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ARTICLE

Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures

Raúl A. Torres*

I. What is a Free Zone?

Free zones[1] have become increasingly popular as trade promotion policy instruments, especially in developing countries, to the point where in some developing countries a large proportion of their exports currently originates in free zones. In 1992, the World Bank defined export processing zones as 'fenced-in industrial estates specializing in manufacturing for exports that offer firms free trade conditions and a liberal regulatory environment',[2] this concept has evolved and rules on domestic sales and the physical delimitation of the zones have in some cases become more flexible. Nevertheless, the objectives pursued by countries that use free zones have remained constant. These objectives include: development of disadvantaged regions, generating income and employment, attracting investment – especially foreign direct investment, and promoting technology transfer. The objectives listed above are usually pursued through free zones by providing a series of incentives to companies and firms operating in those zones. These incentives are commonly of a fiscal nature (tax breaks and exemptions), regulatory nature (flexible rules on importation and labour), and infrastructural nature (easy access to improved services, research facilities and skilled labour). This article will focus mostly on the fiscal incentives provided in the free zones and how they are regulated by the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM Agreement).

II. The Obligations in the SCM Agreement

The obligations in the SCM Agreement have a direct impact on the free-zone programmes of WTO Members. Given the nature of the obligations in the SCM Agreement this impact concerns mostly the type of free zones where there is some manufacturing activity, rather than just transit or commercial activities. In order to understand how the SCM Agreement affects free zones it is important to recall some of the basic definitions in the Agreement. Article 1.1 defines a subsidy as a financial contribution by a government that confers a benefit to the recipient. Article 1.2 introduces the concept of specificity and provides that only those subsidies that are specific are covered by the Agreement. Another important concept that is relevant in the context of the disciplines that regulate which kind of subsidies that Members may use is the distinction between prohibited and actionable subsidies. Prohibited subsidies are those which are either contingent upon export performance or upon the use of domestic over imported goods; these subsidies are commonly referred to as export subsidies and import substitution subsidies. The second category is actionable subsidies, which includes all subsidies that are not prohibited and which may cause adverse effects to the interests of other Members. Regarding specificity, the Agreement provides that a subsidy may be considered specific if access to it is limited to a particular industry, enterprise or group of enterprises, or region. Subsidies

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* The author is a Legal Affairs Officer in the Development Division of the WTO Secretariat. The views expressed in this article are those of the author and do not represent, in any way, the official views of the WTO Secretariat or its Members. The author wishes to thank Jesse Kreier, Gary Lebowitz, Mark Koulen, Alberto Campeas and Hans-Peter Werner for their valuable input into this article. However, any mistakes are exclusively attributable to the author.

1 Although the term free zone is used in this article, these types of programmes are also known, among other terms, as free trade zones, foreign trade zones, duty free zones, export processing zones, enterprise zones and special economic zones. As explained in this article the actual name of the programme is not relevant for determining its status under the WTO SCM Agreement. What is relevant is the type of benefits and conditions associated with the operations of enterprises inside the free zone.

2 World Bank, *Export Processing Zones*, Policy and Research Series Paper 20. Industry and Energy Department (Washington, D.C.: World Bank, 1992).

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are also automatically deemed to be specific if they fall within the prohibited subsidies category. It is important to keep this in mind, because in some cases the type of benefits and the structure of some free zones might actually put them into the prohibited subsidies category. Prohibited subsidies, as the name implies, is the category that is more strictly regulated by the Agreement. The reason for this is that Members consider that this type of programmes directly affect international trade and alter competitive conditions.

The SCM Agreement does not have rules specific to free zones. Therefore, the conformity of free zones cannot be analysed as a single programme. Rather, it is the different incentives, benefits and requirements of a free zone, which have to be looked into in order to see how they fit within WTO rules. So, in order to find out whether a free-zone scheme can be considered to confer subsidies and, if so, whether those subsidies are prohibited or merely actionable, the benefits that companies receive when operating in a free zone have to be examined, as well as, the conditions for establishment in a free zone.

When looking at the benefits and incentives granted to enterprises operating in a free zone, it is difficult to generalize since the different types of incentives and benefits of a free zone can vary greatly from country to country or even within countries. Nevertheless, some benefits and incentives can be identified that are relevant for the purpose of this analysis:

- One of the most common incentives given in free zones is an exemption from payment of import duties and charges on all imported goods. These goods may be inputs, machinery or productive assets or goods destined for sale.
- Many free zones also grant as a benefit a total or partial exemption from the payment of direct taxes (e.g., income tax) and social welfare charges (e.g., social security contributions).
- Some free zones also grant exemptions from the payment of indirect taxes (e.g., sales tax) and prior stage cumulative taxes, (e.g., value added tax). They may also grant full or partial exemptions from fees and charges payable to the government in connection with exports.
- In some cases governments, directly or by entrusting a private company, provide goods or services to the enterprises located in a free zone at prices below those paid in the rest of the market.

All of the benefits and incentives just mentioned fulfil the three requirements of a subsidy, namely: (1) they are a financial contribution (in most cases in the form of revenue forgone); (2) they are provided by the government or public body; (3) they confer a benefit since enterprises operating in the free zones are at an advantage when compared to those enterprises operating in the customs territory of the country.

There may also be other incentives for enterprises operating in free zones, such as less onerous labour regulations or facilities in the creation and incorporation of companies, particularly with respect to participation of foreign capital, and access to improved general infrastructure, such as roads, phone lines or ports and trade facilitation measures. However, these types of benefits are generally outside the scope of the SCM Agreement, as they are not considered to be financial contributions.[3]

As mentioned above, for a subsidy to be subject to the rules of the SCM Agreement it has to be specific. In most cases, for free zones, the specificity is implicit in the requirements and conditions for establishment and operation of free zones and for enterprises therein. This is why it is also important to look at these conditions. As was the case for the benefits, the requirements and conditions for free zones can vary. However, most free zones are limited to a particular geographical area. This is the case especially for free zones, which aim to develop depressed or disadvantaged regions. In a specificity analysis this geographical limitation makes those benefits granted within the free zone a specific subsidy, in terms of regional specificity.

Not all free zones need to have a geographical identity. In some countries, such as the Dominican Republic and the United States, companies may get free-zone treatment irrespective of their location. Nevertheless, there may be other elements that confer specificity to the benefits given in free zones and other export-processing zones.

For a company to operate from a free zone, it may need an authorization or license from the government. Often, these licenses are granted on the basis of compliance with a series of requirements, such as the obligation to export a certain proportion of the production or the use of a minimum percentage of locally produced inputs. This very authorization process may confer specificity to subsidies granted in a free zone. First, in a licensing process the government may choose which industries it wants to promote and which will be authorized to operate inside the free zone. The Agreement provides that when the granting authority or the legislation governing its actions expressly limits access to the subsidy in favour of particular enterprises or industries there is a specific

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3 *See*, e.g., Article 1.1(a)(1)(iii) of the SCM Agreement, which explicitly excludes the provision of general infrastructure by a government from being considered a financial contribution.

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subsidy. Second, the imposition of an explicit requirement that free zone enterprises export part of their production or use a certain level of domestically produced inputs turns all benefits provided in a free zone into either export or import substitution subsidies. These are subsidies in the prohibited category and, as mentioned before, are automatically considered to be specific.

Although the general rule is that export subsidies are prohibited, developing countries and least-developed countries (LDCs) benefit from special and differential treatment under Article 27 of the SCM Agreement. Among the flexibilities accorded to developing countries, Article 27.2 of the SCM Agreement provided a transition period of eight years from the entry into force of the WTO Agreement for the elimination of export subsidies. This transition period expired at the end of 2003. However, some developing countries obtained an extension of the transition period under the rules in Article 27.4 of the SCM Agreement. The SCM Agreement in Article 27.2 also provides that for certain developing countries the export subsidy prohibition shall not apply.[4] The issue of extensions of the transition period and graduation of Annex VII countries will be analysed in more detail later in this article.

The majority of free-zone schemes have some specific rules on the sale and export of items produced in the free zone into the customs territory of the country.[5] In many cases these rules establish restrictions on the quantities that may be sold or 'exported' to the customs territory of the country. A restriction on the sales to be made domestically is at the same time a requirement for the enterprise to export a portion of its production, thus turning the benefits received by enterprises in the free zone into export subsidies.

Moreover, most free-zone schemes also have a rule that in case of sales and exports into the national customs territory the exempted taxes and duties should be paid. This restriction gives a clear incentive for producers established in a free zone to engage in exports and needs to be analysed in detail in the light of the provisions of the SCM Agreement. With respect to indirect taxes and duties, Footnote 1 and Annex I to the SCM Agreement provide that the exemption of indirect taxes and duties on the exported product borne by the like product when sold domestically is not a subsidy. Nor are the non-excessive remission of duties and indirect cumulative taxes accrued on the exported product and paid on the domestically sold product, is not a subsidy. However, any remission or exemption of direct taxes related to exports is a prohibited export subsidy. This is also the case for the remission or exemption of indirect taxes and duties on capital goods used in manufacturing of the export product.

What are the consequences of a subsidy falling in the prohibited category of the SCM Agreement? On a multilateral level any WTO Member may request the establishment of a dispute settlement procedure to obtain a ruling recommending that the offending subsidies must be withdrawn without delay. If the Member found in violation does not comply with the recommendation, the complaining party may eventually receive authorization from the Dispute Settlement Body to take appropriate countermeasures. Even those exports originating from Members with an extension of the export subsidies prohibition transition period may be subject to dispute settlement procedures if they cause adverse effects to the interests of other Members.

Those specific subsidies that do not have an export performance or import substitution component, remain actionable subsidies. Accordingly, if they are considered by a Member to cause adverse effects to its interests in the form of injury to its domestic industry, nullification or impairment of WTO benefits or serious prejudice[6] it may request the establishment of a WTO panel. If the complaining Member can demonstrate that the specific subsidies cause adverse effects, the panel will recommend that the subsidizing Member withdraw the subsidy or remove its adverse effects. Also, it is important to always keep in mind that subsidized imports (regardless of whether the subsidies are prohibited or actionable) causing injury to the domestic industry of the importing country may be subject to countervailing measures.

As noted above, Annex VII countries are exempt from the export subsidy prohibition. This is not, however, an absolute exemption in that Annex VII(b) countries may graduate out of this category if their GNP per capita reaches USD 1,000 in constant

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4 These countries are listed in Annex VII of the SCM Agreement and are generally refered to as Annex VII countries. The list in Annex VII includes LDCs designated as such by the United Nations and countries with a GNP per capita below USD 1,000. An updated list of countries with a GNP per capita below USD 1,000 – known as Annex VII(b) countries – can be found in WTO document G/SCM/110/Add.3; currently these countries are: Bolivia, Cameroon, Congo, Côte d'Ivoire, Egypt, Ghana, Guyana, Honduras, India, Indonesia, Kenya, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe.

5 In fact, many countries treat operations in free zones as being outside their borders or 'national customs territory'. In the context of this article, the phrase 'sales and exports into the national customs territory' means sales of products originating in the free zone for consumption in the domestic market of the country that has established the free zone.

6 In the case of developing countries, SCM Agreement Article 27.9 provides that their actionable subsidies may only be challenged if they cause nullification and impairment of WTO benefits or injury to the domestic industry of a Member.

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1990 dollars for three consecutive years.[7] Also if products originating from Annex VII countries reach export competitiveness[8] under the provisions of Articles 27.5 and 27.6 of the SCM Agreement then the Member has an eight-year period to phase out export subsidies with respect to the product that has reached export competitiveness.

III. What Does a Member Need to do to Bring its Free Zones Into Line With the SCM Agreement?

There are two answers to this question, depending on whether the Member wishes merely to turn those subsidies which are prohibited into actionable ones or whether the intention is to get rid of the subsidies altogether. In the first case, since free zones are not prohibited subsidies *per se*, Members may keep these schemes in place, but they would need to get rid of all aspects that could make a free zone a prohibited subsidy. The aspects that may turn free zones into prohibited subsidies include: (1) requirements to use domestic over imported goods; (2) requirements to export a certain amount of the production; (3) limitations on sales and exports into the national customs territory (including the payment of certain taxes on those sales). These requirements together with the benefits provided put free zones in the prohibited subsidy category of the SCM Agreement. Therefore, in order for the benefits granted in a free zone not to be considered prohibited subsidies one fist step that must be taken is to eliminate the requirements listed above. Even after this is done, free zones would continue to be considered specific subsidies and thus actionable multilaterally or potentially subject to countervailing measures.

Another option available to Members would be to turn free-zone schemes into simple duty drawback and indirect tax exemption or remission systems for exports. Footnote 1 of the SCM Agreement provides that, '... the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy.'

Since the types of programmes covered by Footnote 1 are not even considered to be subsidies, there is no risk of multilateral dispute settlement procedures or countervailing measures on these. Nevertheless, Members must be careful when using duty and tax exemptions as incentives because the illustrative list of export subsidies in Annex I of the SCM Agreement has many nuances.

Annex I of the SCM Agreement in paragraphs (e)–(i) provides details on the circumstances under which direct tax, indirect tax, prior stage cumulative tax and import duty exemptions and remissions may be considered as export subsidies. In this context, it is clear that any kind of direct tax or social welfare charge exemption, remission or deferral related to exports would be considered an export subsidy.[9] These export-related incentives should, therefore, be eliminated for a free-zone scheme to be in conformity with the SCM Agreement. Direct tax exemptions in free zones may remain in place as long as they are not contingent upon export performance. In practice, this would mean that revenues from sales and exports into the national customs territory should receive the same treatment as foreign export sales, even if producers outside of the free zone do not enjoy the same type of tax benefits.[10]

In the case of indirect tax exemptions or remissions on the export sales of products manufactured in the free zones, the main principle is outlined in Footnote 1, mentioned above, and in Paragraph (g) of Annex I. This means that exemptions or remissions from indirect taxes are not to be considered an export subsidy (or a subsidy of any kind) provided they are not in excess of the indirect taxes levied on sales of like products when sold for consumption in the national customs territory.

Exemption, remission and deferral of prior-stage cumulative taxes as well as remission or drawback of import charges and duties on goods and services used in the production of goods exported from free zones receive similar treatment under the SCM Agreement. The general principle is that any such exemption, remission, deferral or drawback shall not be in excess of the prior-stage cumulative taxes and import charges and duties on goods and services used in the production of like products when sold for domestic consumption. Moreover, Annex I paragraphs (h) and (i) provide that only goods used or consumed[11]

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7 *Implementation-Related Issues and Concerns*, Decision of the Ministerial Conference. 14 November 2001, para. 10.1, WT/MIN(01)/17.

8 Export competitiveness is reached when a developing country member's exports for a given product reach 3.25 per cent of world trade in that product for two consecutive calendar years.

9 Footnote 58 of the SCM Agreement also makes it clear that taxes on the ownership of real property are akin to direct taxes and therefore any type of exemption or reimbursement of these taxes contingent on export activities would be considered an export subsidy.

10 As noted above, this type of benefit, although no longer considered a prohibited export subsidy, would remain an actionable subsidy.

11 SCM Agreement Footnote 61 provides that inputs consumed in the production process are those that are physically incorporated into the exported product, as well as, energy, fuels, oils and catalysts.

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in the production process of the exported product may be the subject of exemptions, remissions, deferrals or drawback upon export from the free zone. Therefore, these rules do not provide coverage for exemptions and remissions of duties and indirect taxes on capital goods used in the production process of the exported product. Thus, any such type of incentive provided in a free zone would need to be phased out if the free-zone progamme is to be brought into conformity with the rules in the SCM Agreement concerning export subsidies.

Although significant adjustments in the type of benefits provided to companies operating in free zones are necessary, it is possible for a WTO Member to implement a free-zone scheme that does not run afoul of the export subsidy rules in the SCM Agreement. This is possible even if the free zones grant some import-duty exemption type of incentives. Take for example the US Foreign-Trade Zones (FTZ) program. In the US-FTZ, as in most free zones, duties on imported inputs are not collected. However, if the product manufactured in the free zone is ultimately sold for consumption in the US customs territory, the manufacturer has the choice of either paying the import duties that were not collected on the inputs or paying the duties for the finished product. This mostly provides an administrative advantage, as the producer in the free zone can source inputs from abroad and later decide whether the product will be sold in the US customs territory or for export to another country, while still avoiding the administrative complexities of a drawback or duty-reimbursement system. It also provides an advantage to the producer in the free zone in cases of inverted tariff structures, in which duties on components are higher than duties on finished products. Since duty exemptions on inputs are permitted under Footnote 1 and Paragraph (i) of Annex I of the SCM Agreement and it is not more attractive for the producer to export its product rather than sell it in the US customs territory, the type of benefits provided in the US-FTZ might not be considered prohibited subsidies. If anything the type of advantages of the FTZ make it easier for producers in the zones to sell into the US customs territory, especially when compared to those producers outside the zones.

IV. Entry Into Force of the Export Subsidy Prohibition for Developing Countries and Recent Developments in the WTO – Article 27.4 Extensions

A milestone regarding the treatment of free zones in the developing countries came at the end of 2002 with the entry into force of the prohibition on export subsidies. As part of the special and differential treatment provisions in Article 27 of the SCM Agreement, developing countries benefited from a transition period of eight years since the entry into force of the Agreement to bring their export subsidies into conformity with the rules in Article 3.1(a). However, Article 27.4 offers a way for Members to obtain one-year renewable extensions of this transition period, plus a two-year phase-out period from the date of the last extension.

During the so-called 'implementation process' prior to the launch of the Doha Development Agenda, several developing countries expressed concern that some of their internal tax and import duty exemption programmes, that would be covered by the prohibition, were still of crucial importance for achieving their development objectives. Many of these programmes were free-zone schemes. Also among these programmes were some which envisaged exemptions and remissions of duties on imports of capital goods. Developing countries were encouraged to make use of the system for extensions of the transition period provided for in Article 27.4 of the SCM Agreement. However, developing countries were not happy with that system, as it only envisaged the grant of year-to-year extensions. Members that wanted to obtain extensions for periods longer than one year would have to go back to the committee every year and justify this extension in light of economic, financial and development needs. Obviously, this would result in a great deal of uncertainty for the governments and private investors involved. In the light of this difficulty, Members in the SCM Committee came up with a special 'fast-track' system for extensions to be applied to certain programmes from certain developing countries. This decision, titled 'Procedures for extensions under Article 27.4 for certain developing country Members', was adopted on November 2001 and circulated as WTO document G/SCM/39.

The fast-track extension process allowed certain Members to obtain an extension for certain programmes until the end of 2007 without the need to go through the process of yearly renewals and justification. There were, however, several conditions. First, there would be an approval process in the Committee whereby requesting Members had to provide information on the programmes to be covered and justify their request for extension. Second, the programme was limited to existing export-subsidy programmes in the form of tax and duty exemptions. Third, only Members with a share of world trade in goods not greater than 0.1 per cent and a gross national income at or below USD 20 billion in 2000 would be eligible. Fourth, the extended programmes would have to be subject a yearly transparency review in the SCM Committee. Fifth, there was a standstill commitment, so that programmes would not be made more favourable than they were in 2001.

In addition, the decision also contains a provision whereby Annex VII(b) countries – those with a GNP

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per capita under USD 1,000 – could reserve their rights to use the fast-track process in the event of graduation. Four Annex VII(b) countries chose to reserve those rights.[12]

By the end of 2002, under the fast-track procedures a total of 19 Members obtained extension of the transition period for 43 different programmes. Among those are 13 free-zone programmes of 11 Members. In addition to the fast-track programmes, Colombia obtained an extension for its free zone and capital goods and parts import-export regimes on the basis of Paragraph 10.6 of the Doha Ministerial Declaration. This extension in favour of Colombia was granted for two years plus the two-year phase-out period in Article 27.4. Another eight programmes from four Members received extension on the basis of Article 27.4 alone; however, none of these are free zones.

Since the extensions were granted, the yearly review of extended programmes has been dutifully carried out in the SCM Committee. In the context of the ongoing DDA, the Negotiating Group on Rules has not received any proposals that would modify the current treatment of free zones under the SCM Agreement. However, the SCM Committee has received a couple of proposals, one from a group of small economies[13] and one from Panama with the support of Uruguay, Costa Rica and Jordan, that ask for a further extension of the transition period until 2018. The proponents have made it clear that this extension would only cover those programmes that already enjoy an extension under G/SCM/39 and that it is not their intention to bring in any new programmes or countries. Although, the proposals are not formally under the umbrella of the DDA negotiations, it would, of course, be difficult to consider them completely in isolation. It is therefore possible that they may be the subject of trade-offs with other proposals in the negotiations. In any case, these proposals are in their early stages of consideration and it is not possible to predict whether or not the SCM Committee will agree to them. Members have requested that the proponents give further information on how each of the programmes helps them achieve their development objectives and why an extension is needed. They have also asked proponents what efforts have been made to adjust their economies to the realities of the Article 3 prohibition on export subsidies and expressed their concern that they do not want the extension process to turn into a full 'carve out' from the obligations in the SCM Agreement for the beneficiary countries. Some developing countries have expressed concern over the impact further extensions under Article 27.4, which benefit only a small group of developing countries, would have on the competiveness of exports from other developing countries in the same region and their ability to attract investment.

V. Conclusion

The structure of some free-zone schemes exposes them to claims of providing export subsidies. Except for those Members that were granted an extension under Article 27.4 or that are included in Annex VII, export subsidies are prohibited in the SCM Agreement and should be brought into conformity by all Members. Although, certain free zones may be considered to provide export subsidies, it is not necessary to completely eliminate free zones. Rather, a Member may just choose to eliminate the requirements and incentives for exporting the production of enterprises in the free zones and letting the enterprises freely determine the market for their products. In doing so Members may turn the incentives provided in free zones from prohibited to actionable subsidies reducing their exposure. Free zones could also be turned into simple 'drawback' schemes; thus they would not even be considered a subsidy.

Developed and developing countries who did not get an extension should already be in the process of phasing out the export-subsidy component of their free zones, as this considerably lowers the risk of being taken to WTO dispute settlement. Developing countries who obtained an extension for their free-zone programmes should start to think how they are going to phase out the export-subsidy component of their free zones, as there is no guarantee that their current requests for further extensions will be agreed to in the SCM Committee. This is why it is important to have good communication and coordination between the private-sector beneficiaries of the free zones and the government. This would allow a redesign of the free-zone programmes that would satisfy the needs of the beneficiaries while at the same time making them less trade distortive. This would go a long way to reduce the risk that the government would be forced to come up with ways to bring their free zones into conformity under the stricter deadlines of a WTO dispute settlement process.

Although the adjustments necessary to bring free zones into conformity with the SCM Agreement may involve phasing out some of their fiscal benefits, it is important to keep in mind that the attractiveness of free zones as catalysts for investment and development

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12 Bolivia, Honduras, Kenya and Sri Lanka.

13 Antigua and Barbuda, Belize, Barbados, Dominica, Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Mauritius, Papua New Guinea, St Kitts and Nevis, St Lucia, and St Vincent and the Grenadines.

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lies not just in the tax incentives that they may offer. It also lies in the synergies that can be created by having a group of enterprises, including SMEs, in close proximity and with access to improved infrastructure, research and development institutions, an educated workforce and trade facilitation programmes. In this way, free zones can fulfil their role as genuine development poles, contributing to the economic growth and welfare of the many countries that have such programmes.

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