THE DISPUTE OVER THE INDONESIAN NATIONAL CAR PROGRAM

CASE A

Setting

> *In 1995 auto industry exports only amounted to $250 million while imports were over $1.5 billion. This situation cannot continue and it is imperative that we develop our own industry.*
>
> — Indonesian Minister for Coordination and Production, Harto May 1996[1]

> *I made it clear that in our view, this* [i.e., tax incentives and tariff exemptions] *was a policy that was discriminatory against European car manufacturers and also that it was contrary to the obligations Indonesia has undertaken with the WTO…*
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> — European Union Commissioner for External Affairs, Sir Leon Brittan, following an April 23, 1996 meeting with Indonesia President Soeharto.[2]

At the beginning of 1996, Indonesia was one of the most interesting places for global automakers to invest. It appeared to offer many advantages to foreign investors—a population of 190 million people (the fourth most populous state in the world), extensive natural resources, a stable (if not democratic) government, decent economic growth (averaging 8 per cent in the 1994–1996 period) and an excellent repayment record on its huge but manageable foreign debt. Investment in manufacturing and in consumer goods had great potential as the per capita GDP climbed above $1,000.

By June of 1996, the situation had changed dramatically. The introduction of Indonesia's National Car Program in the spring of 1996 forced the leading motor vehicle manufacturers in Europe, Japan and the United States to revaluate their plans for the Indonesian market and to put their investments on hold. Trade officials in the European Union, Japan and the United States, in a rare show of unanimity, threatened to take Indonesia to the WTO.

Part I

The National Car Dispute

Development of Indonesian Automotive Industry and Auto Trade Policies

[1] Business Times (Singapore) May 28, 1996, pg. 12
[2] European Report, European Information Service, April 27, 1996

Automobile production in Indonesia began in 1927 when General Motors started assembling and trading automobiles in the Indonesian market. The growth, popularity and utility of these vehicles prompted the Indonesian Government, after World War II, to develop a national automobile industry. In the government's view, such development could help satisfy growing public demand for transportation facilities; contribute to economic growth; facilitate technology transfer in nascent industries; create employment opportunities, and generate government revenue through import duties and taxes. The process went through several distinct phases before the unfolding of the National Car Program in 1996.

Phase One — General Motor's production facilities were nationalized in 1950 under a program dubbed "Program Banteng". However, due to a shortage in foreign exchange, the program had to be shelved for a later time.

Phase Two — In 1968, the New Order Government, instituted by President Soeharto upon easing President Sukarno from office, strove to develop an independent industrial sector. The sector was to be fueled by import substitution policies, with the automotive industry at center stage. This approach was consistent with the views of leading economists and international donor agencies of the day. In 1972, the New Order Government banned the import of "completely built-up" (CBU) automobiles. Government-licensed agents, which were in effect Indonesian-owned subsidiaries of foreign auto manufacturers, were instead only permitted to import vehicles in "completely knocked down" (CKD) form. Tariff and non-tariff barriers such as quotas and local content requirements were implemented to ensure the success of a domestic automotive industry.

The import substitution policies encouraged the creation of many national automobile assembly companies. Within one year, 22 Indonesian assemblers had entered the domestic automobile market with over 50 models and 20 different brands. Japanese firms had most of this business. The policies, however, did not foster the development of a domestic automotive industry capable of producing, rather than assembling, automobiles and did not result in the transfer of parts manufacturing technology.

Phase Three, The "Deletion Program" — Recognizing that domestic automobile parts manufacturing and production was crucial for a national automotive industry, the Soeharto government introduced the "Deletion Program" in 1977. The program was designed to stimulate production of automobile components in Indonesia by requiring local assemblers of CKD kits to "delete" (i.e., replace) foreign produced automobile parts with locally produced ones. Failure to do so led to the imposition of 100 percent ad valorem import duties on those foreign parts that were also locally produced.

The "Deletion Program" achieved minimal success. It resulted in the domestic production of only a few components: tires, headlamps and accumulators. Local content targets were pushed back as: (a) local producers did not have sufficient technological capacity; (b) distributors, who were seeking high profits, kept the cost of the domestic products high; (c) with so many brands and models, the market was too fragmented to be efficient, and (d) foreign manufacturers preferred to keep their local agents as distributors rather than full-scaled local manufacturers.

Phase Four, The 1993 Incentive Program — In June of 1993, Indonesia abandoned the deletion program and introduced a series of measures designed "to foster development of a domestic motor car industry". These measures gave domestic automobile manufactures incentives to produce automobile parts locally. The incentives were:

a. Lower import duties on automotive parts and accessories depending on the percent of local content of the finished motor vehicles in which the parts were used.
b. Lower import duties on imports of "subparts," such as components, subcomponents, semi-finished and raw materials used in the manufacture of automobile parts, depending on the local content of the completed part or accessory.
c. Reduction in the sales tax on luxury goods-for certain categories of motor vehicles with specified local content rates.

Indonesian Ministry of Industry Decree No. 114/M/SK/6/1993 of June 6, 1993 provided for the reduced duties. Import duties were based on the amount of local content or value added by local manufactures. The higher the local content of domestically made parts or of finished autos, the lower the duty on the remaining parts that were imported. Thus, if an engine was considered to constitute 25 percent of the value of a finished automobile and if 50 percent of the engine's value were considered local value added, the local content for that vehicle would be 25 percent times 50 percent or 12.5 percent.

Table 2
Passenger Car Parts Incentives

Local Content of Finished Car in which Parts Used	Import Duty Rate on Imported Parts and Components
If less than 20%	100%
20% to 30%	80%
30% to 40%	60%
40% to 60%	40%
More than 60%	0%

The program offered significant advantages for local car manufacturers. In addition to the base duty of 175% for passenger cars, there was an import surcharge of 100%. The duties on commercial vehicles were less, but still quite high. The program achieved, however, very little. The local content of commercial automobiles was only approximately 20% by the time it was terminated.

Minister of Finance Decree No. 647/KMK.04 (June 10, 1993) provided for the reduced luxury sales tax for motor vehicles with sufficiently high Indonesian domestic content. For passenger cars with engines less than 1600ccs, the luxury tax was 35 percent of the vehicle's value if its domestic content was 60 percent or less, and 20 percent if greater than 60 percent.

Phase Five, From Protectionism to a Market Oriented Approach (albeit temporary) — In 1995, the Indonesia Government appeared to make a fundamental policy shift away from protectionism and towards a market-oriented approach. This shift was sparked by rapid progress in sector-specific industrial development through technology transfer, and best management techniques and capital inflows through foreign direct investment.

On May 3, 1995 the Indonesia Government issued a deregulation package. The package modified the incentives program by further reducing duties on components used in vehicles that achieved specified local content levels. The package also removed restrictions on investments in the automobile industry for the production of new commercial vehicles and provided for the lowering of duties on imported parts and vehicles. By 2003, the maximum duty on built-up autos was to be 40 percent and on knocked down kits (CDW), 25 percent.

Automobile firms in the United States, Japan and the European Union all applauded the shift, which was also consistent with advice from the International Monetary Fund (IMF) and the World Bank. Heading into 1996, prospects appeared promising for the revitalization of an ailing automotive industry in Indonesia.

The National Car Program

On February 19, 1996 Indonesian Minister of Trade and Industry, Tungky Ariwibowo, launched a new National Car Program to foster development of an indigenous automotive industry. The full program was spelled out in a Presidential Decree and several ministerial decrees, all enacted on February 19, but not announced until February 28.

> Presidential Instruction No. 2 of 1996 directed the Minister of Industry and Trade, the Minister of Finance, and the State Minister for Mobilization of Investment Funds to implement coordinated measures for the speedy realization of the national automobile industry.
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> Ministry of Industry and Trade Decree No. 31/MPP/SK/2/1996, entitled "National Motor Vehicles," implemented parts of Presidential Instruction No. 2 by providing that a "national motor vehicle" must satisfy the following criteria: (a) be domestically produced using facilities owned by national industrial companies or Indonesian statutory bodies with total shares belonging to Indonesia citizens, (b) use trade marks not yet registered in Indonesia and owned by Indonesians, and (c) be developed with technology, designs and engineering based on national capacity. Automobiles companies that met the above requirements were to be

called "pioneer companies". National automobile companies were to use an increasing amount of local content in their autos, starting at 20% at the end of the first year, 40% the second and 60% by the end of the third year.

Ministry of Finance Decree No. 82/KLM.01/1996 revised Decree No. 645/KMk.01/1993. The Decree in essence provided that parts and equipment used in the assembly or manufacture of a national motor vehicle may be imported duty-free rather than at reduced rates provided for in the 1993 incentives programs.

Government Regulation No. 20/1996 of February 19, 1996, amended Government Regulation No. 50/1994 to exempt National Cars from the luxury tax. The purpose of the regulation was to support further growth of the domestic automotive industry to make it globally competitive.[3]

Kia Motor /Timor Putra Nasional Joint Venture — On Monday, February 26, 1996 Kia Motor Corporation ("Kia") of Korea and the Indonesian company, PT Timor Putra Nasional ("TPN") announced the establishment of a joint venture to produce national motor vehicles. TPN happened to be controlled by Hutomo Mandala Putra, the youngest son of President Soeharto. The joint venture, which was entitled PT Kia Timor Motor ('Kia Timor") and was 30% owned by Kia, announced that it would produce a car (to be called "Timor"). The Timor was to be based on the 1,500cc Kia Sephia sedan and built at a plant to be constructed in Cikampek, West Java. TPN said that it would produce 50,000 sedans by 1998 and intended to start selling cars in Indonesia by September of 1998. TPN also said that its cars would sell at half the price of comparable models manufactured by Japanese subsidiaries in Indonesia. In announcing the National Car Program, Tungky confirmed that the TPN venture would be the first and for the moment the only company to qualify for "National Car" status and for the tax and tariff benefits conferred by the program.

The Government also announced a further series of measures on February 27 and March 6, 1996. These measures (a) provided the investment approval and tax benefits needed for the establishment of a national car industry,[4] (b) designated TPN as a "pioneer national motor vehicle enterprise"[5] and (c) designated TPN to establish and produce a National Car.[6]

Rational of Indonesian Government and Private Sectors Supporters — In launching the National Car Program Indonesian officials voiced unhappiness with the pace of development of a domestic car industry to date and expressed fear that they were falling behind other ASEAN countries. Tungky said on Feb 28 that the National Car Program was designed to develop national self-reliance in the automobile industry, to allow the

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[3] Elucidation accompanying regulation.
[4] Decree of the State Minister for Mobilization of Investment Funds/Chairman of the Investment Coordinating Board No. 01/SK/1996
[5] Decree No. 002/SK/DJ-ILMK/II/1996 of the Ministry of Industry and Trade
[6] Decision of State Minister for Mobilization of Investment No. 01/SK.1996 of March 5, 1996

industry to export its products and to procure components from different sources. Tungky also compared the program to the Proton program in Malaysia and stressed that "the Timor cars will be produced by PT Timor Putra as a wholly-owned Indonesian subsidiary."[7]

The PTN venture was not the first national car project envisaged for Indonesia. In 1995 the National Science Agency had proposed to produce a national car and was still talking about it in 1996 and 1997. President Soeharto's support of his son was a key factor in determining the vigor with which Indonesia pursued the National Car Program.

The National Car Program struck a responsive cord among some Indonesians. Many Indonesians shared the view that Japan had held a virtual monopoly on the Indonesian car market since the 1960's. One business consultant said that if Japan had allowed Astra to export 8 years ago, Indonesia would not have been forced to turn to the Koreans.[8] On March 1 the Chairman of the Indonesian Chamber of Commerce and Industry Aburizal Bakrie welcomed the National Car Program with the following comment: "I welcome and support any policy which will cut the prices of domestic products, including automobiles." Dr. F.H.H. Eman, former chairman of the Indonesian Motor Vehicle Association (Gaikindo) and current director involved in the TPN project, said that prior to the release of the new policy the automobile industry in Indonesia depended too heavily on companies in Japan and the United States and that now is the time to develop its own competitive, national automobile industry.[9]

On the other hand, the National Car program and the TPN venture were controversial from their inception in Indonesia. The unexpected shift in policy contradicted the government's recent May 1995 market-oriented policy of deregulation and liberalization of the automobile industry. Local and foreign newspapers reported the stunned reaction of Indonesian manufacturers who were already involved in manufacturing foreign brand autos under license. The stock of the leading local manufacturer of the Toyota, Isuzu and Daihatsu marques, Astra International, fell sharply after the announcement that Timor's low price was expected to sharply reduce sales of other manufacturers. By March 17 Astra's shares had fallen some 28.3%.[10] Indonesians stopped buying cars in anticipation of the cheaper Timors and even demanded a return of the down payments on cars they had already agreed to purchase.[11]

Analysts noted that TPN would have a difficult time achieving its stated goals since it was a new company, had no manufacturing facilities in Indonesia, and would have difficulty satisfying the domestic content requirements of the national car program.

One editorial noted that advantages to PT Timor Putra were immense as duties and taxes make up more than 60% of the showroom price of sedans. The editorial suggested the

[7] Jakarta Post Feb 29, 1996
[8] Business Times, Singapore, May 28, 1996, pg. 12.
[9] Jakarta, Kompass Online 3/7/96
[10] Reuters Asia-Pacific Business Report 3/18/96 p. 17-18 US exhibits
[11] Jakarta, Kompas Online, 3/7/96

government should really focus on investment for research, design, development and engineering if it wanted a competitive car industry.[12] The National Car Program was most widely criticized because it favored one local firm over and above other Indonesian firms that had been in the auto business a longer time.

The selection of TPN raised not only nepotism issues regarding whether a son of the President was being favored over foreign businesses and non-family business, but also the specter of a brewing family feud. On March 15, President Soeharto's eldest son Bambang Trihatmojo said that his Bimantara business would launch a 1,500cc sedan with the South Korean Hyundai Motor Corporation and that the sedan met the requirements for designation as a "National Car" and the tax and customs benefits conferred by the program. Tungky repeatedly said that only TPN could benefit under the National Car Program during the next three years. Many local observers, however, felt that Bambang had a reputation of getting what he wanted.

On May 30 Bambang announced that he had received from the government licenses to manufacture 1500cc and 1600cc vehicles based on existing Hyundai models. However, on May 31 Tunky again said that only PTN was to receive the tax and tariff benefits of the National Car Program and that they would not be extended to others.[13]

Foreign Government and Auto Manufacturers Reaction, Japan — Japanese automakers responded to the National Car Program by shelving or threatening to cut back on production plans. Both Honda and Mitsubishi said that they would scale back on projects to build an "Asia-concept car" in Indonesia. Production of the Honda car was to start in August of 1996 and to carry an Indonesia brand name.[14] Japanese manufacturers were concerned both that the Timor could grab a huge share of the Indonesian market (e.g., 75%) in the same way that the Proton had in Malaysia[15] and that the National Car Program would have an adverse impact on the investment climate in Indonesia.[16] On the other hand, some Japanese parts suppliers hoped that the new policy would put pressure on the assemblers to reduce costs and increase domestic content and that their parts ventures in Indonesia would benefit from such a development.[17]

The Japanese Government reacted soon after the announcement of the National Car Program. The Minister of International Trade and Industry (MITI) said that Japan was examining various aspects of the issue, including the possibility of taking Indonesia to the World Trade Organization (WTO). He hoped that Indonesia would consider withdrawing or revising the policy before the problem became more serious.[18] Japanese government officials pointed out that they believed that the National Car Program violated the WTO TRIMs Agreement and provisions of the GATT. Japanese officials were concerned that

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[12] Jakarta Post, March 1, 1996
[13] Asia Times, June 3, 1996
[14] The Nikkei Weekly, March 25, 1996,
[15] ibid.
[16] ibid.
[17] ibid.
[18] Jakarta, Kompas Online, 3/12/96

other countries would adopt national car programs if Indonesia's plans were successful. Brazil had already adopted a program in 1995 that hurt Japanese manufacturers.[19]

Europe — The EU Commission also attacked the national car program. During an April 23 visit to Jakarta, EU Trade Commissioner Sir Leon Brittan said that the policy discriminated against European car manufacturers and was contrary to Indonesia's WTO obligations, including those under the TRIMs agreement. Sir Leon said that the national car program hurt European manufacturers more that the Japanese because the Europeans primarily made sedans while the Japanese made a wider range of commercial and passenger vehicles. He warned that the EU had different and separate interests from Japan and would not be satisfied even if the Japanese were accommodated.[20]

United States — US companies initially reacted to the National Car Program by announcing cutbacks in plans to invest in Indonesia while continuing to invest in other Asian countries. Chrysler, which was seeking to develop joint automobile programs within the ASEAN region, announced that it had decided to postpone its plan to build a new factory in Indonesia because the climate was not considered to be conducive.[21] In April, David Snyder, President of Ford's Thailand Regional Office, said "Ford has a goal of 10 percent market share across Asia. That's a long-term regional goal." Snyder announced plans for new ventures in India, Thailand and Vietnam and expansion plans for Malaysia and South Korea, but said with respect to Indonesia that "If those [i.e., the national car] policies stay we'll have to modify our plans in Indonesia." Ford had earlier announced plans to set up a complete knock down facility in Indonesia.[22]

In May of 1996 the three big US automakers submitted a white paper outlining in detail their objections to the National Car Program.[23] The paper warned that based on experience in other markets the National Car Program policies will result in less technology, fewer exports and lower employment than if the deregulatory policy established in 1993 were continued unchanged. The US automakers also said that the 60% local content target was unachievable. They noted that they had firm plans to assist the development of the auto industry in Indonesia and to make Indonesia a key part of their ASEAN, Asian and Global plans, but that these plans were on hold. The industry contended that Malaysia's efforts had failed since development of the industry in Malaysia was lagging behind that in other countries in Asia and the Proton was not completing successfully.

June 1996 Revisions to the National Car Program

By late May of 1996 TPN's inability to meet its goal of selling Indonesia-made Timors in the local market by September 1 was self-evident. In mid-May TPN President Hutomo said that the Astra group, the Indomobil group and PT Utadin would assemble the

[19] The Nikkei Weekly, April 15, 1996, pg. 6, pp26-27 US exhibits
[20] European Report, 4/27/96, p. 31-32 US exhibit
[21] Jakarta, Kompas Online, 3/12/96
[22] The Reuters European Business report, 4/25/96.
[23] Indonesia Automotive Industry, US Auto Industry Position Paper (check on this)

Timor.[24] However, by late May Kia admitted that TPN had approached these companies and was rebuffed. Astra said it would have to build a new assembly plant, which would take nine months, and Indonmobil said it had no idle assembly facilities. Kia announced that it would import 4,000 Timors in semi-knocked down (SKD) condition in June and TPN revealed that its assembly plant in Cikampek, West Java would only be ready in 1998.[25]

As TPN problems grew proponents of the National Car Program increasingly pointed to the importance of the scheme for Indonesia. Fritz Eman, President of TPN's assembly division, said on May 28 that because foreign companies' main concern was reaping maximum benefits from Indonesia's huge market, not establishing a reliable domestic car industry, "it is very important for Indonesia to make a breakthrough in its car industry before the WTO's free trade principles are fully applied in 2003"[26]

After TPN encountered problems finding a factory in Indonesia in which to build the Timor, the Indonesia government announced in June of 1996 modifications to the program. These modification provided that for a one-year period and on a one-time basis, National Cars in fully built-up form could be imported free of duty and luxury tax if they were made by Indonesian workers and satisfied the domestic content requirements of the National Car Program.

In particular, on June 4, Presidential Decree No. 42/1996 provided that National Cars which are made overseas by Indonesia workers and which fulfill the local content stipulated by MIT will be treated equally with national cars made in Indonesia.

Rather than require that Indonesian parts and components actually be used in the Kia Sedans imported from Korea, the government on June 4 introduced Ministry of Industry and Trade Decree No. 142/MPP/Kep/6/1996, which provided that the domestic content requirement on national cars produced overseas can be satisfied if the producer purchased a certain amount Indonesian parts and components. Under this counter purchase arrangement, the producer had to purchase a minimum of 25 percent of the import value of the national cars assembled abroad. In sum, Kia only had to purchase Indonesian made motor vehicles parts and components in an amount equal to 25% percent of the value of the Kia Sephia sedans it was importing from Korea duty-free as the Indonesian "national motor vehicle."

In announcing the new measures Tungky said on June 4 that the government would allow 45,000 Timor sedans to be produced in South Korea and imported into Indonesia and still receive the tax benefits of the National Car Program. Tungky said this measure was necessary "to speed up the national car project". Tungky also said "The government gives PT Timor Putra Nasional a period of 12 months, from June 1996 through June 1997, to assemble the cars in Korea. The deal will also involve the export from Indonesia of "a sufficient number of Indonesian workers who would be sent to Korea for an

[24] AFP story date 5/17/96
[25] Business Times Singapore of May 25, 1996.
[26] Business Times Singapore, 5/30/96.

adequate amount of time" to produce the car and to "ensure an effective transfer of know-how". Kia sources indicated that about 1,000 Indonesian workers would be sent to Korea.

Also on June 4, Government Regulation No. 36/1996 modified the luxury tax schedule so that any sedans of less than 1600cc made in Indonesia with domestic content in excess of 60 percent would also be exempted from the luxury tax. (National Cars were already exempt.) This announcement was made in the context of a deregulation package, which provided tariff reductions on some 1,497 tariff line items. Tungky's announcement was less generous than it might at first appear. None of vehicles manufactured in Indonesia could pass this 60 percent test. Most sedans at the time had only 15 percent local content and the Timor was expected to have only 20 percent domestic content in the first year.[27]

Foreign Reactions -- Foreign automakers and government officials from the EU Commission, US and Japan reacted sharply to the June 4th modifications in the National Car Program. The Japanese automakers, who had the most to lose, and their government reacted first. An outraged Japanese Ministry of Trade and Industry told the Nikkei Weekly that the Indonesia program was "sheer nonsense" and that Japan would take action in the WTO as soon as Indonesia imported duty-free cars from South Korea.[28] Another MITI official said in early June, "going to WTO remained a strong possibility of Japanese action". However, Japan was not sending a clear signal regarding its intentions as the same MITI official conceded that at this point the possibility was a trial balloon. Japanese officials also attempted to dispel speculation that Japan would use development assistance as leverage at an aid-pledging conference to be held in Paris on June 19.[29] Japanese officials were worrying that Indonesia could respond to Japanese pressure by taking a tough stance on the supply of oil and gas. One official spoke of patiently explaining to Indonesia that "this program is hurting Indonesia's own interest" and companies would view Indonesia as a less favorable place to invest.[30]

The Japanese auto industry was even more cautious. An industry official noted that while the US and EU officials said that they would file their own complaint following a Japanese complaint to the WTO, he was not sure if such concerted action was possible.[31] The Indonesians did not appear to be impressed and repeated that they were trying to develop domestic production. Indonesian officials said privately that they did not take the WTO threat seriously since Japan was subject to complaints about its own protectionist practices. Indonesian Foreign Minister Ali Alatas said: "The matter will not disturb economic relations. The Japanese government does not link this issue with others."[32]

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[27] Indonesian Commercial Newsletter of July 8, 1996.
[28] The Nikkei Weekly, June 17, 1996.
[29] Ibid.
[30] ibid.
[31] Asia Times, June 13, 1996.
[32] ibid.

The US reaction was predictably strong from the beginning and along the lines of their reaction to the February program. Andrew Card, President of the American Automobile Manufacturers Associations, said, “The National Car Program is a giant stop sign to investors. The government changed the rules in the middle of the game.” On June 11 Donald Sullivan, head of General Motors Asian and Pacific Operation, announced that the company had frozen its investment plans in Indonesia.

Part II

WTO Rules and National Trade Laws At Stake

In assessing options at the end of June 1996, all the parties—the EU, US, Japan and Indonesia—had to deal with certain internationally agreed trade rules and procedures, which they had all pledged to observe, as well as with their own national legislation. Of most importance were the WTO rules then in effect as a result of the completion of the Uruguay Round of Multilateral Trade Negotiations in March of 1994 and the entry into effect of the agreements establishing the World Trade Organization on January 1, 1995. Among the WTO rules and procedures, those regarding taxes, duty exemptions, export performance and domestic content requirements, subsidies and dispute resolution were of particular relevance.

The GATT and WTO Rules

The Uruguay Round produced new rules governing the types of measures governments can take to attract investment or promote the development of domestic industries. Some rules, however, had been in place for almost half a century as they were contained in the General Agreement on Tariffs and Trade (GATT).[33]

Indonesia became a GATT member in 1950 under a provision that allowed countries that were colonies of GATT members to declare their membership upon becoming independent (Art. 26.5). Indonesia was the first country to take advantage of this provision. Indonesia became a member of the WTO January 1, 1995, when the WTO came into effect.

Most Favored Nation Principal — One of the fundamental principles of the GATT and WTO systems is the most-favored-nation (MFN) principle. If a country grants another country a special favor (such as a lower tariffs rate on its products or tax exemptions for its products), the country must do the same for all other WTO members. The MFN clause, which is found in GATT Article I, was the cornerstone of the GATT 1947 system; it provided that:

> ...any advantage, favour, privilege or immunity granted by any contracting party [now Member] to any product originating in or destined for any other country shall be accorded

[33] The GATT comprises both the body of rules and the organization that oversaw the development of the international trading system from 1947 until the WTO came into existence on January 1, 1995.

> immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties [Members]

The MFN principle is also the starting-point of the WTO system of rights and obligations. It is fundamental to all the multilateral trade agreements annexed to the WTO Agreements. Under the WTO Agreements, countries cannot normally discriminate between their trading partners.

National Treatment Principle — A second fundamental principle of international trade law found in the GATT and WTO is that foreign products should receive the same treatment as domestic products once they cross a country's border and enter its customs territory. This principle, commonly referred to as the national treatment principal, is set forth in Article III of the GATT.

In particular, paragraph 1 of Article III provides that internal taxes and regulations should not be applied to imported and domestic goods so as to protect domestic production. Paragraph 2 of Article III states specifically that imported products should not be subject to higher internal taxes than like domestic goods. The second sentence of paragraph 2 makes clear that internal taxes should not be applied, so as to protect domestic production. As noted below the second sentence of paragraph 2 prohibits a country from protecting domestic interests by taxing certain imported goods more heavily than similar or directly competing domestic goods.

Paragraph 4 of Article III provides that once an imported product crosses the border it cannot be treated less favorable than a like domestic product with respects to any laws, regulations or other matters affecting its competitive position in the domestic market. Paragraph 4 is one of the most important provisions in the GATT and has been the subject of many disputes. Paragraph 8 makes clear that the national treatment requirement does not prohibit a government from giving subsidies directly to domestic producers and discriminating in government purchases.

As a result of a 1984 dispute settlement panel ruling, GATT members were on notice that their investment regulations that permitted a company to invest only if it agreed to purchase a certain amount of domestic production would be found to violate the national treatment provision of GATT Article III. In this proceeding the United States had charged that Canada violated GATT rules when its Foreign Investment Review Agency required, as a condition of approval of a foreign investment, that the foreign investor agree to certain undertakings regarding the amount of Canadian content the investor would used in manufacturing a product and/or regarding the amount of his production the investor would export.[34]

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[34] 4 GATT Panel Report on "Canada-Administration of the Foreign Investment Review Act" adopted February 7, 1984. The report can be found in the 30th Supplement to the GATT publication *Basic Instruments and Selected Documents* (BISD), page 140.

Quantitative restrictions — Another fundamental objective of the GATT was the avoidance of quantitative limitations on trade. Quantitative limitations can take the form of quotas that limit the absolute amount that can be imported or exported. Quotas are often enforced through licensing regimes that control the volume of trade. Quantitative limitations are particularly objectionable to advocates of trade liberalization as stifle trade more than tariffs. With quotas trade levels are set by administrative fiat and factors such as price, quality and other commercial considerations play no role. Article XI of the GATT sets forth the basic limitation on quantitative measures; it provides that:

> No prohibitions or restrictions other than duties, taxes or other charges, whether made effective through quotas, import or export licenses or other measures, shall be instituted or maintained by any contracting party on the importation of any product of the territory of any other contracting party….

The GATT, however, had recognized since the mid-1950's that developing countries should be able to take measure to protect infant industries or otherwise promote economic development and raise their standards of living, even if such measures violated basic GATT rules. These deviations were only permitted, however, if countries requested authority to do so and agreed to certain reporting requirements. Few developing countries chose to resort to these provisions and no country did so after the 1960's. Countries instead introduced investment incentives and protected domestic industries without subjecting themselves to the consultation and reporting requirements envisaged by the GATT.

Trade-Related Investment Measures (TRIMs) — The Uruguay Round sought to address the growing concern about trade-related investment measures by formulating rules to ensure that government measures to attract investment did not distort trade. Developed countries wanted to adopt new rules to discipline the use of investment measures, whereas developing countries wanted to limit the discussion to how the existing GATT rules applied to trade-related investment measures. Developed countries wanted rules that banned certain trade measures, whereas developing countries wanted to ban measures only if they were shown to distort trade. In the end, the Agreement on Trade-Related Investment Measures (TRIMs) that emerged from the Uruguay Round was closer to the position advocated by the developing countries than to that advocated by developed countries.

The TRIMs agreement recognizes that certain investment measures restrict and distort trade. It provides in Article 2 that no contracting party shall apply any TRIM inconsistent with GATT Articles III (national treatment) and XI (prohibition of quantitative restrictions). The agreement includes in an annex an illustrative list of TRIMs that are considered to be inconsistent with articles III and XI. The list includes measures which require particular levels of local procurement by an enterprise ("local content requirements") and which restrict the volume or value of an enterprise's imports to the volume or value of its exports ("trade balancing requirements").

Article 3 permits a country to invoke the same exceptions provided under GATT 1994. The exceptions permit a country to take measures to protect such things as health and safety, the environment or national security, even though they are inconsistent with the provisions of the TRIMS agreement. Article 4 permits developing countries to deviate from the provisions of Article 2 in order to protect a country's balance of payments situation. Article 5 provides for a transitional period for developing countries: They are allowed to maintain until January 1, 2000 TRIMs that were in existence 180 days prior to the WTO coming into force on January 1, 1995 provided the country notified the TRIM to the WTO prior to March 31, 1995. Indonesia notified its 1993 Incentive System under Article 5 on May 23, 1995, but on October 28 1996, withdrew its notification.

Agreement on Subsidies and Countervailing Measures (SCM) — Subsidies were considered a major problem for trade policy officials in the 1970's because they were widely used. By the mid-1990's the debt crises of the early and mid-1980's had impoverished many developing countries to the point where they could no longer afford expensive subsidy programs; furthermore, the structural adjustment and economic reform programs mandated by the IMF forced countries to eliminate subsidies. Nevertheless, the Uruguay Round negotiators sought in the Agreement on Subsidies and Countervailing Measures (SCM) to strengthen the disciplines on subsidies introduced by the Subsidies Code, which was concluded during the Tokyo Round negotiations of 1975–79, and to build on that agreement. One of the primary objectives of the SCM Agreement is to limit the use of trade distorting subsidies.

Unlike the Tokyo Round Subsidies Code, the SCM Agreement contains a definition of a subsidy. A subsidy is deemed to exist if there is a financial contribution by a government or public body. Situations where subsidies may exist include those where a government practice involves a direct or potential direct transfer of funds (e.g. grants, loans, and equity infusions) and where government revenue that is otherwise due is foregone or not collected (e.g., fiscal incentives such as tax credits). The SCM Agreement further provides that only "specific subsidies" are subject to the rules in the agreement. A specific subsidy is considered, for the most part, to be a subsidy available only to an enterprise or industry or group of enterprises or industries within the jurisdiction of the authority granting the subsidy. Subsidies that are explicitly limited by legislation or the agency granting them to certain enterprises are considered specific. Subsidies that are granted on objective, neutral criteria and are automatically granted to a firm meeting the criteria are considered generally available, and not specific subsidies.

Prohibited subsidies — The SCM Agreement explicitly prohibits two types of subsidies that are designed to distort trade—export subsidies, and subsidies granted on the condition that the receiver uses domestic rather than imported goods. Export subsidies are defined as those that are contingent, in law or in fact, whether solely or as one of several other conditions, upon export performance. Subsidies that encourage the use of domestic over imported goods are defined as subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods. The SCM Agreement provides special dispute settlement procedures for dealing with prohibited subsidies. In the case of prohibited subsidies, there is an expedited timetable for action by the Dispute Settlement body, and, if a subsidy is found to be prohibited, it must be immediately withdrawn. If withdrawal does not take place within the specified time period, the complaining member is authorized to take countermeasures.

Actionable subsidies — The SCM Agreement stipulates in Article 5 that no member should cause, through the use of specific subsidies, adverse effects to the interests of other signatories. The article lists the following three categories of adverse effects: (a) injury to a domestic industry of another signatory, (b) nullification or impairment of benefits accruing directly or indirectly to other signatories under the General Agreement (in particular the benefits of bound tariff concessions), and (c) serious prejudice to the interests of another member. Subsidies that result in such adverse effects are considered "actionable" and the WTO member that is the victim of such subsidies, with exceptions, can resort to the remedies provisions of Article 7 of the SCM Agreement.

Serious prejudice is a concept found in the original GATT that has been carried over into the SCM agreement. The concept, which in essence refers injury to trade interests, becomes particularly useful when a WTO member is concerned about subsidies of another member that may be harmful to its export interests. In such situations serious prejudice can serve as the basis for a complaint under the SCM Agreement.

Article 6 of the SCM Agreement in paragraph 1 provides that serious prejudice shall be presumed to exist for certain subsidies, including when the total *ad valorem* subsidization of a product exceeds 5 per cent. In such a situation, the burden of proof is on the subsidizing member to show that the subsidies in question do not cause serious prejudice to the complaining member. Paragraph 2 of Article 6 provides that a subsidizing member can avoid the presumption of serious prejudice if it can show that the subsidy in question has not resulted in certain enumerated effects spelled out in paragraph 3.

Pursuant to paragraph 3 serious prejudice can arise where a subsidy causes either: (a) displacement or impedance of imports of a like product from the complaining Member in the market of the subsidizing Member; (b) displacement or impedance of exports of a like product of the complaining Member's exports to a third country market; (c) significant price undercutting, price suppression or depression, or lost sales, of the complaining Member's product in a given market; or (d) an increase in the subsidizing Member's world market share of a subsidized primary product or commodity.

The SCM Agreement also provides special dispute settlement procedures for dealing with actionable subsidies. In the case of actionable subsidies, the expedited timetable is longer than for prohibited subsidies. If as a result of the dispute settlement proceeding adverse effects are determined to exist, the subsidizing member has more time to withdraw the subsidy or remove the adverse effects.

Special and Differential Treatment Provisions — The SCM Agreement recognizes in Article 27 that subsidies may play an important role in economic development programs of developing countries, and in the transformation of centrally-planned economies to market economies. Therefore, the SCM Agreement's disciplines on subsidies of developing countries are far more relaxed and dispute settlement provisions are tilted in favor of developing countries granting subsidies. Least-developed countries and developing countries, such as Indonesia that have less than $1,000 per capita GNP, are exempted from the disciplines on prohibited export subsidies. In addition, such countries are exempt from the disciplines on prohibited subsidies that are contingent on the use of domestic over imported products until January 1, 2000.

The procedures regarding dispute settlement are also different for developing countries. In the case of prohibited subsidies, developing countries are subject to the extended time period provided for actionable subsidies rather than the ones for prohibited subsidies (Article 27.7). Article 27.8 provides that, in the case of subsidies that would normally be presumed pursuant to Articles 6.1 to cause serious prejudice, developing countries are not subject to this presumption and such subsidies must be demonstrated by positive evidence.

In the case of other actionable subsidies, a claim of serious prejudice normally may not be brought against a developing country. Rather, Article 27.9 provides that a complaining party may only invoke the remedies provisions of the SCM Agreement against a developing country's actionable subsidies if it shows the following: That the subsidies are nullifying and impairing tariff concessions or other obligations under GATT 1994 in such a way as to either (a) displace or impede imports of like products of the complaining Member into the market of the subsidizing country or (b) cause injury to a domestic industry in the market of an importing Member.

The text of relevant parts of Articles 1-3, 5-6 and 27 of the SCM Agreement can be found in Appendix A.

Dispute Settlement Procedures — The new WTO came with a system for resolving disputes that was faster and more legalistic, binding and automatic than the system existing under the GATT. The Understanding on Rules and Procedures Governing the Settlement of Disputes ("DSU") provides for 60 days of consultations and then a complaining party has the right to ask the Dispute Settlement Body (DSB), the WTO institution that oversees the operation of the DSU, to establish a panel. Panels are expected to complete their work in approximately six months and the DSB is expected to adopt their report within 60 days. If the panel finds that a defending country's practices are inconsistent with WTO rules, the defendant is expected to bring them into conformity within a reasonable period of time. There is a presumption that a reasonable period of time should not exceed 15 months.

The SCM Agreement permits developing countries to maintain certain subsidies and only requires a country to modify them if it is shown that they are causing serious prejudice to the interests of another country. In contrast, if a measure is found to be violating a GATT article or the TRIMs Agreement, a country is required to bring the measures into conformity with its WTO obligations whether or not it is actually hurting the interests of another WTO member.

The most significant difference between the WTO dispute settlement system and that of the GATT is its automaticity. Under the GATT a defendant could and did block the formation of a panel or the adoption of a panel report. Under the new system the DSB has to approve the formation of a panel no later than the second meeting after the request for one is made. A panel's report is approved unless there is a consensus not to do so.

National Legislation and Approaches to Dealing with Foreign Trade Barriers

Indonesian trade officials, in considering how the United States, European and Japanese governments would react to their continued pursuit of the National Car Program, had to take into account certain domestic laws in the United States which affected the way it dealt with foreign trade barriers. These laws had assumed a certain notoriety due to the way that they had been used in previous trade disputes with other Asian countries. In addition, the EU was seeking to implement its own version of these statutes and to take a more aggressive position in dealing with foreign trade barriers. Japan, on the other hand, was most often viewed as a country that had to defend itself against charges that it engaged in unfair practices that closed its market to foreign products, rather than as a country that took the lead in attacking unfair trade practices in other countries.

The US Section 301 and Super 301 Procedures — The United States was associated with two pieces of trade legislation that became widely criticized in the late 1980's. Section 301 of the Trade Act of 1974 provides a domestic procedure whereby US companies may petition the USTR to investigate foreign government policies or practices that adversely affect US exports or commerce. In particular, Section 301 permits and envisions that the Trade Representative will impose sanctions on another country if the country's trade practices are found to be unfair as a result of a Section 301 investigation and the offending country does not agree to change them. Sanctions often took the form of 100 percent tariffs on selected exports of the offending country.

The United States always argued that it could administer Section 301 in a manner consistent with its WTO obligations. However, other countries complained that the US engaged in unilateral action when it invoked Section 301 to either threaten or actually impose 100 percent duties on products from a country accused of unfair trade barriers. Indonesia had to be aware of recent US uses of Section 301 and Super 301. In the summer of 1995 the United States had threatened to impose 100% duties on Japanese luxury auto exports to the United States if Japan had not agreed to take steps to provide US automakers with better market access. In January of 1995 and again in the spring of 1996 the United States threatened to impose 100 percent duties on a wide range of Chinese exports, including in 1996 apparel exports, if China had not agreed to take steps to introduce strong laws protecting intellectual property rights and to more vigorously enforce those laws.

The Clinton Administration was under some pressure to show that Section 301 was still a viable tool to protect US trade interests. Some domestic critics had complained that the new Uruguay Round dispute-settlement provisions had weakened Section 301 because, if the US imposed sanctions in the form of 100 percent tariffs on products of another WTO member that violated WTO tariff bindings, the country could initiate dispute settlements proceeding in the WTO and the United States could not block the proceeding.

In addition, the Clinton Administration reintroduced in March of 1994 by executive order the Super 301 provisions that had been first enacted in the Omnibus Trade and Competitiveness Act of 1988. In 1995 the executive order was extended for an additional two years. Super 301 was even more controversial than Section 301 because it was conceived at a time when there was a great deal of public concern about the US trade deficit and whether it was caused by unfair trade practices of Asian countries such as Japan. Super 301 directed the USTR to review US trade expansion priorities and identify priority foreign country practices, the elimination of which is likely to have the most significant potential to increase United States exports, either directly or through the establishment of a beneficial precedent. In the eyes of many Asian nations, having one's trade practices identified in the Super 301 report was the equivalent to having the US declare one's country an outlaw and was clearly something to be avoided.

As the Super 301 executive order existed in 1996 the USTR was required to conduct the Super 301 review and issue a report to the Congress by September 30 of every year. In the 1994 and 1995 reports, the USTR did not identify any priority foreign country practices. However, in the context of the 1994 report, USTR launched a regular section 301 of Japanese auto practices. That investigation led to an agreement with Japan in June of 1995 after the USTR threatened to impose 100 percent tariffs on Japanese luxury automobile exports to the United States. In September 1995, Korea was able to avoid having its automobile trade barriers identified in the Super 301 report by reaching a last-minute agreement to reduce them. Super 301 was by 1996 becoming a law the United States was frequently threatening to invoke to resolve disputes concerning automobile trade barriers in Asia.

Europe — In December of 1994 the EU Commission adopted its own version of Section 301, which was called the Trade Barriers Regulation (TBR).[35] The Commission described the TBR as "an instrument of commercial offence to open third country markets by eliminating obstacles to trade for the benefit of Community exporters".[36] The TBR gave EU firms the right to lodge a complaint, which obliges the Commission to investigate and evaluate whether there is evidence of violation of international trade rules resulting in adverse trade effects. The TBR proceeding was expected to lead either to a mutually agreed solution to the problem, or to dispute settlement. Unlike Section 301, the EU only envisaged using the TBR in the context of WTO dispute settlement proceedings in order to avoid the charge of "unilateral action" that it and other countries frequently levied at US Section 301 and Super 301 proceedings. This meant however that the TRB was not as confrontational and feared as the US regulations.

Japan — While Japan did not have legislation or highly visible regulations dealing with foreign trade barriers, it did have a bureaucratic structure and a mechanism for consulting

[35] Council Regulation No. 3286.
[36] See description on EU website under Trade Policy Instruments Existing Instruments: Trade Barriers Regulation, November, 1999.

with its private sector. The Subcommittee on Unfair Trade Policies and Measures is a part of the Committee on the World Trade Organization of the Industrial Structure Council. The Industrial Structure Council is an official advisory body to the Minister of International Trade and Industry.

APPENDIX A

GATT, 1994
Selected Articles

Article III*
National Treatment on Internal Taxation and Regulation

1. The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements effecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.

2. The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph I.

4. The products of the territory of any contracting party imported into the territory of any other contracting party shall be accorded treatment no less favourable than that accorded to like products of national origin in respect of all laws, regulations and requirements affecting their internal sale, offering for sale, purchase, transportation, distribution or use….

8. (a) The provisions of this Article shall not apply to laws, regulations or requirements governing the procurement by governmental agencies of products purchased for governmental purposes and not with a view to commercial resale or with a view to use in the production of goods for commercial sale.
   (b) The provision of this Article shall not prevent the payment of subsidies exclusively to domestic producers, including payments to domestic producers derived from the proceeds of internal taxes or charges applied consistently with the provisions of this Article and subsidies effected through governmental purchases of domestic products.

In addition, Article III must be read in light of the following interpretative provisions found in Annex I of GATT 1994 Notes and Supplementary Provisions:

Ad *Article III*

Any internal tax or other internal charge, or any law, regulation or requirement of the kind referred to in paragraph 1 which applies to an imported product and to the like domestic product and is collected or enforced in the case of the imported product at the time or point of importation, is nevertheless to be regarded as an internal tax or other internal charge, or a law, regulation or requirement of the kind referred to in paragraph 1, and is accordingly subject to the provisions of Article III.

Paragraph 1

The application of paragraph 1 to internal taxes imposed by local governments and authorities with the territory of a contracting party is subject to the provisions of the final paragraph of Article XXIV. The term "reasonable measures" in the last-mentioned paragraph would not require, for example, the repeal of existing national legislation authorizing local governments to impose internal taxes which, although technically inconsistent with the letter of Article III, are not in fact inconsistent with its spirit, if such repeal would result in a serious financial hardship for the local governments or authorities concerned. With regard to taxation by local governments or authorities which is inconsistent with both the letter and spirit of Article III, the term "reasonable measures" would permit a contracting party to eliminate the inconsistent taxation gradually over a transition period, if abrupt action would create serious administrative and financial difficulties.

Paragraph 2
A tax conforming to the requirements of the first sentence of paragraph 2 would be considered to be inconsistent with the provisions of the second sentence only in cases where competition was involved between, on the one hand, the taxed product and, on the other hand, a directly competitive or substitutable product which was not similarly taxed.

WTO Agreement on Trade-Related Investment Measures
Selected Articles

Article 2
National Treatment and Quantitative Restrictions

1. Without prejudice to other rights and obligations under GATT 1994, no Member shall apply any TRIM that is inconsistent with the provisions of Article III or Article XI of GATT 1994.

2. An illustrative list of TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 and the obligation of general elimination of quantitative restrictions provided for in paragraph 1 of Article XI of GATT 1994 is contained in the Annex to this Agreement.

Article 3
Exceptions

All exceptions under GATT 1994 shall apply, as appropriate, to the provisions of this Agreement.

Annex
ILLUSTRATIVE LIST

1. TRIMs that are inconsistent with the obligation of national treatment provided for in paragraph 4 of Article III of GATT 1994 include those which are mandatory or enforceable under domestic law or under administrative rulings, or compliance with which is necessary to obtain an advantage, and which require:

    a. the purchase or use by an enterprise of products of domestic origin or from any domestic source, whether specified in terms of particular products, in terms of volume of products, or in terms of a proportion of volume of its local production…

WTO AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

PART I: GENERAL PROVISIONS

Article 1
Definition of a Subsidy

1.1 For the purpose of this Agreement, a subsidy shall be deemed to exist if:

(a)(1) there is a financial contribution by a government or any public body within the territory of a Member (referred to in this Agreement as "government"), i.e. where:

(i) a government practice involves a direct transfer of funds (e.g. grants, loans, and equity infusion), potential direct transfers of funds or liabilities (e.g. loan guarantees);

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)[37];

(iii) a government provides goods or services other than general infrastructure, or purchases goods;

(iv) a government makes payments to a funding mechanism, or entrusts or directs a private body to carry out one or more of the type of functions illustrated in (i) to (iii) above which would normally be vested in the government and the practice, in no real sense, differs from practices normally followed by governments;

or

(a)(2) there is any form of income or price support in the sense of Article XVI of GATT 1994;

and

(b) a benefit is thereby conferred.

1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2.

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[37]In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, 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.

Article 2
Specificity

2.1 In order to determine whether a subsidy, as defined in paragraph 1 of Article 1, is specific to an enterprise or industry or group of enterprises or industries (referred to in this Agreement as "certain enterprises") within the jurisdiction of the granting authority, the following principles shall apply:

(a) Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.

(b) Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions[38] governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.

(c) If, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) and (b), there are reasons to believe that the subsidy may in fact be specific, other factors may be considered. Such factors are: use of a subsidy programme by a limited number of certain enterprises, predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy.[39] In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

2.2 A subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific. It is understood that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement.

2.3 Any subsidy falling under the provisions of Article 3 shall be deemed to be specific.

2.4 Any determination of specificity under the provisions of this Article shall be clearly substantiated on the basis of positive evidence.

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[38]Objective criteria or conditions, as used herein, mean criteria or conditions which are neutral, which do not favour certain enterprises over others, and which are economic in nature and horizontal in application, such as number of employees or size of enterprise.

[39]In this regard, in particular, information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered.

PART II: PROHIBITED SUBSIDIES

Article 3
Prohibition

3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact[40], whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I[41];

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1.

PART III: ACTIONABLE SUBSIDIES

Article 5
Adverse Effects

No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e.:

(a) injury to the domestic industry of another Member[42];

(b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994[43];

(c) serious prejudice to the interests of another Member.[44]

This Article does not apply to subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture.

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[40] This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.

[41] Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

[42] The term "injury to the domestic industry" is used here in the same sense as it is used in Part V.

[43] The term "nullification or impairment" is used in this Agreement in the same sense as it is used in the relevant provisions of GATT 1994, and the existence of such nullification or impairment shall be established in accordance with the practice of application of these provisions.

[44] The term "serious prejudice to the interests of another Member" is used in this Agreement in the same sense as it is used in paragraph 1 of Article XVI of GATT 1994, and includes threat of serious prejudice.

Article 6
Serious Prejudice

6.1 Serious prejudice in the sense of paragraph (c) of Article 5 shall be deemed to exist in the case of:

(a) the total ad valorem subsidization[45] of a product exceeding 5 per cent[46];

(b) subsidies to cover operating losses sustained by an industry;

(c) subsidies to cover operating losses sustained by an enterprise, other than one-time measures which are non-recurrent and cannot be repeated for that enterprise and which are given merely to provide time for the development of long-term solutions and to avoid acute social problems;

(d) direct forgiveness of debt, i.e. forgiveness of government-held debt, and grants to cover debt repayment.[47]

6.2 Notwithstanding the provisions of paragraph 1, serious prejudice shall not be found if the subsidizing Member demonstrates that the subsidy in question has not resulted in any of the effects enumerated in paragraph 3.

6.3 Serious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one or several of the following apply:

(a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member;

(b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market;

(c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market;

(d) the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity[48] as compared to the average share it had during the previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted.

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[45]The total ad valorem subsidization shall be calculated in accordance with the provisions of Annex IV.

[46]Since it is anticipated that civil aircraft will be subject to specific multilateral rules, the threshold in this subparagraph does not apply to civil aircraft.

[47]Members recognize that where royalty-based financing for a civil aircraft programme is not being fully repaid due to the level of actual sales falling below the level of forecast sales, this does not in itself constitute serious prejudice for the purposes of this subparagraph.

[48]Unless other multilaterally agreed specific rules apply to the trade in the product or commodity in question.

6.4 For the purpose of paragraph 3(b), the displacement or impeding of exports shall include any case in which, subject to the provisions of paragraph 7, it has been demonstrated that there has been a change in relative shares of the market to the disadvantage of the non-subsidized like product (over an appropriately representative period sufficient to demonstrate clear trends in the development of the market for the product concerned, which, in normal circumstances, shall be at least one year). "Change in relative shares of the market" shall include any of the following situations: *(a)* there is an increase in the market share of the subsidized product; *(b)* the market share of the subsidized product remains constant in circumstances in which, in the absence of the subsidy, it would have declined; *(c)* the market share of the subsidized product declines, but at a slower rate than would have been the case in the absence of the subsidy.

6.5 For the purpose of paragraph 3(c), price undercutting shall include any case in which such price undercutting has been demonstrated through a comparison of prices of the subsidized product with prices of a non-subsidized like product supplied to the same market. The comparison shall be made at the same level of trade and at comparable times, due account being taken of any other factor affecting price comparability. However, if such a direct comparison is not possible, the existence of price undercutting may be demonstrated on the basis of export unit values.

6.6 Each Member in the market of which serious prejudice is alleged to have arisen shall, subject to the provisions of paragraph 3 of Annex V, make available to the parties to a dispute arising under Article 7, and to the panel established pursuant to paragraph 4 of Article 7, all relevant information that can be obtained as to the changes in market shares of the parties to the dispute as well as concerning prices of the products involved.

6.7 Displacement or impediment resulting in serious prejudice shall not arise under paragraph 3 where any of the following circumstances exist[49] during the relevant period:

(a) prohibition or restriction on exports of the like product from the complaining Member or on imports from the complaining Member into the third country market concerned;

(b) decision by an importing government operating a monopoly of trade or state trading in the product concerned to shift, for non-commercial reasons, imports from the complaining Member to another country or countries;

(c) natural disasters, strikes, transport disruptions or other *force majeure* substantially affecting production, qualities, quantities or prices of the product available for export from the complaining Member;

(d) existence of arrangements limiting exports from the complaining Member;

(e) voluntary decrease in the availability for export of the product concerned from the complaining Member (including, *inter alia*, a situation where firms in the complaining Member have been autonomously reallocating exports of this product to new markets);

(f) failure to conform to standards and other regulatory requirements in the importing country.

[49]The fact that certain circumstances are referred to in this paragraph does not, in itself, confer upon them any legal status in terms of either GATT 1994 or this Agreement. These circumstances must not be isolated, sporadic or otherwise insignificant.

6.8 In the absence of circumstances referred to in paragraph 7, the existence of serious prejudice should be determined on the basis of the information submitted to or obtained by the panel, including information submitted in accordance with the provisions of Annex V.

6.9 This Article does not apply to subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture.

PART VIII: DEVELOPING COUNTRY MEMBERS

Article 27
Special and Differential Treatment of Developing Country Members

27.1 Members recognize that subsidies may play an important role in economic development programmes of developing country Members.

27.2 The prohibition of paragraph 1(a) of Article 3 shall not apply to:

(a) developing country Members referred to in Annex VII.

(b) other developing country Members for a period of eight years from the date of entry into force of the WTO Agreement, subject to compliance with the provisions in paragraph 4.

27.3 The prohibition of paragraph 1(b) of Article 3 shall not apply to developing country Members for a period of five years, and shall not apply to least developed country Members for a period of eight years, from the date of entry into force of the WTO Agreement.

27.4 Any developing country Member referred to in paragraph 2(b) shall phase out its export subsidies within the eight-year period, preferably in a progressive manner. However, a developing country Member shall not increase the level of its export subsidies[50], and shall eliminate them within a period shorter than that provided for in this paragraph when the use of such export subsidies is inconsistent with its development needs. If a developing country Member deems it necessary to apply such subsidies beyond the 8-year period, it shall not later than one year before the expiry of this period enter into consultation with the Committee, which will determine whether an extension of this period is justified, after examining all the relevant economic, financial and development needs of the developing country Member in question. If the Committee determines that the extension is justified, the developing country Member concerned shall hold annual consultations with the Committee to determine the necessity of maintaining the subsidies. If no such determination is made by the Committee, the developing country Member shall phase out the remaining export subsidies within two years from the end of the last authorized period.

27.5 A developing country Member which has reached export competitiveness in any given product shall phase out its export subsidies for such product(s) over a period of two years. However, for a developing country Member which is referred to in Annex VII and which has

[50]For a developing country Member not granting export subsidies as of the date of entry into force of the WTO Agreement, this paragraph shall apply on the basis of the level of export subsidies granted in 1986.

reached export competitiveness in one or more products, export subsidies on such products shall be gradually phased out over a period of eight years.

27.6 Export competitiveness in a product exists if a developing country Member's exports of that product have reached a share of at least 3.25 per cent in world trade of that product for two consecutive calendar years. Export competitiveness shall exist either *(a)* on the basis of notification by the developing country Member having reached export competitiveness, or *(b)* on the basis of a computation undertaken by the Secretariat at the request of any Member. For the purpose of this paragraph, a product is defined as a section heading of the Harmonized System Nomenclature. The Committee shall review the operation of this provision five years from the date of the entry into force of the WTO Agreement.

27.8 There shall be no presumption in terms of paragraph 1 of Article 6 that a subsidy granted by a developing country Member results in serious prejudice, as defined in this Agreement. Such serious prejudice, where applicable under the terms of paragraph 9, shall be demonstrated by positive evidence, in accordance with the provisions of paragraphs 3 through 8 of Article 6.

27.9 Regarding actionable subsidies granted or maintained by a developing country Member other than those referred to in paragraph 1 of Article 6, action may not be authorized or taken under Article 7 unless nullification or impairment of tariff concessions or other obligations under GATT 1994 is found to exist as a result of such a subsidy, in such a way as to displace or impede imports of a like product of another Member into the market of the subsidizing developing country Member or unless injury to a domestic industry in the market of an importing Member occurs.

27.13 The provisions of Part III shall not apply to direct forgiveness of debts, subsidies to cover social costs, in whatever form, including relinquishment of government revenue and other transfer of liabilities when such subsidies are granted within and directly linked to a privatization programme of a developing country Member, provided that both such programme and the subsidies involved are granted for a limited period and notified to the Committee and that the programme results in eventual privatization of the enterprise concerned.

27.14 The Committee shall, upon request by an interested Member, undertake a review of a specific export subsidy practice of a developing country Member to examine whether the practice is in conformity with its development needs.

27.15 The Committee shall, upon request by an interested developing country Member, undertake a review of a specific countervailing measure to examine whether it is consistent with the provisions of paragraphs 10 and 11 as applicable to the developing country Member in question.