EXPORT PROCESSING ZONES AND THE LAW OF THE WORLD TRADE ORGANIZATION

// ZONAS DE PROCESSAMENTO DE EXPORTAÇÃO E A LEI DA ORGANIZAÇÃO MUNDIAL DO COMÉRCIO

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>> ABSTRACT // RESUMO

Export processing zones (EPZs) are everywhere, in both developing and developed countries. Yet, it is not clear whether these zones are coherent with the Law of the World Trade Organization (WTO). One might assume such consistency, arguing that, if there were a violation regarding such an important trade issue, there would have already been a dispute brought to the WTO. However, it is argued that exactly because EPZs exist all around the world, generally, it is not in most countries' best interest to raise this case. The conclusion is, in sum, that the exemption from import duties on goods, which is the most common feature that EPZs worldwide have in common, constitutes a prohibited export subsidy within the meaning of art. 3.1(a) of the Subsidies and Countervailing Measures Agreement. Nonetheless, it is also analysed whether there are some exceptional situations in which a prohibited export subsidy would be permitted and the implications of these findings. // Zonas de processamento do exportação (ZPEs) estão por toda a parte, tanto em países em desenvolvimento quanto nos desenvolvidos. Entretanto, não está claro se essas zonas são compatíveis com a Lei da Organização Mundial do Comércio (OMC). Poder-se-ia presumir dita conformidade, ao argumento de que, se houvesse uma violação com relação a um tema de tal importância, a questão já teria sido submetida ao sistema de solução de controvérsias da OMC. Entretanto, justamente porque as ZPEs existem ao redor do mundo, não interessa à maioria dos países suscitar essa controvérsia. Conclui-se, em síntese, que a isenção dos tributos incidentes sobre a importação de bens, que é a característica que as ZPEs têm em comum, consiste em um subsídio à exportação proibido nos termos do Art. 3.1(a) do Acordo de Subsídios e Medidas Compensatórias (SMC). Não obstante, analisam-se hipóteses excepcionais em que um subsídio proibido à exportação seria permitido e as respectivas implicações para o comércio internacional.

>> KEYWORDS // PALAVRAS-CHAVE

Export processing zones; World Trade Organization; Prohibited subsidies; Import duties; Exemption; Most Favoured Nation Clause.
// Zonas de processamento de exportação; Organização Mundial do Comércio; Subsídios à exportação proibidos; Tributos de importação; Isenção; Cláusula da Nação Mais Favorecida.

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INTRODUCTION

Export processing zones (EPZs) have spread to become one of the most popular means to promote trade and investment in a country. They are everywhere, in both developing and developed countries. Yet, determining the rules applicable to these zones is challenging, for the Law of the World Trade Organization (WTO) do not regulate them. Indeed, it is not clear whether these zones are coherent with WTO rules on subsidies and with their purposes.

The basic argument is this work is that the exemption from import duties on goods, the most common feature of export processing zones all over the world, constitutes a prohibited export subsidy within the meaning of art. 3.1(a) of the Uruguay Round Agreement on Subsidies and Countervailing Measures (SCM)[1].

It is argued, however, that there are two different situations. First, where the referred tax break is restricted to these zones, the most favoured nation principle, set out in art. I:1 of the General Agreement on Tariffs and Trade (GATT) of 1994, is violated. Second, where a drawback scheme is adopted as a *national general policy*, within the terms of Annexes II and III, EPZs are exceptionally consistent with the norms of the WTO.

To put this thesis to the test, this work is further divided into four parts. Part 1 investigates general aspects of export processing zones. Part 2 examines whether these exemptions are a prohibited export subsidy within the meaning of art. 3.1(a) of the SCM Agreement and explores relevant international trade precedents to illuminate this issue. Part III analyses whether there are some exceptional situations in which a prohibited export subsidy would be permitted. Part IV discusses some implications of these findings.

1. EXPORT PROCESSING ZONES

One of the difficulties to study export processing zones is that there is not a standardized definition of EPZs, nor a standardized model. Their nomenclature also varies greatly. Some use the terms *free trade zones (EPZs), special economic zones, maquiladoras, free zones, free export zones, special economic zones, economic and technological development zones, export-oriented units, foreign trade zone, trade development zones* and *enterprise zones* as synonyms. Some distinguish between these terms[2]. Others adopt the term *export processing zone* as a general expression that covers all its different variations[3].

Since an analysis of the conformity of EPZs with the SCM Agreement in general is intended, it shall not examined any given free zone, nor characteristics that are solely typical of some countries. It shall be focused then on the one feature that export processing zones have in common worldwide: the exemption from import duty. Therefore, the core definition provided by the International Convention on the Simplification and Harmonization of Customs Procedures, on Chapter 2 of the

Specific Annex D, in which it is stated that "'free zone' means a part of the territory of a Contracting Party where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the Customs territory" is adopted.

Usually export-processing zones are intended to stimulate export and, therefore, to promote the balance of payments, to foster production and competition, to attract foreign direct investments (FDI), to reduce regional inequalities, to encourage technology diffusion and economic development. Social development is also envisaged, since it is believed that "[t]he economic and technological development of a society affects the degree to which it can provide welfare rights to its members"[4].

These objectives might seem to suit only the needs of developing countries. In fact, in the early sixties, emerging from the post Second World War pessimism, some of them adopted a policy shift from an import-substitution-based industrialization to gradual outward-looking production as an alternative to economic growth[5]. It is estimated that, by 1975, there were 79 EPZs spread out in 25 countries and that, by 2006, 130 countries hosted 3,500 EPZs[6]. The rapid proliferation of these zones, however, was not limited to developing countries[7]. Some of the richest countries host EPZs, like Australia, Singapore, the United States, Italy, Ireland, Spain and other European countries[8].

Among the advantages offered by EPZs to attract FDI, "[m]ost zones offer simplified import and export procedures to their users"[9]. Countries also often "apply different ('more lenient') labour laws there than in the rest of the country"[10], to meet the search of some firms, especially manufacturing and service multinational enterprises (MNEs) for "plentiful supplies of cheap and well-motivated unskilled or semi-skilled labour""[11]. Another benefit that might be granted is the derogation from environmental regulations. In these zones, even when these advantages are not available, tax concessions are.

2. EXPORT SUBSIDIES

Export subsidies have always been a prominent and disputed matter. On the one hand, some scholars stand for their adoption, especially by developing countries[12]. They assert that "[e]conomic theory suggests (…) that subsidies are not as trade distorting as other trade instruments (like, for example, quantitative restrictions or tariffs) which affect two margins (both the producer's and the consumer's)", whereas "subsidies affect one margin only (the producer's)"[13]. On the other, it is argued that export subsidisation distorts free trade; "such subsidies cut into the exports of the countries that have a natural comparative advantage in those products, and so distort the world's allocation of resources"[14].

Despite these academic disputes, it is clear, with respect to export subsidies, that, since the negotiations that resulted in the adoption of the General Agreement on Tariffs and Trade of 1947[15], the view that they must be avoided is prevalent not only in international instruments, such as the

General Agreement on Tariffs and Trade of 1994 (GATT 1994) and the SCM Agreement, but also in the dispute settlement of the WTO[16]. As a matter of fact, the WTO Panel, in *Canada – Measures Affecting the Export of Civilian Aircraft (Canada – Aircraft),* considered that the "object and purpose of the SCM Agreement could more appropriately be summarised as the establishment of multilateral disciplines 'on the premise that some forms of government intervention distort international trade [or] have the potential to distort [international trade]'"[17].

To analyse whether the exemption from import duties on goods entering EPZs is consistent with art. 3.1(a) of the SCM Agreement, it is sufficient to determine whether this measure falls within the definition of "export subsidies" contained in the Agreement. There is no need to prove adverse effects on other Members within the meaning of its art. 5, since "the damage, in a case where recourse to a prohibited subsidy is being made, is not the trade effects caused, but rather the act of subsidization itself"[18]. Under the WTO Agreement Export, subsidies are presumed to cause negative trade effects[19].

An "export subsidy" is a species of the genus "subsidy". So, firstly, it shall be examined whether the tax breaks referred to are subsidies. Under the Law of the WTO, the terms *subsidy* and *prohibited export subsidies* have precise technical meanings. A subsidy is a measure that falls within the provisions of articles 1 and 2 of the SCM Agreement. According to these, a subsidy is a (i) financial contribution or any form of income or price support (ii) by a government or a public body (iii) that confers a benefit (iv) to a specific recipient. Four elements of characterization, therefore, can be outlined; each should be examined with respect to the exemptions from import taxes in export processing zones.

It seems clear that they are a *benefit*, since they reduce expenses; they constitute an advantage *sponsored by the domestic treasury*, provided that the levy of a tax and, of course, its relief are intimately linked to the sovereignty of a State; and, since there is a presumption that any export subsidy is *specific*, no test of specificity is required, by virtue of Article 2.3 of the SCM Agreement[20].

What is not so clear is the fourth element that constitutes the definition of a subsidy. Under Article 1.1(a)(1)(ii), there is a *financial contribution* if "a government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)". The main difficulty is to determine what this term means, "since there is no definition of 'otherwise due' concept in the Uruguay Round Subsidies Agreement"[21]. And as Skykes points out, "[t]he absence of any market benchmark is an especially acute problem for cases involving the second type of financial contribution under SCMs article 1 – revenue foregone by the government"[22].

The WTO dispute settlement dealt with this issue in *United States – Tax Treatment for Foreign Sales Corporations (US – FSC).* According to the WTO Panel, in its original report, to define the term "otherwise due", it was necessary to establish if the contested measure was the actual cause of the revenue loss. Therefore, in their view a "but for test", a "test commonly used to determine actual causation"[23], should be applied. The

WTO Panel "took the term 'otherwise due' to refer to the situation that would prevail but for the measures in question. It is thus a matter of determining whether, absent such measures, there would be a higher tax liability"[24].

The use of a "but for" test was, nonetheless, rejected by the WTO Appellate Body (AB):

> *However, we have certain abiding reservations about applying any legal standard, such as this "but for" test, in the place of the actual treaty language. Moreover, we would have particular misgivings about using a "but for" test if its application were limited to situations where there actually existed an alternative measure, under which the revenues in question would be taxed, absent the contested measure. It would, we believe, not be difficult to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to the revenues in question, absent the contested measures.*[25]

The AB clarified what the "actual treaty language" means when it refers to "government revenue that is otherwise due is foregone or not collected", *verbis*:

> *...the word 'foregone' suggests that the government has given up an entitlement to raise revenue that it could 'otherwise' have raised. (...) Therefore, there must be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised 'otherwise'.*[26]

The WTO Panel Report on *United States – Tax Treatment for Foreign Sales Corporations – Recourse by the European Communities to Article 21.5 of the DSU (US – FSC (Article 21.5 – EC))* rejected two interpretations of the term "otherwise due". The first interpretation was rejected under the argument that, if it were "to be construed in an equivalent narrow and formalistic manner", it "would effectively ensure that any Member that was careful enough to sever any self-evident formal link between a measure at issue and its default regime would thereby insulate itself from effective discipline under the *SCM Agreement*"[27]. The second interpretation was rejected in a presumptive or speculative reasoning: "one cannot simply assert that revenue is otherwise due in the abstract", it "cannot be presumed"[28].

The WTO Panel thus adopted the reasoning of the original Appellate Body Report that "the comparison to be made involves revenues due under the contested measure and those that would be due in some other situation and that the basis of the comparison must be the tax rules applied by the Member in question"[29].

In the WTO AB's view in *US – FSC (Article 21.5 – EC)*, "to distinguish between situations where revenue foregone is 'otherwise due' and situations where such revenue is not 'otherwise due'"[30], a "but for" test may be applied only if "the measure at issue might be described as an 'exception' to a 'general' rule of taxation'"[31]. Yet the Appellate Body found that, "[g]iven the variety and complexity of domestic tax systems, it will usually be very difficult to isolate a 'general' rule of taxation and 'exceptions' to that 'general' rule". It held, instead, that "panels should seek to compare the fiscal treatment of legitimately comparable income"[32] and of taxpayers in comparable situations[33] "to determine whether the contested measure involves the foregoing of revenue which is 'otherwise due', in relation to the income in question"[34].

Even though, apparently, the identification of "legitimately comparable income" has been left to a case-by-base determination, this criterion has worked successfully in *US – FSC*. In sum, the AB has compared the rules of taxation regarding the foreign-source income of US citizens and residents with the rules concerning "qualifying foreign trade property" (QFTP), which was assumed to be characterized as sort of foreign-source income[35], with respect to these same taxpayers[36].

Observe that there are two general systems of income tax: the *residence* and the *source principles* or *jurisdictions*. According to the latter, "[i]ncome may be taxable under the tax laws of a country because of a nexus between that country and the activities that generated the income", whereas under the residence jurisdiction, a country "may impose a tax on income because of a nexus between the country and the person earning the income"[37].

The United States adopts as a rule the *residence principle* to tax its citizens and residents, including certain former citizens and long-term residents[38]. It follows from the adoption of this principle that foreign source-income derived from US persons must be taxed. Nonetheless, when the American regulation considered that part of the foreign income was actually not connected with a US trade or business, it incorporated elements of the *source principle*. This is the context in which the "but for" test should be understood. "The Panel seems to be implying that the U.S. cannot adopt a worldwide system of taxation for incorporate income, and then selectively apply source principles for certain types of that income"[39].

It is not reasonable to agree with the Appellate Body's findings that a "but for" test would require the identification of a "general" rule of taxation; what it requires is the recognition of *any* rule imposing the obligation. If a revenue is "due", it means precisely that there is an underlying obligation, and a fiscal obligation is legally imposed.

The Panel's conclusions that the defendant would have to prove that the foregoing of revenue *otherwise due* was never due in the first place are as well worthy of criticism. Following the same reasoning developed above, if the revenue was not due in the first place, it means there was no law imposing the tax, so the revenue was not "otherwise due". By contrast, Article 1.1(a)(1)(ii) applies when the revenue is "otherwise due", which means that, if it were not for the measure at issue, then the revenue would be due. Thus, the "but for" test is appropriate to interpreting this rule.

It is striking, moreover, that the wording of this provision includes the definition of a *fiscal exemption*. It does not mean, though, that any tax exemption is a subsidy; after all, tax breaks can be generally granted, as long as they do not fulfil the specificity requirement (Article 2). It means solely that any tax exemption is a financial contribution within the meaning of Article 1.1(a)(1)(ii).

It is not correct, however, to assert that any government revenue otherwise due that is foregone or not collected is a fiscal exemption. Tax exemptions are included in this provision, but the latter may entangle other kinds of government revenue other than tax. It is worth mentioning that this broader formulation is welcome, because it prevents a Member from circumventing Article 1.1(a)(1)(ii) by claiming that a certain revenue that was *due* is not a tax, according to its domestic concept.

Having been examined the contour of the provision at issue, it shall be returned to the analysis of EPZs. The benefit of importing duty-free comes out easier as a financial contribution rather than an exemption from an income tax, provided that, when import occurs, it is obvious that government revenue is due[40]. And this contribution is equivalent to the amount that the tax payer has not paid, although it was due.

So far, it was only determined that the grant of tax exemption, a common State practice around the world, is a subsidy, which does not mean that it is *prohibited*. Indeed, not every subsidy is prohibited[41]; "only subsidies that create a certain level of trade distortion need disciplining"[42]. As the WTO Appellate Body Report stated in *Canada – Measures Affecting the Export of Civilian Aircraft – Recourse by Brazil to Article 21.5 of the DSU (Canada – Aircraft (Article 21.5 – Brazil))*: "the granting of a subsidy is not, in and of itself, prohibited under the SCM Agreement. Nor does granting a 'subsidy', without more, constitute an inconsistency with that Agreement. The universe of subsidies is vast. Not all subsidies are inconsistent with the SCM Agreement. The only 'prohibited' subsidies are those identified in Article 3 of the SCM Agreement; (...)"[43].

Nor every export subsidy is forbidden. If it were so, any stimulus to exportation would be prohibited. The Agreement on Subsidies and Countervailing Measures, for instance, explicitly allows some, such as drawback schemes – a theme considered bellow. Export subsidies are only prohibited as defined in the SCM Agreement. Article 3.1(a) provides, in the relevant part, that, "within the meaning of Article 1", shall be *prohibited* "subsidies contingent, in law or in fact, whether solely or as one of several conditions, upon export performance, including those illustrated in Annex I". At this point, it shall be analysed how WTO Panels and the Appellate Body have addressed this rule.

The starting point is the understanding of the word "contingent", whose ordinary meaning is "conditional" or "dependent for its existence on something else"[44]; hence, "the grant of the subsidy must be conditional or dependent upon export performance"[45].

Secondly, Footnote 4 "describes the relationship of contingency by stating that"[46] the granting of a subsidy must be 'tied' to 'actual or anticipated exportation or export earnings'. Even though this Footnote refers only to *de facto* subsidies, it can also be applied to in law subsidies, provided that "the legal standard expressed by the word 'contingent' is the same for both *de jure* or *de facto* contingency. There is a difference, however, in what evidence may be employed to prove that a subsidy is export contingent"[47] – a theme outside the scope of this paper.

Thirdly, with respect to the term "tied to" in footnote 4, whose ordinary meaning is "'restrain or constrain to or from action; limit or restrict as to behaviour, location, conditions, etc.' (...) When read in the context of the 'contingency' referred to in Article 3.1(a), we consider that the connection between the grant of the subsidy and the anticipated exportation or export earnings required by 'tied to' is conditionality"[48].

This is as far as the dispute settlement has gone in interpreting art. 3.1(a). WTO case law has not yet determined what kind of conditionality this provision refers to, only that it has to be stronger than a mere "expectation"[49]. There are two types of conditions. "[I]f export is only a *sufficient condition*, you receive the subsidy every time you export, but you are not required to export in order to receive the subsidy", whereas, "if export is only a *necessary condition*, you receive the subsidy only if you export, although export does not guarantee receipt of the subsidy"[50].

Further clarifications are still needed. However, even though the issue has not been addressed explicitly, most decisions seem to adopt the *necessary conditionality.* In *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather (Australia – Leather II)*, the WTO Panel found that the beneficiary's "anticipated export performance was one of the conditions for the grant of the subsidies"[51]. The AB in *US – FSC (Article 21.5)* considered that the requirement of exportation with respect to the property produced within the US "makes the grant of the tax benefit contingent upon export performance"[52]. In *Canada – Certain Measures Affecting the Automobile Industry (Canada – Autos)*, the Appellate Body clearly had the same interpretation:

> *In our view, as the import duty exemption is simply not available to a manufacturer unless it exports motor vehicles, the import duty exemption is clearly conditional, or dependent upon, exportation and, therefore, is contrary to Article 3.1(a) of the SCM Agreement.*[53]

In these cases, the dispute settlement system considered that subsidies that are *contingent upon export performance* are dependent upon the existence of export. In other words, beneficiaries cannot receive them unless they export[54], so that exporting is deemed to be a *necessary condition*. Turning back to export processing zones, provided that the benefit of importing duty-free is only available if (i) the recipients are in an EPZ and if (ii) they export, after processing or final assembly, this customs benefit is "upon export performance" within the meaning of Article 3.1(a) of the SCM Agreement. Therefore, waiving import duties between an EPZ and foreign countries constitute a prohibited export subsidy.

There is no exception to this proscription, not even the claim that the subsidies would provide *assistance to disadvantaged regions*. Firstly, this hypothesis is not included in the general exceptions of art. XX of the GATT 1994; even if it were, it would be highly disputable whether this provision would apply to this case. Secondly, notwithstanding that art. 8.2(b) of the SCM Agreement prescribes that subsidies for the development of disadvantaged regions shall be non-actionable, this provision was only applicable until the 1st January 2000. "The implication is that while certain domestic policy objectives could explicitly be used as a justification for, and protection of, the use of certain specific subsidies before January 2000, after this date policy objectives no longer give rise to special treatment for any type of specific subsidy"[55].

3. PERMITTED EXPORT SUBSIDIES?

To investigate whether there are some hypotheses in which *prohibited subsidies* are permitted, footnote 1 and Annexes II and III of the SCM Agreement shall be examined.

3.1 THOU SHALT NOT EXPORT TAXES

Footnote 1 provides, in the relevant part, 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".

This provision acknowledges a fiscal policy internationally applied[56] aiming to strengthen the export-oriented industry. This policy consists essentially in the "non-exportation" of indirect taxes; its underlying principle is that the burden of taxes should rely solely on domestic consumption[57]. Then export goods will be exempt from duties and taxes on production, so that these will not be included in the final prize.

Note that "[t]he tax measures identified in footnote 1, not constituting a '*subsidy*', involve the exemption of exported *products* from *product-based* consumption taxes", according to the WTO AB Report, in *US – FSC*[58]. Thus Footnote 1 only applies to "indirect or consumption taxes", not to "import charges"[59]. These are two excluding concepts in the context of the SCM Agreement. Indeed, Footnote 58 defines "indirect taxes" as "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges", whereas it defines the latter as "tariffs, duties, and other fiscal charges (…) that are levied on imports". In conclusion, Footnote 1 does not apply to the exemption from import duties on goods in export processing zones.

3.2 THOU SHALT NOT CONVERT IMPORT TAXES INTO EXPORT DUTIES

The SCM Agreement allows the remission or drawback of import duties on inputs that are consumed in the production of the exported product, by virtue of Annexes II and III. Footnote 61 stipulates that "[i]nputs consumed in the production process are inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product"[60]. So, under this provision, "[i]n order to implement an ideal duty drawback scheme, the tax authorities need to have information from every exporting firm on the quantity exported, the quantity of imported intermediates used in export production, and the tariff on the imported intermediates"[61].

Such relief, therefore, is restricted to imported intermediate inputs that are actually used in the production process. It is not extended to capital goods, nor to goods that are not consumed. This conclusion is supported by Keck and Low's suggestion that, to transform EPZs into WTO-compatible incentive schemes, "exemptions from direct taxes and from import duties on goods that are not consumed in the production process would need to be eliminated"[62].

According to letter (i) of the Illustrative List of Export Subsidies contained in Annex I to the SCM Agreement, export subsidies shall be "[t]he remission or drawback of import charges in excess of those levied on imported inputs that are consumed in the production of the exported products". Hence, *a contrario sensu*, a certain amount of remission of import charges is consistent with the agreement.

The *raison d'être* of this authorisation is that a policy as such prevents import duties turning themselves, in practice, into export taxes. In fact, tariffs on imported inputs, not only reduce the competitiveness of exporters, but also increase the cost of export goods[63]. That is why it is often said that they "lead to, and indeed are, a 'tax' on exports"[64]. Thus the drawback scheme is the other side of the coin of the policy permitted by Footnote 1.

The provision in Annexes II and III stating that drawback schemes are allowed is not an exception to the regulation on subsidies; rather, it is consistent with the SCM Agreement. These Annexes only outline what the interpretation of art. 1 would permit. Indeed, a drawback system does not constitute a subsidy, because, in this case, there is no government revenue that would be "otherwise due" within the meaning of art. 1.1(a)(1)(ii). The adoption of a drawback scheme means that there is no obligation to pay import duties in the first place.

Nonetheless, the SCM Agreement did not take into account the existence of export processing zones. This Agreement did not consider the possibility that, in certain regions of a country, different rules applied. The problem is that, when the exemption of import duties only apply to EPZs, then there will be government revenue that is otherwise due, so that certainly this will be a subsidy.

The rules of the SCM Agreement regarding drawback schemes, in fact, adopt as a premise that there is a general drawback policy in that country's territory. This can be illustrated with the provision stating that the verification procedures of a substitution drawback system have to be "based on generally accepted commercial practices in the country of export"[65].

This is the only interpretation that is consistent with the objectives of the SCM Agreement, to whom *non-specificity* is a key concept. The latter "requires that allocation criteria are neutral, non-discriminatory and horizontal (that is, do not target or benefit some sectors more than others)"[66]. In fact, this Agreement does not prohibit non-specific subsidies, since it does not intend to hinder governmental public policies; it aims solely to obstruct measures that will distort free trade. The importance of a WTO regulation limiting the concession of specific subsidies at the domestic level is that international norms "are less likely to be influenced by interest groups (…). By adopting supranational regulation, national interventions in the benefit for the often small but political influential groups are restrained"[67]. To claim, consequently, that this agreement would shelter "drawback" as a policy limited to a specific region of a country would not be compatible with the aims of the WTO regulation on subsidies.

This is, in addition, the only interpretation that harmonises Annexes II and III of the SCM Agreement with the *most favoured nation* (MFN) *principle* within the meaning of art. I:1 of the GATT 1994. This is discussed in the following section.

3.3 DRAWBACK SCHEMES AND THE NON-DISCRIMINATION PRINCIPLE

The most favoured nation principle is applicable to the Agreement on Subsidies and Countervailing Measures. Trebilcock and Howse have identified nine exceptions to this principle, and none of them covers the foregoing agreement[68]. However, drawback schemes and the MFN principle will be consistent only where the drawback system is adopted as a general national policy. If, on the contrary, import duties are waived solely in specific regions of the country, this policy tends to discriminate against other WTO Members, depending on the region with which they conduct business.

This interpretation is supported by WTO case law. To establish a violation of the MFN principle, according to the WTO Panel report in *Indonesia – Certain Measures Affecting the Automobile Industry (Indonesia – Autos)*[69], re-affirming the findings of the Appellate Body, "in *Bananas III*, (…) there must be an advantage, of the type covered by Article I and which is not accorded unconditionally to all 'like products' of all WTO Members"[70].

Each of these three elements will be analysed.

(i) the presence of an advantage. The WTO Panel, in *Indonesia – Autos*, in the relevant part, examined whether *The National Car Programmes* of February 1996 and of June 1996, that exempted Indonesian companies that met certain criteria from import duties on components of Indonesian motor vehicles, violated art. I:1 of the GATT. It found no difficulty in concluding that customs duty benefits are the type of *advantages* covered by the most favoured nation principle – a conclusion that can be extended to the instant hypothesis.

(ii) the likeness requirement. The WTO Panel considered, in that case, that this requirement was also fulfilled, since the exempt imported products had no unique characteristic that would differentiate them from other motor vehicle components of other WTO Members. "[B]enefitting from reduced customs duties and taxes are not based on any factor which may affect *per se* the physical characteristics of those cars and parts and components, or their end uses"[71]. Turning to exporting process zones, there is no obstacle to assuming that goods introduced in an EPZ might be granted a better benefit than like goods imported to another region of the host country.

(iii) the conditionality element. The WTO Panel also considered that "[t]he GATT case law is clear to the effect that any such advantage (here tax and customs duty benefits) cannot be made conditional on any criteria that is not related to the imported product itself"[72].

In *Canada – Autos*, the WTO Panel took a *different* view and expressly rejected that the conditionality should be related to the imported product *per se:*

> *...the fact that conditions attached to such an advantage are not related to the imported product itself does not necessarily imply that such conditions are discriminatory with respect to the origin of imported products.*[73]

It also took a *broader* view, asserting that "[t]he word 'unconditionally' in Article I:1 does not pertain to the granting of an advantage *per se*, but to the obligation to accord to the like products of all Members an advantage which has been granted to any product originating in any country"[74]. This case, in the relevant part, considered the grant of duty-free treatment by Canada to imports of automobiles, buses and motor vehicles to manufactures that met certain conditions.

Despite this contradiction, both judgements were based on the decision on *Belgian Family Allowances*, a GATT Panel Report adopted on the 7 November 1952, that analysed a Belgian legislation that "introduced a discrimination between countries having a given system of family allowances and those which had a different system or no system at all, and made the granting of the exemption dependent on certain conditions"[75].

Charnovitz suggested, examining the foregoing report, that the understanding of the term "condition" in 1947 would be a better guide than the use of the latest dictionary: adopting an historical perspective, he concluded that "unconditional MFN was understood either to preclude all origin-based conditions or to manifest a strong presumption against them"[76]. To reconcile the findings on *Indonesia – Autos* and on *Canada – Autos*, this is indeed a useful recommendation.

From this interpretation, it follows that, in EPZs, there is an advantage granted by the host country to products originating in other country that are not accorded "unconditionally" to the similar product originating in the territories of all the other contracting parties. Then, there is a violation to the MFN principle.

Such a violation is likely to occur notwithstanding the rules imposing the conditions are origin-neutral. In *Canada – Autos*, the import duty exemption applied to imports from any country entitled to Canada's MFN rate[77], yet the Panel considered that the exemption gave rise to *de facto* discrimination. Indeed, according to GATT/WTO case law, art. I:1 of the GATT 1994 covers in law and in fact discrimination[78]. Just as in *Canada – Autos*, the discrimination regarding EPZs might arise from conditions regarding the eligibility of the beneficiary importers rather than from conditions pertaining the products imported[79]. This violation is also likely to occur even if the host country did not intend it. For Article I:1, "the focus has been on the effect of the measure, although there are different views as to how the effect should be measured"[80], rather than on intent.

Usually there are, in export processing zones, multinational enterprises; MNEs typically sell to, purchase from and share resources with a related person[81]. This is evidence that points to the existence of *de facto* discrimination in EPZs. The Panel Report, in *Canada – Autos*, reached the same conclusion:

> *While these eligible importers are not in law or in fact prevented from importing vehicles under the exemption from any third country, in view of their foreign affiliation and the predominantly, if not exclusively, "intra-firm" character of trade in this sector, imports will tend to originate from countries in which the parent companies of these manufacturers, or companies related to these parent companies, own production facilities.*[82]

It could be argued, moreover, that the WTO system solely applies to governments and that, with respect to EPZs, in practice, the beneficiary countries would be determined not by the host government, but by the enterprises installed in the EPZ. Nevertheless, the WTO Panel in *Indonesia – Autos* outlined that "[i]n the GATT/WTO, the right of Members cannot be made dependent upon, conditional on or even affected by, any private contractual obligations in place"[83]. Accordingly, in *Canada – Autos*, the WTO Panel decided that, even though the Canadian government was not responsible for the decisions made by importers, it was accountable for limiting the number of eligible importers and, as a result, "the geographic distribution of imports benefitting from the import duty exemption [was] determined by the commercial decisions of a closed category of importers mainly consisting of subsidiaries of firms based in certain countries, rather than by the commercial decisions of a broader, open-ended group of importers"[84].

One might argue, furthermore, that the same country that suffers a disadvantage with respect to one input shall be favoured with regards to another or that a violation to the MFN principle would only take place if there was concrete evidence that the enterprises installed in EPZs were privileging inputs derived from certain WTO Members. It is acknowledged that the application of the MFN principle in this context does generate some complexities; however, it is argued these only outline the inappropriateness of the SCM Agreement to regulation of export processing zones.

4. PROHIBITION OF THE EXEMPTION FROM IMPORT DUTIES IN EPZS: IMPLICATIONS FOR THE MULTILATERAL TRADE SYSTEM

One might think concluding that there is a breach of the SCM Agreement may not seem coherent with the fact that EPZs exist all around the world. It is argued that exactly because a large number of countries, either developed or developing, hosts them, there has not yet been a case alleging that infringement. It is very likely that the dispute settlement mechanism has not been made yet due to a "gentleman's agreement", whose objective is the maintenance of an industrial policy that seems to be advantageous to every country.

In a globalized world with globalized firms, it is improbable that some of these will raise the issue before their governments, provided that the export processing zones meet the interests of these multinational enterprises[85]. The influential lobby of exporters rather points to the expansion of EPZs, which even might compensate, in the government's view, for revenue losses. "If the gains accrue to powerful lobby groups, for example, a trade restriction might well lead to a gain for the defendant [country] in political support which exceeds the complainant's loss"[86]. It is also doubtful that the issue will be raised by any other international forum. Indeed, "[t]he invasion of the UN system by the private corporate actor has been underway for some time. In the 1970s and 1980s, international organisations such as UNIDO, UNCTAD and UNDP were 'facilitating the further liberalisation of international and national markets' by heavily promoting free trade and export-processing zones of interest to transnational corporations"[87].

The proliferation of EPZs, however, may have some negative implications. Firstly, as seen above, it may distort free trade. Secondly, it can set up an international competition to attract FDI that might lead to the decrease of taxes worldwide, which was termed as "harmful tax competition" by the Organization for Economic Cooperation and Development (OECD). "[T]hese schemes can erode national tax bases of other countries, may alter the structure of taxation (by shifting part of the tax burden from mobile to relatively immobile factors and from income to consumption) and may hamper the application of progressive tax rates and the achievement of redistributive goals"[88]. Observe that the practice of harmful tax competition is not a privilege of developing countries. Some wealthy States, for instance, make tax breaks available on a case-by-case basis; "[t]hese arrangements are frequently unpublicized, but the practice appears to be relatively common"[89]. Thirdly, this international competition tends to impoverish the weakest countries and enrich the strongest corporations. On the one hand, poorer countries do not have the financial means to support the concession of subsidies[90]; even if they made the effort, it would not be worthwhile, since "[t]he multitude of tax breaks and holidays are easily matched and competed downwards by other zones around the world"[91]. On the other hand, government revenue is transferred to powerful enterprises[92], as a result of such competition for investment

In conclusion, in order to bring free zones into line with the SCM Agreement, national policy-makers should phase out the referred exemption. Even in this case, some of the aims envisaged by EPZs would still be attained, since the importance of free zones is not limited to the tax breaks. Its attractiveness "also lies in the synergies that can be created by having a group of enterprises, including SMEs [small and medium enterprises], close to research and development institutions, and with access to improved infrastructure, an educated workforce and trade facilitation programmes"[93].

CONCLUSION

This paper has concluded that the exemption from import duties on goods entering export processing zones, which is the most common feature that EPZs worldwide have in common, constitutes a prohibited export subsidy within the meaning of art. 3.1(a) of the SCM Agreement. Nonetheless, this prohibition does not apply when this exemption is part of a drawback scheme adopted as a *national general policy*, within the terms of Annexes II and III. As discussed above, when such a tax break is restricted to EPZs, it tends to violate the most favoured nation principle set out in art. I:1 of the GATT 1994 and is inconsistent with the purposes of the WTO rules on subsidies.

Despite this inconsistency, there has not been a dispute brought to the WTO regarding this trade issue yet. Since EPZs exist all around the world, it is not in most countries' best interest to raise this case. However, no country can argue that the exemption from import levies strictly on goods entering these zones should be allowed, on the basis that it constitutes a common practice all around the world. Like the WTO Panel's findings, in *Brazil – Export Financing Programme for Aircraft*, "[t]his would entail a race to the bottom, as each WTO Member sought to justify the provision of export subsidies on the grounds that other Members were doing the same"[94] – a race that is already taking place and has been named harmful tax competition.

Harmful tax competition goes beyond the mere reduction of duty rates or duty bases. Its harmfulness affects free trade and the fairness of tax systems. It also leads to the transference of income from governments to multinational enterprises. Despite of the fact that it aims to promote social and economic development, in the final reckoning, these objectives are very likely to be jeopardized.

Non-compliance, indeed, does not invalidate art. 3.1(a) of the SCM Agreement.

It has finally been stressed that, if the referred tax incentives were removed, public spending to establish the EPZs would not be in vain.

Countries, producers and consumers would still benefit from other measures usually taken to establish a free trade zone, such as the proximity with research institutions, with a well-educated labour force and the decrease of costs regarding transportation, infrastructure and logistics.

>> ENDNOTES

[1] This study will not be relevant to developing country Members referred to in Annex VII of the SCM Agreement, to whom the prohibition of Article 3.1(a) does not apply, by virtue of Article 27.2(a).

[2] See World Bank Group 2008, 9.

[3] See ILO 2007.

[4] Kelley 1998.

[5] See Kundra 2000, 24.

[6] See Boyenge 2007.

[7] See Hanson 2001, 9.

[8] See Boyenge 2007.

[9] WTO 2006, 79.

[10] Hoekman and Kostecki 2009, 629.

[11] Dunning and Lundan 2008, 68-69.

[12] Chang 2005, 14-16.

[13] Matsushita, Schoenbaum and Mavroidis 2006, 332.

[14] Irwin 2009, 147.

[15] See art. XVI of the GATT 1947.

[16] See, for instance, *Canada – Measures Affecting the Export of Civilian Aircraft (Canada – Aircraft)*, WT/DS/70/R 14 April 1999, para. 9.119.

[17] WT/DS/70/R 14 April 1999, para. 9.119.

[18] Matsushita, Schoenbaum and Mavroidis 2006, 369.

[19] See Baccheta and Jansen 2003, 60.

[20] This article provides: "Any subsidy falling under the provisions of Article 3 shall be deemed to be specific". See *United States – Subsidies on Upland Cotton (US – Cotton)*, WT/DS267/R, WTO Panel Report, 8 September 2004, para. 7.1153.

[21] Benitah 2001, 187.

[22] 2009, 27.

[23] "But-for test". *Wex Dictionary (Cornell Law School)* 2013.

[24] WT/DS108/R, 8 October 1999, para. 7.45 (emphasis added).

[25] WT/DS108/AB/R, 24 February 2000, para. 91. Also note that, despite the opinion given in this extract, the WTO Panel Report on *US – FSC – Recourse to Article 21.5 of the DSU by the European Communities (US – FSC (Article 21.5 – EC))* (WT/DS108/RW, 20 August 2001, para. 8.11) considered that "the Appellate Body *upheld* our use of a 'but for' analysis".

[26] *Ibid*, para. 90.

[27] WT/DS108/RW, 20 August 2001, para. 8.15.

[28] *Ibid*, para. 8.17.

[29] *Id*.

[30] WT/DS108/AB/RW, 14 January 2002, para. 89.

[31] *Ibid*, para. 91.

[32] *Id*.

[33] See *ibid*, para. 92.

[34] *Ibid*, para. 91.

[35] See *ibid*, para. 97.

[36] See *ibid*, para. 101.

[37] Arnold and McIntyre 2002, 15.

[38] *Id*.

[39] O'Leary 2001.

[40] The dispute settlement mechanism in the WTO has also found that duty benefits were financial contributions, as it will be discussed in Part 2.3.

[41] See *Canada – Measures Affecting the Export of Civilian Aircraft – Recourse by Brazil to Article 21.5 of the DSU (Canada – Aircraft (Article 21.5 – Brazil))*, WT/DS70/AB/RW, 4 August 2000, para. 47.

[42] WTO Report 2006, p. 196.

[43] WT/DS70/AB/RW, 4 August 2000, para. 47.

[44] See AB Report, *Canada – Aircraft*, para. 166.

[45] AB Report, *US – FSC (Article 21.5)*, para. 111.

[46] *Id*.

[47] AB Report, *Canada – Aircraft*, para. 167.

[48] Panel Report, *Canada – Aircraft*, para. 9.331. See also AB Report, *Canada – Aircraft*, para. 171.

[49] See AB Report, *Canada – Aircraft*, para. 172.

[50] WorldTradeLaw.net 2010, 11.

[51] WT/DS126/R, 25 May 1999, para. 9.67.

[52] Above footnote 11, para. 118.

[53] WT/DS139/AB/R and WT/DF142/AB/R, 31 May 2000, para. 104.

[54] Magnus 2006.

[55] WTO 2006, 201.

[56] This policy, for example, is applied in the UK: "In general, the export of goods from the UK is zero rated", D. Bertram and R. Lawson, *Business Tax and Law Handbook* (Harlow 2003, 322).

[57] See Tokarick and Subramanian 2003, 25.

[58] WT/DS108/AB/R, 24 February 2000, para. 93.

[59] Against my view, see Creskoff and Walkenhorst 2009, 30.

[60] This definition is complemented by Annex II.II.3.

[61] Tokarick and Subramanian 2003, 8.

[62] Keck and Low 2004, 20.

[63] See Tokarick and Subramanian 2003, 7.

[64] *Id*.

[65] Annex III.II.2.

[66] Hoekman and Kostecki 2009, 219.

[67] Luja 2003, 21.

[68] 2005, 54-55.

[69] WT/DS54/R, WT/DS55/R, WT/DS59/R and WT/DS64/R, 2 July 1998.

[70] *Ibid*, para. 14.138.

[71] *Ibid*, para. 14.141.

[72] *Ibid*, para. 14.143.

[73] Panel Report, *Canada – Autos*, para. 10.24.

[74] *Ibid*, para. 10.23.

[75] Report Panel, *Belgian Family Allowances*, BISD 1S/59, 7 November 1952, para. 2.

[76] 2005.

[77] See *Canada – Autos*, Panel Report, para. 10.37.

[78] See *ibid*, para. 10.38.

[79] See *Canada – Autos*, Panel Report, para. 10.38. To support this argument, the Panel referred to: *European Communities – Regime for the Importation, Sale and Distribution of Bananas (EC – Bananas III)*, AB Report, WT/DS27/AB/R, 25 September 1997, para. 232; *Spain – Tariff Treatment of Unroasted Coffee*, Panel Reports, 11 June 1981, BISD 28S/102; *European Economic Communities*

– *Imports of Beef from Canada*, Panel Report, 10 March 1981, BISD 28S/92; *Japan – Tariff on Imports of Spruce-Pine-Fir (SPF) Dimension Lumber*, Panel Report, 19 July 1989, BISD 36S/167.

80 Lester et. al. 2008, 338.

81 See Dunning and Lundan 2008, 238.

82 See *Canada – Autos*, Panel Report, para. 10.25.

83 *Ibid*, para. 14.145.

84 *Canada – Autos*, Panel Report, para. 10.46.

85 This point is well illustrated by Irwin's analysis on dumping cases brought before the US Department of Commerce and the US International Trade Commission, in which "[s]ome petitioners exclude[d] certain countries from petitions as a matter of corporate strategy" see above footnote 14, p. 156. See also International Centre for Trade and Sustainable Development, *Bridges: Weekly Trade News Digest*, vol. 6, 22 January 2002, pp. 3-4.

86 Bütler 2000.

87 Emadi-Coffin 2002.

88 OECD 1998, para. 23.

89 Hanson 2001, 3.

90 See WTO 2006, 205.

91 Keck and Low 2004, 20; see WTO 2006, 78.

92 See Hoekman and Kostecki 2009, 588.

93 Torres 2007, 223.

94 WT/DS46/R, 14 April 1999, para. 7.26.

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