Regulating for Globalization

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Subsidies in Free Trade Zones: Extension of Territorial Limits and State Responsibility

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Introduction

Free Trade Zones and Special Economic Zones ('zones') have a unique character in international law. They are very much part of the geographical territory of a sovereign State. At the same time, they are deemed to be generally outside the customs territory. Such a unique character of these zones has been successfully used by several States to run aggressive export-oriented programmes.

Creation of separate fictional customs territories to attract investment and facilitate trade and other economic activities has been effectively replicated in several East Asian economies. These fictional zones are known by different names across the world including but not limited to export processing zones, export promotion zones, free trade zones, special economic zones, etc. The concept of special economic enclave was taken one step further, prominently with the Chinese state-owned enterprises playing a pioneering role in establishing champion industries not only within its geographical territory, but even in other jurisdictions presumably under the Belt and Road Initiative.

The establishment of these zones through joint efforts, politically and economically, by two or more countries necessarily involves a contribution of resources from participating countries. The enterprises located in these zones are generally incorporated in the country of location of the zone, but may derive significant financial support and resources from their parent corporations or the home governments of their parent corporations. Any benefit that these enterprises obtain as a result of pass-through of fiscal and non-fiscal incentives received by the parent corporation or provided by the participating countries in the nature of lower taxes or preferential financing, is particularly difficult to trace. Moreover, the disciplines on subsidies under the WTO SCM Agreement limits its scope to subsidies provided within the territory of the country. The debate on the territorial limitation of the SCM Agreement has revived recently when the European Union issued a final anti-subsidy determination for the imposition of countervailing duty on imports of glass fibre fabric (GFF) from China and Egypt.[i] The European Commission attributed certain Chinese subsidies provided to two enterprises located in Suez Economic and Trade Cooperation Zone (SETC Zone) to Egypt. These enterprises in question were established as joint ventures between a Chinese state-owned enterprise, Egyptian Suez Canal Administration, the National Bank of Egypt and four more Egyptian state-owned enterprises. Furthermore, the Cooperation Agreement between the two governments allowed recognized SETC Zone as a China overseas investment

zone and entitlement of preferential lending and insurance terms from Chinese policy banks.

This piece discusses briefly the approach taken by the European Commission ('Commission') and how this practice can set a precedent for similar countervailing actions against subsidies or financial contributions made by governments or parent state-owned corporations or enterprises outside their geographical territories. This piece also attempts to map whether the negotiating history of the SCM Agreement provides any guidance in establishing the legality of countervailing measures.

Commission's determination in the GFF investigation

The Commission initiated a countervailing duty on imports of glass fibre fabric from China and Egypt in 2019. To determine subsidization in China, the Commission undertook the general analysis regarding the presence of a financial contribution, benefit and specificity, and calculated the amount of benefit and subsidization linked to the Chinese subsidies.

For quantifying the subsidization in Egypt, the investigation examined direct subsidies provided by the Government of Egypt in the nature of direct transfer of funds, government revenue foregone and government provision of goods or services for less than adequate remuneration. The Commission also examined the indirect subsidies provided by Chinese government through the Government of Egypt. The investigated Egyptian producers located in the SETC Zone were predominantly Chinese State-owned enterprises, established pursuant to a joint investment of China and Egypt. The SETC Zone has been in existence since 1997, and the recent Cooperation Agreement between the countries formalized the conventional practice. The Egyptian Government accepted the zone as one of the 'overseas investment zone' as part of China's Belt and Road Initiative. It also allowed China to continue to apply its laws relating to operators in the SETC Zone. Overseas investment zones use preferential financing, and the Cooperation Agreement also confirmed that the zone would continue to receive policy support and facilitation from the Chinese Government. The implementation mechanism of the Cooperation Agreement required active efforts from the parties to implement the incentive provided under the Chinese as well as Egyptian laws and regulations. The Commission determined that the Chinese preferential measures in favour of the enterprises in the SETC Zone were identified and accepted by Egypt as its own. By means of Cooperation Agreement, the Government of Egypt expressed its endorsement of the Chinese preferential financing for the SETC Zone.

The Commission applied Article 11 of the International Law Commission Articles on the Responsibility of States for Internationally Wrongful Acts (ILC Articles on State Responsibility) as 'relevant rules of international law' under Article 31(3)(c) of the Vienna Convention on Law of Treaties (VCLT). The Commission attributed the Chinese incentives under the Belt and Road Initiative to the Government of Egypt while interpreting the terms 'by the government or public body' under Article 1.1(a)(1) of the SCM Agreement.[ii]

It is interesting to note that the Commission avoided interpreting the expression 'by the government or public body within its territory' under Article 1.1(a)(1) of the SCM Agreement or Article 3(1)(a) of its domestic regulation despite specific objections from both China and Egypt. It decided to attribute the provision of incentives and preferential treatment by one government i.e. China within its territory to another government.[iii] The adoption of this approach has already been criticised by a few scholars. [iv]

The next section traces the negotiating history of the SCM Agreement to explore whether foreign subsidies were expressly excluded from the scope of the Agreement.

A review of the negotiating history of the SCM Agreement

The territorial limitation on the obligations under the SCM Agreement can be identified in different provisions, including Article 1.1(a)(1), 2.1, 7, 13, 14(a) and 25.[v] The negotiating history of the SCM Agreement suggests that the focus of the SCM Agreement was on addressing trade-distorting subsidies offered by Members in their own 'territories'.

The SCM Agreement and its predecessor, the Tokyo Subsidies Code were heavily influenced by the United States practice. According to Horlick, some of the earlier cases addressed claims of State-aid, especially international aid, for example, loans from international organizations, Marshall Plan aid to European countries, West German subsidies to West Berlin, etc.[vi] As a matter of foreign relations, the Department of Commerce decided not to treat the subsidies given outside a government's territory – what we refer as 'foreign' subsidies in this piece —as countervailable. This policy of the Department ultimately became the basis for inclusion of 'within the territory' in Article 1.1(a)(1) of the SCM Agreement.[vii]

The initial draft of the SCM Agreement did not contain the terms 'within its territory'.[viii] The phrase 'by a government or any public body within the territory of a signatory' was added only in the second draft in 1990.[ix] Although the discussion between the parties regarding this change is not publicly available, the second draft gives an impression that only subsidies that were given within the territory of the concerned Member was included within the purview of the SCM Agreement.

Furthermore, Article 2 of the present SCM Agreement prescribes the specificity of a subsidy. The determination in Article 2 is whether a subsidy is specific to an enterprise or industry or a group of the two 'within the jurisdiction' of the granting authority. The fourth revision of the draft text did not include 'within the jurisdiction' initially.[x] It was proposed to clarify that specificity may exist only within the territory of a signatory.[xi] Article 2.1 was however subsequently amended together with Article 2.2 at the request of Canada because when read together, these provisions deemed any subsidy offered by a provincial government in Canada to be specific even if it was generally available throughout the province. The gist of Canada's request was that specificity should be determined within the limited scope of the granting authority as against the whole territory of a Member. If a subsidy is provided by a provincial government generally for all enterprises within its territory, it should not be understood to be a region-specific subsidy within Article 2.2. As a result, both Articles were revised to clarify this position by adding the term 'within the jurisdiction of the granting authority'.[xii] The negotiating history of the limited provisions provides some indication of the intention of parties to limit the scope of the SCM Agreement to the subsidies provided within the territory of the Member only. We should however add that the negotiating history is not conclusive regarding the applicability of the SCM Agreement to subsidies by entities outside their jurisdiction.

Conclusion

The discussion surrounding the inclusion of foreign subsidies has come into limelight as a result of the final determination issued by the Commission. It is pertinent to note that two other cases with similar complaints are pending before the Commission.[xiii] This unique approach of the

Commission may be replicated by other Members. The lack of literature and prior practice only contributes to the challenges in addressing foreign subsides within the framework of the current SCM Agreement.

Further, the increasing trend of jointly developing and implementing free trade zones or other economic enclaves could contribute the perplexing field of subsidies. These subsidies may have a detrimental impact of distorting the level playing field in terms of competition, investment, acquisition and public procurement in the internal market of Members hosting such enterprises.[xiv] It will be useful for WTO Members to discuss the applicability of the SCM Agreement or any other provisions to deal with foreign subsidies before the appropriate forum at the WTO.

(The views expressed in this piece are personal.)

[i] Commission implementing Regulation (EU) 2020/776 of 12 June 2020 imposing definitive countervailing duties on imports of certain woven and/or stitched glass fibre fabrics originating in the People's Republic of China and Egypt and amending Commission Implementing Regulation (EU) 2020/492 imposing definitive anti-dumping duties on imports of certain woven and/or stitched glass fibre fabrics originating in the People's Republic of China and Egypt, Official Journal of European Union, L 189/1 (15 June 2020) at para. 686-689

[ii] Ibid.

[iii] Ibid at 697.

[iv] V. Crochet & V. Hegde, 'China's 'Going Global' Policy: Transnational Subsidies under the WTO SCM Agreement', Leuven Centre For Global Governance Studies, Working Paper No. 220 (February 2020); SJ Evenett, JD Sud & E Vermulst, 'The European Union's New Move Against China: Countervailing Chinese Outward Foreign Direct Investment', Global Trade And Customs Journal (forthcoming).

[v] V. Crochet & V. Hegde, 'China's 'Going Global' Policy: Transnational Subsidies under the WTO SCM Agreement', Leuven Centre For Global Governance Studies, Working Paper No. 220 (February 2020), 9-16.

[vi] Gary N. Horlick, 'An Annotated Explanation of Articles 1 and 2 of the WTO Agreement on Subsidies and Countervailing Measures', 8(19), Global Trade and Customs Journal, 2013.

[vii] Ibid.

[viii] Report by the Chairman to the Group of Negotiations on Goods, Article 3(a), MTN.GNG/NG10/W/38 dated 18 July 1990.

[ix] Draft Text by the Chairman, Article 3.1(a)(1), MTN/GNG/NG10/W/38/Rev.1 (4 September 1990).

[x] Draft Text by the Chairman, MTN/GNG/NG10/W/38/Rev. 3 (6 November 1990).

[xi]Note by the Secretariat, Negotiating Group on Subsidies and Countervailing Measures, para. 3,

MTN/GNG/NG10/24 (29 November 1990).

[xii] Draft Final Act Embodying the results of the Uruguay Round of Multilateral Trade Negotiations, Trade Negotiations Committee, I.2, MTN.TNC/W/FA (20 December 1991).

[xiii] Notice of initiation of an Anti-subsidy proceeding Concerning Imports of Continuous Filament Glass Fibre Products Originating in Egypt, 2019/C 192/15, Official Journal 2019 C 192/30, (7 June 2019) at para 3; Notice of initiation of an anti-subsidy proceeding concerning imports of certain hot rolled stainless steel sheets and coils originating in the People's Republic of China and Indonesia, 2019/C 342/09, Official Journal of European Union, (10 October 2019) at para 3.2.

[xiv] European Commission, 'White Paper on levelling the playing field as regards foreign subsidies',
https://ec.europa.eu/competition/international/overview/foreign_subsidies_white_paper.pdf (visited 16 October 2020).

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