

# COMMENTARY

## Preserving Policy Space for Sustainable Development

### The Subsidies Agreement at the WTO

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<http://www.tradeknowledgenetwork.net>

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The Agreement on Subsidies and Countervailing Measures (SCM) created a significant amount of policy space for nations to address technological, poverty and environmental problems. If negotiators fail to re-authorize this policy space in the current round of negotiations, nations will lose the ability to deploy a set of effective policies for sustainable development.

## Green Light Subsidies in the SCM

The crafters of the SCM made an effort to differentiate among subsidies that can be justified on economic grounds and those that cannot. The SCM agreement loosely defines subsidies as government outlays that directly affect the production of goods. The agreement only applies to specific subsidies when they take the form of export or import competing subsidies. The SCM separates subsidies into three categories: prohibited, actionable and non-actionable. The SCM covers agricultural goods as well as industrial products, except when the subsidies are exempt under the Agriculture Agreement's "peace clause." The non-actionable subsidies are those justified because they can be used to correct for market failures. Non-actionable subsidies included those used for research and development, regional inequality and environmental protection. Article 8 of the SCM outlined in detail the three types of non-actionable or "green light" subsidies. The specific language in the agreement is as follows:

- **Research and Development:** "assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms." These subsidies were limited to the cost of personnel, equipment and overhead activity employed *exclusively* for a research activity. Moreover, government subsidy for research was only permitted up to the point of development of the first non-commercial prototype.
- **Regional Development:** "assistance to disadvantaged regions within the territory of a Member given pursuant to a general framework of regional development." These subsidies were only permitted if they were part of a general regional development policy. The subsidies had to be made available to, and generally used by, all industries within eligible regions. Eligible regions were determined through a formula based on either income or per capita GDP of not more than 85 per cent of the country average or unemployment of at least 110 per cent of the country average, as measured over a three-year period.
- **Environmental Protection:** "assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms." These subsidies were allowed only if they promoted the adaptation of facilities in operation for at least two years to new environmental requirements that were imposed by laws or regulations. In addition, they were limited to 20 per cent of the cost of adaptation, and could not cover the cost of replacing and operating the assisted investment, which had to be fully borne by the firm.

This window for non-actionable subsidies existed for five years, ending on December 31, 1999, and was not extended. However, developing countries refused to sign the Doha Declaration unless the use of these subsidies was revisited. Thus, Article 8 revisitation is specifically mentioned in the Implementation-Related Issues and Concerns decision of November 14, 2001. The text is as follows:

*Proposal to allow certain subsidies for development:* Some countries have proposed that some subsidies in developing countries should not have to face countervailing measures or other actions from other governments. These are described as subsidies with "legitimate development

goals,” and include support for regional growth, technology research and development, production diversification, and development and implementation of environmentally sound methods of production.

The ministers agree that this is an implementation issue to be handled under section 13, which in turn simply refers to Paragraph 12 of the main Doha Declaration. The ministers also agree that during the negotiations their governments will exercise due restraint in challenging these subsidies.

## Give the SCM the Green Light

Despite the commitment of WTO members to revisit the subsidies question during the Doha round, the issue has been eclipsed by heated negotiations over agricultural support, services liberalization and non-agricultural market access. Article 8 subsidies are economically justified because, within a proper institutional setting and discipline, they can be used to correct for market failures and distortions that increase innovation gaps, regional disparities and non-sustainable economic practices.

There are numerous situations in economies where markets fall short of providing certain goods at their optimal level; such cases are called market failures. Economic theory states that when the market fails, policy instruments should be deployed to correct the distortions created by private markets. This theory is referred to as the “second-best” theory, and states that government policy can offset market failures. Subsidies are one tool for correcting market failures.

For instance, if a nation liberalized trade in a sector where its firms are forced to compete with global monopolies or oligopolies, the imperfectly competitive firms can wipe out the local firms and then sell their products at higher prices than they would in a competitive environment. Or in the terms of externalities, when trade is liberalized between two countries and only one of them produces with second-best policies to protect the environment, production can increase in the more environmentally destructive country. Economists have also argued that the WTO has focused on reducing tariff rates, rather than economic distortions—reducing rates can simply maintain existing distortions and even exacerbate such distortions. In such an environment, subsidies used in a careful manner are one of a number of tools that can work as second-best solution to the distortions occurring through trade liberalization.

Climbing up the technology and product ladder is essential for the sustainable growth of developing and developed countries alike. Nations need the ability to develop and obtain knowledge-based assets for development, yet they are faced with enormous market failures in terms of poor information, weak access to credit, weak R&D capabilities, imperfect competition and environmental degradation. In addition, the language that re-instated the ability to subsidize for R&D and allowed for product diversification could help address the declining terms of trade in many developing countries.

Technology adoption, adaptation and development depend on technical and economic niches that are not spontaneously generated from trade and competition. As in any other learning process, knowledge can only accumulate upon previous experience of trials and errors. A critical mass of individual, firm and institutional level capabilities is then a pre-existing condition to absorb and assimilate technical knowledge and transform it into useful economic applications. Disciplined subsidies are a very effective tool for stimulating technological learning and facilitating investment in risky but necessary skill development.

Many times, certain technologies and practices are adopted without a full understanding of their environmental implications. Many of the ecological dangers humanity faces at the present are a result of

these kinds of choices. At the same time, some of those practices are difficult to replace because they have built around them large sets of subsidiary technologies and sub-systems. Temporarily subsidizing the use of cleaner alternatives can speed up their development and local adaptation, making the economic system more efficient and actually alleviating medium- and long-term transition costs.

Markets also fail at distributing wealth and income equally across societies. Continuing to provide the policy space for programs that support the eradication of regional inequality will also be essential for sustainable development. Developing countries have been right to point out that it is only the developed countries that have thus far provided subsidies for regional development. However, it is sometimes overlooked that less developed countries are often the *recipients* of the subsidies themselves. Up until now, the EU has been the leader in providing (and protecting) subsidies for regional development, offering less developed countries up to four per cent of their GDP to upgrade infrastructure, social and environmental programs, and export capabilities.

The United States, while as aggressive as the EU in terms of pursuing regional integration arrangements, has yet to support regional development. However, more than 12 years after the passage of the North American Free Trade Agreement (NAFTA), there is widespread agreement that NAFTA fell short of fulfilling its development promises for Mexico. Mexican incomes rose less than one per cent annually, while industrial competitiveness, poverty and inequality, and environmental degradation all worsened. Recently, a tri-national commission organized by the Council on Foreign Relations was formed to call for a North American economic and security community by 2010 to address shared security threats, challenges to competitiveness and interest in broad-based development across the three countries.

As trade and integration continues across nations with widely disparate levels of development, regional development arrangements will be essential to correct the distortions that come from such integration. Increasingly, developing countries are demanding “adjustment funds” to integrate with developed countries. Without such funds, more integration arrangements will look like the NAFTA rather than the EU.

Finally, markets are notoriously weak at incorporating the full costs of production when it comes to environmental degradation. Therefore there is a key government role to correct such failure with environmental policy. Whereas the original green light subsidies provisions only allowed one-time subsidies for the purchase of end-of-pipe technologies, the new Doha language stresses “sound methods of production.” Some in the environmental community were concerned that the original provisions could give perverse incentives toward encouraging end-of-pipe technology rather than clean production alternatives. Although some environmental problems absolutely require end-of-pipe technology at present, efforts need to foster the shift toward cleaner production alternatives. Moreover, in the interest of developing countries, “production” could also cover the environmental services that are “produced” by developing country rural communities. Indeed, “payment for environmental services” (PES) schemes are gaining momentum in the developing world.

Of course, without the proper policies in place, government subsidies can create more problems than they correct for. Subsidies have to be allocated in a disciplinary manner. A framework for “smart” subsidies has been termed “reciprocal control mechanisms” and was deployed by the most successful East Asian economies. MIT economist Alice Amsden defines control mechanisms as “a set of institutions that disciplines economic behaviour based on a feedback of information that has been sensed and assessed.”

If negotiators fail to re-authorize and improve the use of these subsidies, nations will lose the ability to craft effective policies for sustainable development.