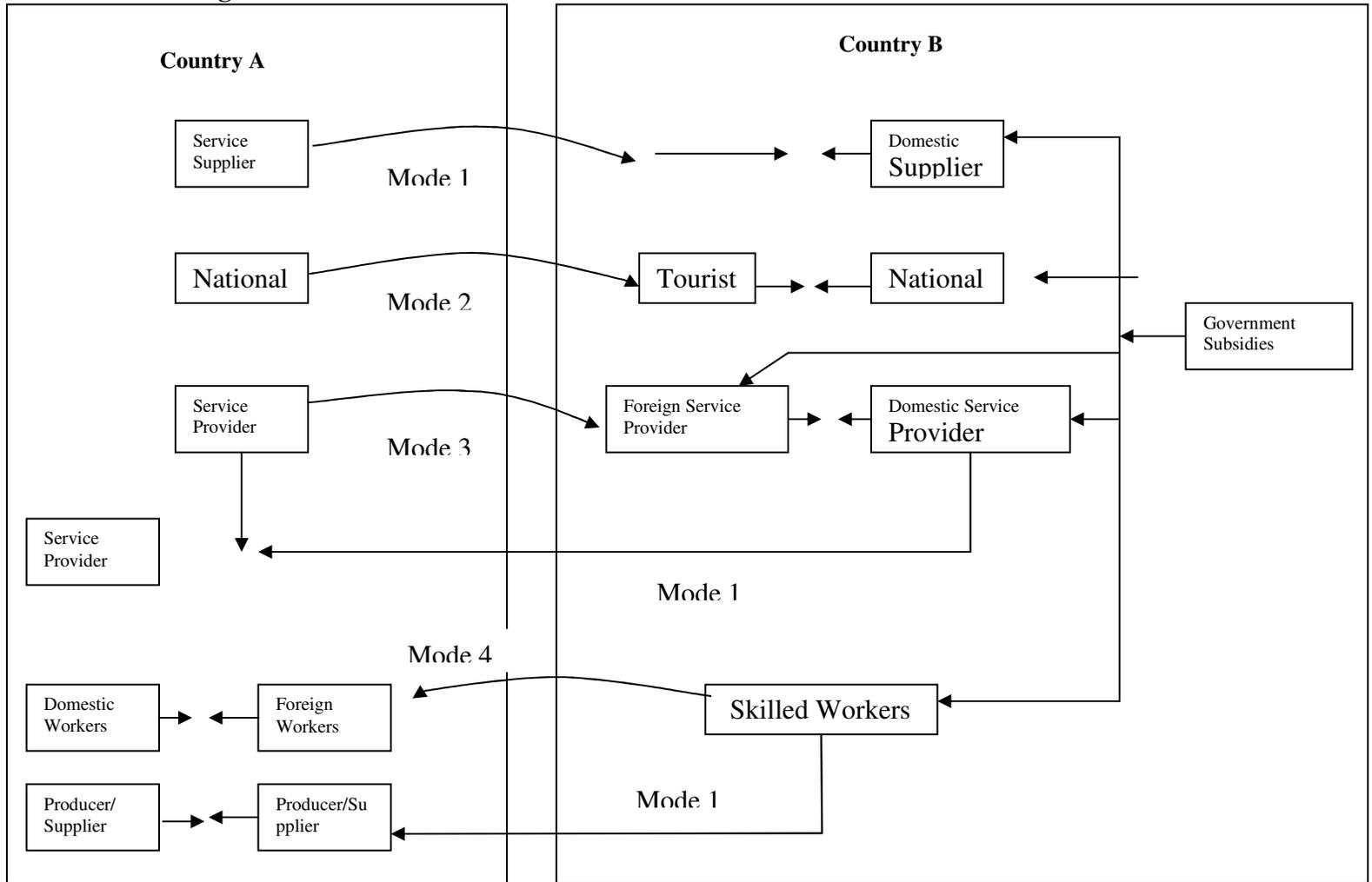
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**Figure 1: Subsidies in case of Merchandise**



**Figure 2: Subsidies in case of Services**



**Table 1: Subsidies in OECD Countries as Reported in Trade Policy Reviews**

<b>Sectors</b>	<b>direct grants</b>	<b>preferential credit guarantees</b>	<b>equity injections</b>	<b>tax incentives</b>	<b>duty free inputs free zones</b>	<b>other unspecified measures</b>	<b>Total</b>
Air transport	2		1	1	1	3	8
Audio-visual	4			2			6
Banking	2	2	3	4			11
Construction	2	1		3			6
Energy	2			1		1	4
Maritime transport	3	1		7	1	3	15
Other & unspecified sectors	3	2	1	1		1	8
Other financial services	1	1		3			5
Rail transport	3			1		1	5
Real estate	1			3			4
Recreation, culture & sports	3			1			4
Software and ITC	3			2			5
Telecom	3						3
Transportation	5	1		2			8
Wholesale & Retail, Dist.	1	1		1			3
Tourism	5	3		2	1	2	13
<b>Total</b>	<b>43</b>	<b>12</b>	<b>5</b>	<b>34</b>	<b>3</b>	<b>11</b>	<b>108</b>

Source: WTO Report No. S/WPGR/W/Add.4

**Table 2: Subsidies in Developing countries with PCY less than US\$ 1000 as reported in TPRs**

<b>Sectors</b>	<b>direct grants</b>	<b>preferential credit guarantees</b>	<b>equity injections</b>	<b>tax incentives</b>	<b>duty free inputs free zones</b>	<b>other unspecified measures</b>	<b>Total</b>
Air transport				1		1	2
Banking		2	2	2	1	1	8
Construction				3	1		4
Energy				3		2	5
Maritime transport	2	1		4	3	1	11
Other & unspecified sectors	1			3		2	6
Other financial services		1			1		2
Rail transport	2			1		3	6
Real estate		1					1
Recreation, culture & sports				4	2		6
Software and ITC				4	2	1	7
Telecom		1		1	1	1	4
Transportation general or unspecified				3	1	2	6
Wholesale & Retail, Dist.				1	1		2
Tourism	2	3		13	8	2	28
<b>Total</b>	<b>7</b>	<b>9</b>	<b>2</b>	<b>43</b>	<b>21</b>	<b>16</b>	<b>98</b>

Source: WTO Report No. S/WPGR/W/Add.4

**Table 3: Subsidies in Least Developed Countries as Reported in TPRs**

<b>Sectors</b>	<b>direct grants</b>	<b>preferential credit guarantees</b>	<b>equity injections</b>	<b>tax incentives</b>	<b>duty free inputs free zones</b>	<b>other unspecified measures</b>	<b>Total</b>
Air transport				1	1		2
Audio-visual services	1			1	2		4
Banking				1	3		4
Construction				1	2		3
Energy				2	1	1	4
Maritime transport	1						1
Other & unspecified sectors		2		1		4	7
Other financial services					2		2
Rail transport				1		2	3
Recreation, culture & sports				2	2		4
Software, ITC					2		2
Telecom					2	2	4
Transportation general or unspecified				2	1	1	4
Wholesale & Retail, Dist.					2		2
Tourism	1	1	1	8	10	3	24
<b>Total</b>	<b>3</b>	<b>3</b>	<b>1</b>	<b>20</b>	<b>30</b>	<b>13</b>	<b>70</b>

Source: WTO Report No. S/WPGR/W/Add.4