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Subsidies and State Aids
The Definition of Acceptable Measures under the European Union and GATT Rules

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1. INTRODUCTION

The use of government subsidies is frequently the cause of friction in international economic relations. Examples of high-level, high profile disputes are legion in discussions on world trade issues: the controversy surrounding support for many of Europe's ailing airlines; US opposition to funding for the Airbus consortium; concern at the high levels of financial assistance granted for new car plants in the US and Europe; the apparently ongoing dispute over aid for steel production; and the recent disagreement over shipbuilding subsidies.

More generally, the substantial reduction or elimination of tariffs within global or regional trading arrangements has meant that attention has focused increasingly on other barriers to trade. In this context, the use, and perceived abuse, of government subsidies has become a major target for criticism in international trade fora.

At the same time, a number of studies have begun to cast light on the volumes of expenditure involved in subsidising industry. The OECD (1992), for example, estimated annual average expenditure over the period 1986-89 to be some $66 billion (around ECU 51 billion)[1]. As part of the Single Market programme, the European Commission undertook an inventory of State aids in the European Union and now publishes regular reports on expenditure. Data in the first of these surveys (CEC, 1988) suggests that the Member States spent some 43 percent more on State aids than was generated in corporation tax revenues! The latest survey published (CEC, 1992) found annual average spending of some ECU 36 billion on State aids to manufacturing industry alone over the period 1988-90[2].

The benefits and drawbacks of subsidies and their effects on the economies in which they are offered, as well as on other economies, have been argued over by trade and industrial economists for many decades. Moreover, as will be seen, the notion of what actually constitutes a subsidy is itself a troublesome question.

The principal concerns about the *harmful* effects of subsidies centre around two sets of issues: economic and trade distortions; and subsidies as "unfair" trade practices[3]. According to classical free trade theory, subsidies can be expected to have two main effects on a domestic market: the reduction of costs to the producer and / or the reduction of the price of the product to the consumer. Resource allocation is affected since more of the product will be sold or produced than would have been the case in the absence of the subsidy. Firms in receipt of subsidies may be able to increase or maintain their market share at the expense of other more efficient firms which may, in extreme cases, be forced to withdraw from the market. It follows from this argument that overall welfare in the subsidising country is reduced since its resources are not being used efficiently.

1 Moreover, the report stressed that its information was based on incomplete reporting by the 22 member countries so that in practice, actual spending was almost certainly considerably higher.

2 As with the OECD report quoted above, there is virtually no disaggregation of the data making it difficult to draw detailed meaningful conclusions, and these figures too are probably underestimates.

3 This discussion draws on Jackson, 1989; Ford and Suyker, 1990; CEC, 1994; and Behboodi, 1994.

From an international perspective, the principal issue is not the *internal* diseconomies and distortions of the subsidising country, but rather the distortion of the economies of other countries. This occurs where the lower costs of subsidised products result in a misallocation of output between foreign and domestic markets and the diversion of resources to less efficient producers. The effect of the subsidy may be the substitution of domestic products for imports and the expansion of exports. A second issue is that subsidies can be effective instruments of protectionism and may replace tariffs as the main source of distortion in international trade.

The so-called “fair trade” argument is essentially a moral one which seems to be centred around an idealised attachment to the principles of a market economy and the notion of a “level playing field”. The principal concern here, which is most vocally expressed by US businesses, is the capacity of firms in the importing country to compete with subsidised imports. The “fairness” argument is difficult to sustain since it assumes that, in the absence of subsidies, the “playing field would otherwise be level”; consideration of the social and economic context and the comparative advantages of nations shows that this is patently not the case. Nevertheless, this is the rationale for retaliatory action against subsidies in the form of countervailing duties, where the aim is to offset the value of the subsidy on an imported product by the imposition of a duty. However, two observations are worth making here. First, Jackson (1989) suggests that “the country who does the subsidizing loses in net national welfare, while the rest of the world gains”. Second, and related, the main promoters of the “fairness” argument tend to be aggrieved producers. These generally have a higher profile than consumer interests which are arguably not best served by the imposition of duties on imported products.

The arguments against subsidies are frequently based on assumptions of perfect competition; in reality, however, this is essentially a theoretical construct. Consequently, in practice, the main justifications for subsidies reflect the presence of market imperfections.

The most commonly cited type of market imperfection occurs in the presence of externalities, that is, when there is a difference between private costs and benefits, and the costs and benefits from the point of view of society as a whole. Obvious instances of positive externalities include R&D and training. The amount of R&D and training which firms are prepared to undertake may be sub-optimal since the benefits may be spread widely but the costs are borne by the firm; in the absence of subsidies towards such costs, some firms may opt to act as “free-riders” by exploiting inventions and attracting skilled labour financed by others but not funding R&D or training themselves.

A frequently cited example of a negative externality is pollution. In the absence of effective regulation or mechanisms for applying the “polluter pays” principle, the only feasible route may be to provide subsidies to support the costs of environmental protection.

Market imperfections also result from the absence of perfect information and an increased aversion to risk as a consequence. This is most likely to impact on so-called “infant industries” and small and medium-sized firms where the degree of uncertainty is perceived to be higher and access to finance from market sources is therefore more difficult and costly. In this context it can be argued that some such activities would be not undertaken without government intervention.

A further aspect of market imperfection concerns the mobility of factors of production. Labour mobility, for example, is limited (although it is by no means clear that perfect mobility of labour would be desirable); as geographical patterns of economic activity change (and often rapidly) there may be efficiency as well as equity-based arguments for governments to intervene to influence the location of productive investments through the operation of regional policies.

In short, economic theory suggests that subsidies involve distortions and therefore welfare losses into domestic and global economies; however, in the presence of market imperfections, subsidies may actually restore efficiency. On the other hand., much government policy involving the use of subsidies is not explicitly designed to improve economic efficiency by countering market failure, but rather aims at wider objectives that are not considered to be addressed adequately by market mechanisms. Nevertheless, it remains the case that “there is no consensus on an optimal norm for subsidy policy” (Lehner and Meiklejohn, 1991).

Reflecting these arguments, as well as wider political considerations, government attitudes to subsidies are characterised by a certain ambivalence. The United Kingdom government, for example, takes the view that “[I]t owes it to UK industry to ensure that its increasing competitiveness is not undermined by unfair subsidies given by other governments” (HMSO, 1994); on the other hand, there are numerous examples of government subsidised investments in the United Kingdom that have attracted criticism from other countries[4].

Similarly, US arguments against the use of subsidies have been described as exhibiting “an almost spiritual attachment, a sort of mystical faith, in a marketplace in which private actors are not assisted by the state, but rather thrive on the fruits of their own labour” (Behboodi, 1994). However, it is well-known that sub-federal level governments in the US provide significant levels of financial assistance to firms and regularly compete for mobile investments by offering subsidies, often in the form of tax concessions. According to Fry (quoted in Trebilcock and Howse, 1995), “at the end of the 1980s, the total annual tab for targeted assistance at the subnational level was over $20 billion for non-agricultural businesses; expenditures and lost revenues for the states approaches $200 billion.”

The central issue is that while there may be compelling domestic reasons for providing subsidies, in practice, in an increasingly interdependent international economy, measures that are *ostensibly* domestic can have effects that go beyond national frontiers. The need for a balance to be struck between these potentially conflicting interests has made the control or discipline of subsidies a matter of growing concern within the European Union and under the global trading arrangements governed by the GATT rules.

The aim of this paper is to compare and contrast two separate systems for defining and disciplining subsidies in the international arena: the rules established on the basis of the Treaty of Rome for the regulation of so-called “State aids” *within* the European Union; and the agreement reached under the Uruguay Round of GATT negotiations with respect to the control of subsidies in a *global* environment. The

4 Aid to the Hualon Corporation for investment in Northern Ireland and financial assistance provided in the context of the sale of Rover to British Aerospace are among recent examples.

focus of the paper is on domestic subsidies[5] to industry and on the *substance* of the rules, as opposed to the institutional or procedural aspects.

The paper begins by outlining the main features of the EU and GATT approaches to State aids and subsidies in turn. In a second section, the question of how State aids and subsidies are defined under the two systems is considered. The third section reviews the provisions concerning "acceptable" types of assistance and the respective rules applicable. A concluding section identifies the main contrasts between the approaches of the two systems and highlights those that raise issues for consideration in the EU.

5 Most authors, for example, Horlick *et al* (1986) and Jackson (1989) deem domestic subsidies to be those which are not contingent upon the export of production.

2. EUROPEAN UNION AND GATT APPROACHES TO CONTROLLING SUBSIDIES

The starting points for subsidy discipline within the European Union and under the GATT rules are fundamentally different. Trade between European Union countries can be considered *internal* rather and than *international* trade and it follows from this that subsidy-related issues that affect trade between EU Member States are dealt with as part of competition policy[6]; the creation and maintenance of a system of undistorted competition is one of the basic principles of the Union. Reflecting this, the European Union system of subsidy discipline is characterised by *supranationalism* and notably the central role played by the European Commission.

In contrast, the GATT system is essentially *multilateral* in approach; there is no provision for the type of supervisory role played by the European Commission. As a result, discipline can only be imposed when complaints are brought. In addition, however, there is a significant *unilateral* dimension to subsidy regulation under the GATT; the agreement permits the imposition of countervailing duties (CVD) to offset the value of subsidies paid on imported products. CVD laws are established under domestic legislation and the conditions under which they are levied decided by domestic courts[7].

2.1 The EU Approach to Controlling Subsidies

The basic provisions for controlling subsidies were incorporated into the Treaty of Rome; it was recognised from the start that mechanisms to control subsidies to firms were an essential component in the rules underpinning the establishment of a common market. As other barriers to trade such as tariffs and quotas were being outlawed, the temptation for governments to resort to other instruments of protectionism was considered likely to increase.

More recently, this view has been reinforced; a number of influential reports (Cecchini, 1988; Padoa-Schioppa, 1987) stressed the need for strict control of subsidies in the context of the completion of the internal market. The further dismantling of barriers to trade that was to take place as part of the Single European Market programme (including public procurement and discriminatory national product standards) would leave subsidies as one of few measures of protectionism at the disposal of EU governments. This meant not only that governments were perceived to be more likely to use subsidies, but also that the *effects* of subsidies would be felt more keenly by competitors in other countries. In response to this, the control of State aids moved higher up the Community policy agenda in the late 1980s. This was reflected in a systematic attempt to catalogue the aids on offer in the EU and the use of this to identify major areas of government expenditure on subsidies and priorities for Commission scrutiny[8].

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[6] One exception to this is support for exports outside the EU; such measures potentially have both internal and international trade effects. In practice, this has resulted in something of a “turf war” between DGIV and DGI (External Relations), with the result that the internal effects of aids for exports to non-EU countries appear to have been neglected.

[7] Again, reflecting the “internal” nature of the EU market, EU countries have renounced the use of CVDs between themselves; however, there is provision for CVD duties to be levied at the European level. This paper is not concerned with EU countervailing provisions but with the *internal* subsidy control mechanisms.

[8] The inventory produced by the Commission has never been made public because of opposition from the Member States. However, the information gathered did lead the Commission to shift its

2.1.1 The Legal Basis for EU Policy

In spite of the resurgence of interest in the issue of government subsidies in the run up to 1992, the legal basis of policy and action on State aids in the European Union has remained substantially unchanged since the Treaty of Rome[9]; the key provisions are Articles 92 to 94[10].

The first paragraph of Article 92 provides that:

> "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between the Member States, be incompatible with the common market."

The second paragraph (Article 92(2)), indicates those aids that are *de jure* exempted from this general ban. Three categories of aid are identified. In broad terms, these are: aids of a "social" nature[11]; aids related to the damage caused by natural disasters[12]; and aids to parts of the Federal Republic of Germany affected by the division of Germany[13].

The third paragraph (Article 92(3)) outlines those types of aid that *may* be considered to be compatible with the common market. These are:

> a) aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment;
>
> b) aid to promote the execution of an important project of common European interest or to remedy a serious disturbance in the economy of a Member State;
>
> c) aid to facilitate the development of certain economic activities or of certain economic areas where such aid does not adversely affect trading to an extent contrary to the common interest…

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focus away from new aid schemes and instead to review many of the schemes it had approved in the past. In doing so, the Commission proposed to concentrate on general investment aids, aids to State-owned industry and export aids (CEC, 1990a).

9 The Treaty on European Union added a new Article 92(3)(d) - relating to aids for culture and heritage conservation - and amended Article 94 to involve consultation of the European Parliament in the event of the Council making regulations on the application of Articles 92 and 93.

10 These articles are the focus of this paper. However, rules on subsidies to agriculture and transport are dealt with elsewhere under the Treaty and rules on subsidies to the coal and steel industries are contained in the European Coal and Steel Community Treaty, the Treaty of Paris; these sectors are not covered in this paper.

11 Aid must be granted to individual consumers and not undertakings (*Luigi Benedetti* v *Munari F.lli s.a.s* [1977] ECR 163).

12 Such as floods, droughts, earthquakes and volcanic eruptions (CEC, 1979).

13 For most of the post-war period the German Federal government operated special measures for the so-called Zonal Border Area (the *Zonenrangebiet*) and West Berlin under these provisions. However, the Commission increasingly questioned the appropriateness of continuing special treatment. With the reunification of Germany, and consequent emphasis on the reconstruction of the new *Länder*, this provision seems likely to fall into desuetude.

d) aid to promote culture and heritage conservation where such aid does not affect trading conditions and competition in the Community to an extent that is contrary to the common interest;

e) such other categories of aid as may be specified by decision of the Council acting by qualified majority on a proposal from the Commission.

In short, Article 92 provides for a general prohibition of State aids insofar as they affect trade between the Member States, but then goes on to identify those aids which *are* compatible with the Treaty and those aids which *may* be compatible with the Treaty.

Perhaps the most striking feature of Article 92 is that it does not define what an aid actually *is*. Most commentators (for example, Schina, 1987) take the view that this apparent omission was intentional on the part of the authors of the Treaty; a clear definition would simply have encouraged governments to find ingenious ways of circumventing the rules. Moreover, a consideration of the wide-ranging powers accorded to the European Commission in the implementation of Article 92 supports this view.

2.1.2 The Role of the European Commission in Monitoring and Controlling State Aids

The basis for the Commission's powers in respect of State aids is Article 93. In practice, these are exercised through the Directorate-General for Competition Policy, DGIV.

(i) *Scrutiny*

Article 93(1) empowers the Commission to keep under constant review all systems of aid existing in the Member States and to propose changes to those measures. Article 93(3) obliges Member States to give prior notification to the Commission of any plans to grant or alter aid[14]; Member States are required not to put the proposed measures into effect until the Commission has reached a final decision. These two aspects of the Commission's role (the review of existing aids and the approval of new aids or changes to existing aids) are linked by an examination and review procedure provided for under Article 92(2). This enables the European Commission, subject to appeal to the European Court of Justice, to propose changes or to require the abolition of an aid offered by a Member State.

It is worth noting at this juncture that the Commission is not generally involved in scrutinising individual awards to firms[15]. Rather, the Commission approves the general framework of an aid scheme and allows the Member State to operate that

[14] The only exception to this is so-called *de minimis* aid. The Community Guidelines on State Aids for SMEs (OJEC C213; 19 August 1992) provide that payments of less than ECU 50,000 to any one firm (of any size) within a three-year period need not be notified under Article 93(3). It is interesting to consider in passing whether in fact the Commission has the competence to make such a rule; Article 94 provides that "the *Council* may, acting by qualified majority on a *proposal* from the Commission… make appropriate regulations for the application of Articles 92 and 93 and may, in particular, determine the conditions in which Article 93(3) shall apply and the categories of aid exempted from this procedure." [emphases added].

[15] In practice, however, the most high profile cases do tend involve individual firms. Moreover, individual cases probably account for a significant proportion of DGIV resources.

scheme within the parameters approved[16]; the vast majority of aid awards to firms are made in the context of schemes or programmes[17].

In undertaking reviews under Article 93, the Commission is required to assess the aids concerned against the provisions of Article 92. However, the application of Articles 92 and 93 has been characterised by the absence of procedural clarity; unlike the provisions relating to Article 85, the Council has never adopted Regulations on the basis of Article 94 to determine the rules and criteria according to which the Commission should take decisions on State aids. This has received considerable attention in the academic literature (for example, Slot, 1990; Winter, 1993); however, the key point to note here is that the absence of Council intervention has enhanced the role of the Commission, increasing its scope for discretion. A bi-product of this has been the Commission trend towards frameworks or codes to outline the conditions under which particular types of State aid are acceptable. This has grown into a significant body of rules (CEC, 1990b) running into several hundred pages and involving extensive interpretation and elaboration of the basic principles enunciated in the Treaty, most notably Article 92(3).

At the same time, Commission discretion has been reinforced by judgements of the Court of Justice; the Court appears to have been reluctant to pronounce on the *substance* of Commission decisions, apparently preferring to limit its review to consider misuse of powers, manifest error or procedural irregularity (Hancher, 1994). As a result, the Commission has enjoyed considerable discretion in the exercise of its powers under Article 93 and this with considerably less interference from the Court of Justice than in the application of Article 85.

(ii) *Enforcement*

The Commission's powers of scrutiny are backed by provisions for the enforcement of its decisions. It has long been established that the Commission has the power to require the repayment of aid paid out illegally[18]; moreover, the provisions of national law, with regard to legal certainty and legitimate expectation[19], and threats to the viability of the recipient firm if reimbursement is required[20] are no defence against repayment orders. On the other hand, it is worth noting that the actual record in securing recovery of aid paid out is quite poor[21]. In addition, it can be argued that there is least motivation for Member States to notify State aid in precisely the cases which the Commission is likely to find most objectionable. In the case of aid for rescue and restructuring, government action is often required to be swift to assure the survival of the firm. The delay involved in notification may put the firm in further jeopardy; moreover, there is every chance that the Commission will not authorise the aid concerned. As a result, there are many instances where unnotified government

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[16] These include, as appropriate, the spatial coverage of the scheme, the type of expenditure that may be subsidised, the sectors that may be supported, the size of firms that qualify for assistance and the total budget for the scheme.

[17] On the other hand, individual awards frequently involve considerably larger sums than entire aid schemes: for example, support for Air France approved in July 1994 amounted to some FF 20 billion (about ECU 3 billion) and assistance for Crédit Lyonnais approved in July 1995 totalled FF 45 billion (almost ECU 7 billion); according to the Commission's *Third Survey* (CEC, 1992) average annual expenditure on State aids in France was ECU 16 billion over the period 1988-90.

[18] *Commission of the European Communities* v *Federal Republic of Germany* [1973] ECR 813.

[19] *Commission of the European Communities* v *Federal Republic of Germany* [1989] ECR 175.

[20] *Commission of the European Communities* v *Kingdom of Belgium* [1986] ECR 89.

[21] In only 13 cases (out of 46 orders) was repayment secured between 1982 and 1993 (CEC, 1994a).

intervention has enabled firms in difficulty to continue to operate and where the aid has subsequently been "uncovered". If repayment is required, this typically takes place several years later; in short, there is an inherent temptation for governments to take the risk of the aid being discovered.

This temptation arguably remains, in spite of the outcome of the *Boussac* case[22]. This established that the Commission could issue an interim order requiring immediate suspension of unnotified aid; in this respect it represents an enhancement of Commission powers, which the Commission frequently cites. However, the Court stopped short of declaring that unnotified aids were *per se* illegal; the Commission must still proceed to examine the aid concerned on its merits to establish its compatibility with the Treaty.

An aspect which is notably absent from the enforcement provisions with respect to the control of State aids is any form of unilateral action or retaliatory mechanism available to the Member States. However, Member States (and other interested parties) can challenge Commission decisions to approve State aid in another Member State and its failure to prohibit them.

2.2 The GATT Approach to Controlling Subsidies

The original GATT agreement of 1947 contained little in the way of rules governing subsidies, except to permit the use of countervailing duties in response to subsidies provided by other Members. Article XVI provided for a fairly general reporting requirement and there was a prohibition on the use of new subsidies to inhibit imports when that country had bound its tariff on the product concerned. However, beyond these provisions, there were no other substantive rules on subsidy practices. The 1955 review session amendments introduced the first substantive obligations regarding subsidies, but these were primarily concerned with export subsidies.

Under the Tokyo Round, negotiations culminated in a "Subsidies Code"[23] in 1979. For the first time, this created international obligations of a multilateral character that explicitly concerned domestic subsidies. However, Jackson (1989) notes that "the Subsidies Code has had a very difficult history subsequent to the completion of the Tokyo Round". In large measure this reflects wide differences of opinion between the contracting parties about the definition, scope and measurement of subsidies and the terms governing the imposition of countervailing duties (Alessandrini, 1991). Resolution of these differences became the major objective of the Uruguay Round negotiations on the Subsidies Code.

2.2.1 The GATT 1994 Subsidies Code

A new Subsidies Code[24] emerged from the Uruguay Round of GATT negotiations concluded in 1993. This is part of the single undertaking that binds all WTO Members. Moreover, the Code does not provide for "grandfather" rights; as such, any existing subsidies that are inconsistent with the Code must be notified within 90 days of the WTO Agreement entering into force and brought into conformity with the Code within three years (Article 28).

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[22] *French Republic* v *Commission of the European Communities* [1990] ECR I-307.

[23] *Agreement on Interpretation and Application of Article VI, XVI and XXIII of the General Agreement on Tariffs and Trade,* GATT, BISD 26th Supp. 56, 1980.

[24] *Agreement on Subsidies and Countervailing Measures*, Final Act Embodying the Result of the Uruguay Round of Multilateral Negotiations, 15 April 1994.

The new Code sought to bridge the very different interests and priorities of the signatories. The United States favoured strengthening subsidy discipline by broadening the category of prohibited subsidies and reinforcing GATT remedies. Most other countries considered that it was countervailing actions that were in need of greater discipline and that subsidies were legitimate instruments of social and economic policy. Some participants, whilst acknowledging the need for discipline in general, sought to protect certain types of subsidy from retaliatory action (Stewart, 1993). These differing positions are reflected in the outcome of the negotiations which resulted in a Code that tightens subsidy discipline and applies stricter conditions to the imposition of countervailing duties.

The Agreement begins with the definition of a subsidy (Article 1), an element that was noticeably absent from the 1979 Code. A subsidy is deemed to be “a financial contribution by a government or any public body” involving the conferral of “a benefit”. In order to fall within the ambit of the rules, a subsidy must be “specific”; the Agreement goes on to define the notion of specificity (Article 2).

Thereafter, the Agreement sets out three categories of subsidy: those which are prohibited (Article 3); those which are actionable (Article 5); and those which are non-actionable (Article 8). This approach has been characterised in the “traffic light” analogy adopted in the north American literature (Jackson, 1989). The categorisation of a subsidy has important consequences for the action that may be taken against it in the case of complaints.

In broad terms, *prohibited* (red light) subsidies are those that are made available on condition of export performance, in law or in fact, or the use of domestic goods in preference to imported goods.

Actionable (amber light) subsidies are those not falling into either the “red light” or the “green light” group, but which cause adverse effects to the interests of other Members. Three types of effect are identified:

a) injury to the domestic industry of another Member;

b) nullification or impairment of benefits accruing under GATT 1994;

c) serious prejudice to the interests of another Member.

Non-actionable (green light) subsidies are divided into two groups: first, those that are not “specific” (Article 8(1)(a)); and second, those that *are* specific but that fall into one of three identifiable categories (Article 8(1)(b)). These categories are detailed in Article 8(2) and, in broad terms, are as follows:

a) assistance for research activities conducted by firms or by higher education or research establishments on a contract basis;

b) assistance to disadvantaged regions within the territory of a Member;

c) assistance to promote the adaptation of existing facilities to new environmental requirements.

Special notification requirements apply where a Member considers that a subsidy falls into one of the three actionable categories.

2.2.2 Notification Requirements

As under previous arrangements, the GATT 1994 Subsidies Code contains notification requirements. Article 25 contains a general requirement for Members to notify subsidies operated within their territories to the WTO Secretariat. This applies to all specific subsidies and the notification must be sufficiently detailed to enable other Members to evaluate the trade effects and understand the operation of the programme. The information provided must include the following: the form of the subsidy; its value (per unit or in total); the policy objective; the duration of the programme; and statistical data permitting an assessment of the trade effects of a subsidy. Notifications must be made by 30 June each year. In the past, it seems that most GATT signatories have ignored the notification requirement. It remains to be seen whether compliance is improved under the 1994 Code, but by the end of 1995, fewer than a quarter of Members had notified subsidy programmes to the Secretariat[25].

More stringent rules apply to existing subsidy programmes that are not in conformity with the Code. As noted earlier, these must be notified within 90 days of the entry into force of the WTO Agreement and must be brought into line within three years. However, within that period, such subsidies are not subject to the provisions on prohibited subsidies (ie. Articles 3 and 4).

Furthermore, different rules apply where a Member considers that a programme falls into the green light category. Such programmes must be notified to the Subsidies Committee[26] *in advance* of their implementation. Notification must be sufficiently detailed for other Members to be able to evaluate the consistency of the programme with the criteria relating to the non-actionability of research, regional development and environmental protection aids as provided for in Article 8.2. Annual updates of such notifications, including details of changes to the programme and levels of global expenditure must also be provided. Other Members have the right to request information about individual cases under a notified programme, although there is no requirement for disclosure of confidential information.

The obligation to notify green light subsidies *in advance* of their implementation raises the question of the status of *existing* subsidies for which Members consider that Article 8.2 can be invoked. It seems unreasonable to conclude that existing subsidies must be actionable even if they meet the terms of Article 8.2; on the other hand, the need to notify such measures in advance suggests this. In any event, it seems that, by the end of 1995, no Member had notified subsidies under Article 8.3[27]

2.2.3 Remedies under the GATT 1994 Subsidies Code

As noted earlier, the GATT comprises both multilateral and unilateral aspects to subsidy discipline in the form of the World Trade Organisation (WTO) dispute settlement procedure and the provisions for countervailing actions respectively. The availability of these is determined by the categorisation of the subsidy concerned.

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[25] *"Good Beginning to Uruguay Round Implementation" says WTO Director General*, Press 33, WTO, 8 December 1995.

[26] The establishment of a Committee on Subsidies and Countervailing Measures is provided for under Article 24. The Committee is to be composed of representatives of each of the Members.

[27] Discussion with DGI European Commission official.

(i) *WTO Dispute Settlement Procedures*

A Member suspected of operating a *prohibited* subsidy[28] must agree to consultations on request. The purpose of these is to clarify the facts and arrive at a mutually acceptable solution. If this is not reached within 30 days, then the matter is referred to the Dispute Settlement Body (DSB), which will normally establish a Panel. If the measure is found to be a prohibited subsidy, the Panel will recommend the withdrawal of the measure within a specified time period; in the event that the recommendation is not followed, the complainant may be authorised to take appropriate countermeasures.

In the case of *actionable* subsidies there is, as noted above, a requirement for injury, nullification or impairment of benefits or serious prejudice to be shown[29]. Serious prejudice may arise where there is an effect on volume or price of trade in the relevant product. There is a *presumption* of serious prejudice in the case of: total *ad valorem* subsidies of a product exceeding 5 percent; subsidies to cover operating losses; and direct forgiveness of debt. This is a rebuttable presumption in the sense that the subsidising Member may demonstrate that the subsidy has had no impact on volume or price of trade in the relevant product. However, it seems likely that it would be difficult to prove the absence of such effects. As with prohibited subsidies, Members suspected of operating actionable subsidies must consult on request for the purpose of finding a mutually agreed solution. This must be reached within 60 days or the matter is referred to the DSB. In the event of a finding that adverse effects have resulted, the Member must take appropriate steps to remove those effects or withdraw the subsidy, otherwise, the complaining Member may be authorised to take countermeasures.

Non-actionable subsidies are not entirely protected from complaints[30]. With regard to eligibility for the green light category, Members can request the Secretariat to review notifications made with a view to determining whether the conditions for non-actionability have been met. The findings of the Secretariat may be reviewed by the Committee; the determination of the Committee and individual violations of the conditions of notified programmes are subject to binding arbitration.

Even programmes that are consistent with the criteria of Article 8(2) may be the subject of consultations where they are suspected of resulting in “serious adverse effects” to the domestic industry of another Member “which would be difficult to repair”. In the event of no mutually agreed solution being reached, the matter may be referred the Subsidies Committee. If the effects claimed are found to exist, then the subsidising Member may be required to remove the serious adverse effects, although withdrawal of the subsidy cannot be required.

(ii) *The Imposition of Countervailing Duties*

Countervailing action may only be taken against prohibited and actionable subsidies. The new code sets out the provisions for the imposition of countervailing measures[31]. In particular, it lays down rules for the initiation of countervail cases by domestic authorities (Article 11); rules of evidence enabling relevant parties to present

[28] Remedies in respect of prohibited subsidies are regulated by Article 4.

[29] Remedies in respect of actionable subsidies are provided for under Article 7; Article 6 defines the notion of “serious prejudice”.

[30] Remedies in respect of non-actionable subsidies are provided for under Article 9.

[31] Part V (Articles 10 to 23) of the Agreement.

information and arguments (Articles 12 and 13); the method for calculating the amount of a subsidy in terms of benefit to the recipient (Article 14); the basis for the determination of injury and the definition of domestic industry (Articles 15 and 16); and the remedies available, notably undertakings, provisional measures and definitive countervail duties.

Unlike the WTO dispute settlement procedure, which can only be initiated by Members, countervail actions can be brought by private individuals and firms in Members' domestic courts.

2.3 Summary and Conclusions

At the start of this section it was noted that there were fundamental differences between the approaches to controlling subsidies under the EU and GATT systems. Leaving aside the obvious institutional differences, there are also significant contrasts in the *approach* of the rules.

First, on definitional issues, the EU rules do not identify what type of measure is subject to control; in contrast, the GATT Code provides a definition of subsidies for the purposes of the Agreement.

Second, the EU rules begin with a general prohibition, but proceed to identify clear exceptions and possible exceptions. It is for the European Commission to decide what the possible exceptions to the general prohibition are. Although Commission decisions to authorise a State aid can be challenged, the scope for doing so in practice is limited. By contrast, the GATT Code only prohibits export subsidies. However, it distinguishes between non-prohibited subsidies, which are actionable if a trade impact can be shown; and domestic subsidies, which are non-actionable for countervailing purposes.

Third, the basic EU rules are brief, comprising only three articles of the Treaty. Because of the wide-ranging discretionary powers of the European Commission and the obligation on Member States to notify aid schemes in advance, there was no requirement for detailed rules in the Treaty itself. In practice, however, these basic provisions have been elaborated both by Commission decision-making and rule making and by judgements of the ECJ, increasing both the transparency and predictability of the application of the Treaty articles. In contrast with the brevity of Articles 92 to 94, the GATT Subsidies Code is lengthy and, in some areas, very detailed. In large measure, this *ex ante* approach reflects the need for greater certainty in an international environment where the remedies include unilateral retaliation in the form of countervail duties.

In spite of these differences, it might be argued that there is a growing convergence of practice in the area of notification. As discussed, under the EU rules, State aids must be notified to the Commission in advance of implementation in order for their compatibility with the Treaty to be assessed. Under the GATT rules, there is a general obligation to notify subsidies (which has always been in place and apparently never taken seriously by the contracting parties). In addition, however, there are new more stringent reporting requirements where a Member considers that a subsidy programme should be deemed non-actionable; these too must be notified in advance of their implementation. There is a fundamental difference between the two systems insofar as the Secretariat does not exercise a supervisory role in the same way as does the European Commission and any action is at the initiative of other Members. Moreover, it seems that the notification provisions for non-actionable subsidies have so far failed to attract any submissions. However, this may change; failure to notify a programme would result in the programme being deemed actionable until such time as it were shown otherwise[32]. This means that the subsidising Member must show the non-actionability of a programme on substance; the burden of doing so, and the threat of countervailing action, may ultimately make prior notification a more attractive option. If so, this would make the monitoring of the subsidy practices of Members a central element of discipline under the GATT as it is under the EU's internal system.

[32] This is suggested by note 35 to Article 10.

3. DEFINING SUBSIDIES

A central issue in any system for disciplining subsidies is the definition of what types of measure are subject to control. It was noted earlier that a striking feature of the EU approach to regulating State aids is that there is no definition of what actually constitutes a State aid. As a result, the scope of Articles 92 and 93 has been a fertile area of Commission decision-making and European Court of Justice jurisprudence. Over time, this has resulted in something approaching a definition. However, the fact that the question of defining State aids has continued to be a matter of case law into the 1990s indicates that there remain issues to be settled.

Subsidy definition became a major issue in the Uruguay Round of GATT negotiations. In large measure this resulted from the divergent views of the Members on the purpose of the Code. Messerlin, for example, has suggested that "To the United States, the [GATT Subsidies] Code is an instrument to control subsidies. To the rest of the world it is an instrument to control US countervailing duties." (quoted in Trebilcock and Howse, 1995)[33]. The European Community, and most other participants, therefore considered that one of the main objectives of the negotiations on the Code should be to arrive at a definition of subsidies which would constrain the use of countervailing duties by the United States[34].

Clearly, the definitions of State aids within the EU and subsidies under the GATT Agreement have been arrived at by quite different routes; rule-making and case law, on the one hand, and multilateral negotiation on the other. This section considers the outcomes of these different processes. It begins by examining the definition of State aid in the EU and goes on to review the subsidy discipline provisions of the Uruguay Round Agreement on Subsidies and Countervailing Measures.

3.1 The Definition of State Aid in the EU

A substantial body of case law spanning a period of over 30 years has elaborated the provisions of Article 92(1) with respect to what is meant by a State aid. Article 92(1) itself indicates only that the "aids" in question are granted "by a Member State or through State resources" and may be "in any form whatsoever". However, in order for Article 92 to apply, the aid must "distort or threaten to distort competition" by "favouring certain undertakings or the production of certain goods". These five aspects are now considered in turn.

3.1.1 The Concept of "Aid"

Early case law in the context of the ECSC Treaty established that the notion of an "aid" was wider than that of a subsidy, but that aids clearly include subsidies:

> "A subsidy is normally defined as a payment in cash or kind made in support of any undertaking other than the payment by the purchaser or the consumer for the goods or services which it produces. An aid is a very similar concept, which, however, places emphasis on its purpose

[33] The US is by far the most frequent user of countervailing duties. Between 1980 and 1986, over 90 percent of cases were brought by the US or Chile. Moreover, apart from a brief period of intense countervailing activity by Chile, the vast majority of cases in the 1980s were brought by the US (figures quoted in Stewart, 1993).

[34] It is perhaps ironic that the European Union should have been one of the main proponents of a firm definition of subsidies under the GATT Code, given the absence of a definition of State aid for internal purposes.

> and seems especially devised for a particular objective which cannot normally be made without outside help. The concept of an aid is nevertheless wider than that of a subsidy because it embraces not only positive benefits, such as subsidies themselves, but also interventions which, in various forms, mitigate the charges which are normally included in the budget of an undertaking and which, without, therefore, being subsidies in the strict sense of the word, are similar in character and have the same effect."[35]

Although the Court drew attention to the purpose and objective of the measure in distinguishing aids from subsidies, this should not be viewed as limiting the definition of an aid. As in other areas of Community law, the European Court has taken an effects-based approach (Quigley, 1988; Hancher, Ottervanger and Slot, 1993). Consequently, the Court found that if the *effect* of a particular measure was to benefit a particular undertaking or category of goods, then it should be regarded as an aid, even if a benefit was *not* the primary intention of the measure[36].

3.1.2 The Meaning of "State" and "State Resources"

Commission decisions supported by Court of Justice rulings have resulted in a wide definition of these terms. Regarding "State", it is now clear that the Treaty provisions are intended to cover measures by all public bodies, or agencies acting on their behalf, at national, regional and local levels. In *Steinike*[37], the Court held that it was not necessary "to make a distinction whether the aid is granted directly by the State or by public or private bodies established or appointed by it to administer the aid." In a case involving assistance granted by a German *Land* government, the Court ruled that Article 92 "is directed at all aid financed from public resources." [38]

It is clear that the benefit concerned must have been brought about by public authorities. In the *Gasunie* cases[39], the Court had to consider the issue of allegedly preferential gas pricing for the Dutch horticultural industry. The State not only held 50 percent of the shares of *Gasunie* but could also approve its pricing structure. Taken together, the Court found that pricing was the result of action by the State, and therefore came within the scope of Article 92.

The nature of a State aid in financial terms is, however, less clear. The notion of "State resources" includes measures for a particular sector financed by parafiscal taxes levied on that sector, if the contributions are imposed by legislation.[40] This implies that an aid need not come directly from public funds, but could involve sums that are essentially circulating between firms within a given sector,[41] unless the

[35] *De Gezamenlijke Steenkolenmijnen in Limburg* v *High Authority of the European Coal and Steel Community* [1961] ECR 1 at 19.

[36] *Italian Government* v *Commission* [1974] ECR 709.

[37] *Firma Steinike und Weinlig* v *Germany* [1977] ECR 595 at 614.

[38] *Federal Republic of Germany* v *Commission of the European Communities* [1987] ECR 4013 at 4041.

[39] *Kwekerij Gebroeders van der Kooy* BV, *Van Vliet, Landbouwschap and Kingdom of the Netherlands* v *Commission of the European Communities* [1988] ECR 219.

[40] *Government of the French Republic* v *Commission of the European Communities* [1970] ECR 487.

[41] In the past, such mechanisms were common in French industrial policy where all firms in a given activity, for example, leather goods, clothing and watch-making, were required to contribute to an "interprofessional" fund. These sums were used to finance incentives for training or technical development in firms within that sector.

contributions are genuinely voluntary. In other words, an aid granted by the State but not financed through State resources, would appear to fall within the scope of Article 92. On the other hand, in *van Tiggele,* a case involving the fixing of minimum prices by regulation, the ECJ held that "[T]he advantages which such an intervention in the formation of prices entails for the distributors of the product are not granted, directly or indirectly, through State resources within the meaning of Article 92".[42]

In the more recent *Sloman Neptun*[43] case, the Court of Justice once more had occasion to consider the issue of State resources. The case arose from the establishment of a German international shipping register. Ships inscribed in this register sail under a German flag, but the employment contracts with the crew are not subject to German employment law if they have no fixed address in Germany. As a result, their pay is lower than that of their German counterparts. *Sloman Neptun* sought to take advantage of this by recruiting Filipino seamen; the *Seebetriebsrat* (works council) complained to the Bremen *Arbeitsgericht* claiming that the legislation amounted to State aid under Article 92(1). Clearly, the advantage that accrues to shipowners in the form of lower wage costs is effectively financed by non-German sailors and not the State (although social security contributions were also correspondingly lower); a preliminary reference made by the Bremen court obliged the ECJ to rule on whether Article 92(1) can apply to government measures that are not financed from public funds.

The view of the Advocate General was that it was not essential that aid be financed out of State resources; in his view, the essential element was that a particular industry was placed in an advantageous position by a well-defined State measure. This called for a broad view of the notion of State aid and one that was supported by the Commission.

The Court did not follow the Opinion of the Advocate General. In its ruling the ECJ referred to *van Tiggele* and noted that "advantages granted from resources other than those of the State do not fall within the scope of the provisions"[44]. As a result, it was necessary to determine whether or not the advantages arising from the inscription on the international register were to be viewed as being granted through State resources. The Court concluded that the benefit to the firm, insofar as it concerned social security concessions, was inherent in the system and that the system did not seek "to create an advantage which would constitute an additional burden for the State"[45].

This line of reasoning was followed in *Kirsammer-Hack*[46]. Again, the Advocate General had sought a wider definition of State aid to encompass a consideration of the extent to which regulatory provisions enable firms to compete on equal terms. However, the Court referred to its judgement in *Sloman Neptun* and noted that no transfer of State resources to undertakings was involved and that the measure (less onerous employment legislation for small firms) could not constitute aid within the meaning of Article 92(1).

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[42] *Openbaar Ministerie of the Kingdom of the Netherlands* v *Jacobus Philippus van Tiggele* [1978] ECR 25 at 42.

[43] *Firma Sloman Neptun Schiffahrts AG* v *Seebetriebsrat Bodo Ziesemer der Sloman Neptun Schiffahrts* [1995] 2 CMLR 97.

[44] At 132.

[45] At 133.

[46] Not yet reported, but see Horspool, 1994.

These recent cases suggest a narrowing of the definition of State aid in relation to "State" and "State resources". However, it remains to be seen how this line of reasoning will evolve in the future. Slotboom (1995) is critical of this approach, arguing that there is no justification for this more restrictive interpretation either on economic grounds or on the basis of Article 92 and its relationship with other Treaty provisions, notably Article 30, 100 and 101. Nevertheless, and of particular interest in the present context, this view of State aid involves a definition that is closer to that of the term "subsidy" employed by the Commission in its application of the countervailing provisions under the anti-subsidy Regulation[47] (Bronckers and Quick, 1989).

3.1.3 The Form of Aid

Article 92 concerns aid "in any form whatsoever". Reflecting this, there is no definitive listing of the types of assistance that fall within the ambit of the Treaty provisions. Clearly, grants, tax exemptions, preferential interest rates, the acquisition of land and buildings on favourable terms are all covered; however, more complicated issues arise in the case of State shareholdings or capital injections. Consideration of these issues by the Commission and the Court has resulted in the "market investor" principle[48]. In short, if the transaction is undertaken in circumstances which a private investor would not be prepared to accept, then this would constitute a State aid.

3.1.4 The Distortion or the Threat of Distortion of Competition

The provision of State aid does not, of itself, contravene the Treaty; in order to fall foul of Article 92, it must distort or threaten to distort competition (and, as discussed below, it must do this by favouring certain firms or products). In practice, this is not a serious limitation on the scope of Article 92 given the increasing interdependence of markets within the EU economy. Nevertheless, in *Philip Morris*[49] the ECJ rejected the Commission's contention (CEC, 1981) that aids always distort competition and that it was therefore not necessary to assess their actual effects.

The reference to the "threat" to competition in Article 92 is obviously necessary since State aid must be notified to the Commission in advance and at that stage its impact cannot be known. Moreover, the distortion may refer to potential competition if the aid is considered to hinder the entry of new competitors into the market.

Article 92 applies even when the firm does not export any of its products, if the firm is in competition on its home market with producers from other States[50]; it also applies even if the firm exports virtually all of its production outside the EU[51].

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[47] Council Regulation (EEC) No. 2423/88 of 1 July 1988 on protection against dumped or subsidized imports from countries not members of the European Economic Community, OJEC L 209; 2 August 1988. This has now been superseded by Council Regulation (EC) No. 3284/94 of 22 December 1994 on protection against subsidised imports from countries not members of the European Community, OJEC L 349; 31 December 1994.

[48] *Public authorities' holdings in company capital,* EC Bulletin 9-1984.

[49] *Philip Morris Holland BV* v *Commission of the European Communities* [1980] ECR 2671.

[50] *French Republic* v *Commission of the European Communities* [1988] ECR 4067.

[51] CEC (1995) point 353.

3.1.5 Favouring Certain Undertakings or the Production of Certain Goods

Article 92 does not apply if all undertakings in the Member State benefit from the measure without distinction between them. Aid is selective if it applies to a particular type of activity, a sector of the economy, a particular geographical area or to firms with the same characteristics (such as small and medium-sized enterprises). In this way, a line is drawn between measures of *general* economic policy, on the one hand, and measures which *directly* or *indirectly* assist certain firms or activities, on the other.

However, this line is not always a clear one and measures that are ostensibly general may, in practice, be found to fulfil the selectivity criterion. For example, an Italian social security concession which provided higher rates of concession in respect of female employees was found to constitute sectoral aid since it favoured the production of goods in which female labour predominated, notably textiles, clothing, leather goods, and so on[52]. The emphasis here is not on the intent of the measure but on its *impact*. Nevertheless, it is somewhat difficult to reconcile this Commission decision with the Court's later finding in *Sloman Neptun* that "the difference in the basis for the calculation of social security contributions… are inherent in the system and are not a means of granting a particular advantage to the undertakings concerned."[53]

The Commission is clearly aware of the difficulty of distinguishing between specific measures which distort competition and general measures which may do so and the extent to which Article 92 on the one hand, or Articles 101 and 102, on the other, may be applicable. The Second Survey contained a discussion of these issues which noted that: "The Commission has started its investigation in greater detail of the distinction between general measures and aids and will integrate the results obtained in a later annual updating of this Survey."[54] (The results of this did not appear in the subsequent survey).

3.2 Subsidy Definition under the GATT 1994 Subsidies Code

As noted earlier, a major difficulty with the Subsidies Code that emerged from the Tokyo Round was the absence of a definition of the term "subsidy". This meant that Members were able to define for themselves the practices of other countries which they considered to constitute subsidies. In the case of US CVD law, this led to a wide-ranging definition. For example, the imposition of export restrictions on Canadian softwood lumber was deemed to be a subsidy on the grounds that the restrictions artificially depressed domestic prices of lumber, effectively giving domestic users of the raw material a cost advantage over importers. In the US approach, the emphasis is very much on the benefit to the recipient and not the cost to government.

In contrast, in the EU, in the few cases decided, a much narrower view of subsidies has been adopted. In *Fediol*[55] the Commission argued that "the criterion of a financial

[52] Commission Decision 80/932/EEC of 15 September 1980 concerning the partial taking-over by the State of employers' contributions to sickness insurance schemes in Italy, OJEC L264; 8 September 1980 at 29.

[53] At 133.

[54] CEC (1990) point 8.

[55] *EEC Seed Crushers' and Oil Processors' Federation (Fediol)* v *Commission of the European Communities* [1988] ECR 4155.

contribution by the State or a charge on the public account is an unwritten characteristic which is necessary for the existence of a subsidy"[56]. Moreover, in the same case, the Commission actively sought to distinguish subsidies from State aids arguing that "the concept of a subsidy is narrower than the concept of aid in Article 92"[57].

A number of GATT Members were keen for a definition of subsidies to be agreed under the Uruguay Round in order to contain and predict the scope of US countervailing activity. For the US, in particular, but also some other countries, the issues of subsidy definition was secondary; the main objective was to have stricter rules on subsidies and extend the scope of the red and amber light categories.

There are two elements to the definition a subsidy agreed in the Uruguay Round. The first concerns the notion of a subsidy itself; the second, is the issue of specificity. In order to be caught by the Agreement, subsidies must be specific. These two aspects are now discussed in turn.

3.2.1 Definition of a Subsidy (Article 1)

Article 1 of the Agreement provides that:

> "**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 or liabilities (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);
> >
> > **(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 the GATT 1994;
>
> and

[56] At 4164.

[57] At 4165.

(b) a benefit is thereby conferred.

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

The key elements of this definition are that a subsidy involves a *financial contribution* by *government or any public body* and a *benefit*; in addition, and as discussed below, in order to fall within the scope of the Agreement, the subsidy must be *specific*. These elements of the definition raise a number of interesting issues and ones that are clearly familiar to the European Commission and the ECJ from their considerations of the notion of State aids.

The reference to a financial contribution by government at first appears tighter than the EU approach to State aids. However, it is not clear that a financial contribution need involve a cost to government; the Agreement itself identifies "potential direct transfers of funds" and cites the example of loan guarantees. Moreover, loans at market rates of interest would not involve any cost, but would still involve a financial contribution. A further issue is whether "contribution by government" ultimately refers to public funds or whether it could mean a financial contribution resulting from government action. This raises the question of whether schemes funded by parafiscal taxes of the type described earlier would be caught by the Agreement. A more significant issue is whether a financial contribution by government could include regulations on natural resource or other commodity pricing. It has to be said that these potential extensions are not explicitly suggested by Article 1 of the Agreement which cites three forms of contribution, direct transfers, revenue foregone and the purchase of goods and services, apparently in a limitative rather than an illustrative sense. Nevertheless, the provisions remain open to this interpretation.

The reference to government or any public body and, in paragraph (iv), to the transactions concerned being delegated to a private body reflects the need to ensure that subsidies do not fall outside the Code simply by dint of being administered on behalf of government. In this respect the approach is indistinguishable from that undertaken under Article 92.

The notion of conferring a benefit serves to distinguish "standard" commercial transactions between governments and firms from those involving subsidies. In this sense, the sale of land and buildings to a firm on market terms would presumably not confer a benefit, whereas sale at less than the market price would. In short, the notion of a benefit suggests a gratuitous element to the financial contribution. This aspect of the definition narrows the scope of the definition of subsidy, one which is further refined by the notion of specificity.

3.2.2 Specificity (Article 2)

The notion of specificity is central since only specific subsidies are actionable. The Agreement contains a lengthy definition of the term. In broad terms, the following are deemed to be specific:

- subsidies that are explicitly limited to certain enterprises (Article 2.1(a));
- subsidies that, notwithstanding the appearance of non-specificity, are in practice specific. Factors that may be taken into account in determining specificity include the use of programme by a small number of firms,

disproportionately large amounts of subsidy to certain firms and the way in which discretion is exercised by the awarding authority (Article 2.1(c));

- subsidies that are limited to enterprises located in a designated geographical area within the jurisdiction of the granting authority (Article 2.2); and

- prohibited subsidies as defined in Article 3. In other words, export subsidies are automatically deemed to be specific (Article 2.3).

The intention here is clearly to distinguish between general measures of economic policy, such as across-the-board tax cuts or the provision of general infrastructure, and measures that benefit certain firms or groups of firms; the motivation is the same as that under the EU State aid provisions and the favouring "of certain undertakings" or the production of "certain goods". From the discussion in the previous section, it can been seen that these have been difficult issues in the EU context; as far as the GATT 1994 Agreement is concerned, the dividing line will ultimately be determined on a case-by-case basis as the relevant authorities administer CVD laws and the Subsidies Committee hears countermeasure cases.

A significant change in the definition of specificity took place in the course of the negotiations. The so-called "Dunkel Draft"[58] referred to subsidies being specific to enterprises or industries "within the territory of the subsidizing country". As pointed out by a number of observers (Hufbauer, 1993; Anderson, 1993), such an approach had serious implications for subnational authorities, especially in federal countries. It would have meant that a subsidy that was generally available in a single US state would have been specific and countervailable, but one that was available throughout a country would not be caught by the Agreement. Given the relative size of the economies concerned this could have led to some anomalies; as Hufbauer notes, the economy of California is around ten times the size of that of Portugal. The same subsidy scheme would have been deemed to be specific in California, but generally available in Portugal.

In the final draft of the Agreement the reference to "subsidizing country" has been replaced by the "jurisdiction of the granting authority". This assures more equal treatment of the different levels of government. Under these terms, a subsidy granted by the Californian state authorities and available throughout California would not be specific; however, a subsidy restricted to certain parts of the state would be, as would a programme restricted to certain parts of Portugal. This is an important concession to countries where the economic development activities of subnational governments are significant and appears to be an area on which the EU was forced to cede ground in the negotiations. The key issue is arguably not, as Hufbauer states, the relative size of the economies of US states or Canadian provinces compared with those of some nation states, but rather whether the jurisdictions concerned constitute, or are merely a part of, monetary unions, that is, genuine single markets. As far as jurisdictions that are coterminous within monetary unions are concerned, the economic justification for allowing generally-available subsidies is that they do not affect relative prices and that the impact of such measures will ultimately be reflected in exchange rate adjustments. This is not the case with subnational jurisdictions where the effects of subsidies are not dissipated in the same way.

[58] GATT Doc. No. MTN.TNC/W/FA.

A further question concerns what is meant by the “jurisdiction of the granting authority”. In an EU context, much of the financial assistance available in the poorer countries is cofinanced by the EU from the Structural Funds, but is available throughout the territories of those countries and administered by national authorities. Are these national bodies the “granting authorities”, even although they may only fund part of the subsidy? If so, such subsidies could be deemed to be generally available[59]. On the other hand, if the European Commission were considered to be the granting authority, the subsidy would be specific since it would be restricted to a part of the European Union.

3.3 Summary and Conclusions

The notions of State aid and subsidy under the EU’s internal rules and under the GATT 1994 Agreement have been arrived at by quite different routes. However, a review of the definitions arrived at shows that the issues addressed in case law and negotiations have been substantially the same; moreover, it can be argued that the outcomes are not now significantly different. Certainly, a number of common characteristics can be identified.

First, both systems clearly aim at transactions involving any public body or on behalf of a public body. This became apparent in the early case law on State aids in the EU and is made explicit in the GATT code. There is, however, a difference in scope insofar as Articles 92 to 94 refer to the activities of the Member States and public bodies within them; this does not generally include the activities of the EU institutions themselves[60]. On the other hand, the status of the European Union as a Member of the WTO (as well as the Member States) means that EU policies do fall within the ambit of the GATT rules.

Second, the EU and the GATT rules are both indifferent to the form of the measures concerned. Article 92 makes clearly that it addresses aid in any form whatever; the GATT rules provide some examples of forms of subsidy, but these are clearly intended to be illustrative rather than exhaustive.

Third, both sets of rules are concerned with transactions that involve a gratuitous advantage to the recipient. The EU rules have developed the “market investor principle” and refer to certain undertakings or the production of certain goods being “favoured”; the GATT rules only concern those measures which involve the conferral of a benefit.

Fourth, the notion of specificity is central to both systems. The aim is to separate general government activity from targeted behaviour. Again, there are strong similarities between the text of the GATT rules and the solution arrived at through Commission policymaking and case law in the EU. However, the scope of the measures covered under the GATT rules is more limited. Under the GATT rules, a subnational government (for example, the State authorities of California) operating a generally-available subsidy (for example, an employment creation grant available on identical terms to all firms in the State creating jobs) would not be subject to GATT disciplines. In contrast, a similar scheme operated by a German Land government, for example, would be caught by Article 92.

[59] Although the way in which such assistance is administered would make this difficult to argue.

[60] An exception to this is EU Structural Fund cofinancing of measures implemented by Member State authorities. The Structural Fund Regulation (No. 2081/93 of 20 July 1993) explicitly requires the conformity of such measures with competition rules. In effect, this has led to Commission scrutiny of EU policies under its own competition rules.

Nevertheless, in these four respects, the definitions of State aid and subsidy and the circumstances in which they are subject to their respective disciplines are very similar. However, it is more difficult to discern whether the *financial* nature of the transactions is now the same.

Early case law in the EU suggested that State aids included subsidies but that the scope of the former was broader. Moreover, in *Fediol* the Commission insisted that State aids and subsidies were different, with the latter involving a charge on the public account. Later developments suggest a *rapprochement* between the two concepts and recent case law in the EU has narrowed the scope of an aid in comparison to what one might have assumed from previous decisions. In *Sloman Neptun* and *Kirsammer-Hack* it was found that the financial benefits that accrued to the firms concerned did not come through “State resources” and that the measures concerned therefore fell outwith the scope of Article 92. If this line of reasoning is pursued, then it becomes difficult to distinguish between the notion of a State aid and the GATT notion of a subsidy as a “financial contribution by a government”.

4. THE DEFINITION OF ACCEPTABLE SUBSIDIES

Both the EU and the GATT systems of controlling State aids or subsidies make provision for certain types of government assistance to be acceptable within the general scheme of discipline.

In the EU context, in Article 92(2), there is a limited, closely-defined list of types of support that are excluded from the general prohibition provided for in Article 92(1). However, this is a restricted list and the provisions of Article 92(3), which provides for types of aid that "may" be compatible with the common market is of considerably more interest in the present context. As noted earlier, EU Member States must notify proposed aid to the Commission in advance of its implementation; it is for the Commission to decide whether one of the exceptions provided for in Article 92(3) shall apply, a process which involves balancing the impact on competition against the "common interest".

In considering these exceptions, the Commission has made increasing use of frameworks and guidelines which, for the most part, are intended to improve the transparency of Commission decision-making and the quality of the notifications by the Member States. A reading of these various codes shows a broadly sympathetic attitude to "horizontal" support such as that for small and medium-sized firms, environmental protection and research and development. On the other hand, a stricter approach is taken to aids for rescue and restructuring (at least in the wording of the guidelines, if not in practice!); and to sectoral aids, such as those for the synthetic fibres or motor vehicles industries, which are considered to be in "overcapacity" in an EU context.

Under the GATT Subsidies Code, the "non-actionable" category of subsidies shelters designated types of support from countervailing action. Three types of support are identified:

- assistance for research activities;
- assistance to disadvantaged regions;
- assistance to promote the adaptation of existing facilities to new environmental requirements.

All three of these categories are the subject of guidelines or frameworks under the EU State aid rules. This section considers each category in turn, comparing and contrasting the types of measure that are deemed to be acceptable under the two systems of subsidy discipline.

4.1 Subsidies for Research and Development

The provisions of the Agreement on Subsidies and Countervailing Duties in relation to research and development assistance are contained in Article 8.2; the EU rules are contained in a framework dating from 1986[61].

The EU framework contains a lengthy preamble on the role of research and development in improving competitiveness and innovative competition, reflecting the wider aspirations of the European Community and not just the narrow issue of

[61] Community framework for State aids for research and development, OJEC C 83; 11 April 1986.

subsidy control; indeed, the framework even makes reference to the subsidy programmes operated by the Community itself under initiatives such as Esprit, RACE and Brite. Understandably, the justification for the use of subsidies for R&D is absent from the GATT rules. However, beyond this obvious contextual difference, there is a striking similarity in substance between the two sets of rules. Both systems address three main issues: the types of research activity concerned; the expenditures which are eligible for assistance; and the level at which research activities may be subsidised. These aspects are now considered in turn.

4.1.1 Eligible Research Activities

Both sets of rules distinguish between three categories of research activity. In the case of the EU rules, these are:

- fundamental research;
- basic industrial research; and
- applied research and development.

Under the GATT rules they are as follows:

- fundamental research;
- industrial research; and
- pre-competitive development activity.

The term *fundamental research* can be dealt with quite quickly since it is used in the same sense in both the GATT Agreement and the EU rules; it is defined as the “enlargement of general scientific and technical knowledge not linked to industrial or commercial objectives”. Moreover, in general, both sets of rules explicitly exclude support for fundamental research from the scope of their control. The EU rules indicate that support for fundamental research will not generally fulfil the conditions of Article 92(1); however, the rules do not exclude the possibility that research carried out in or for particular firms may be caught by Article 92(1). Similarly, the GATT rules do not apply to fundamental research independently conducted by higher education or research establishments. This implies that support for fundamental research carried out by firms *would* fall within the Code.

The EU term *basic industrial research* refers to “original theoretical or experimental work whose objective is to achieve a new or better understanding of the laws of science and engineering as they might apply to an industrial sector or the activities of a particular undertaking.” In spite of the apparent similarity between the terms “basic industrial research” and “industrial research”, *industrial research* under the GATT Code is defined in quite a different way. Here it means “planned search or critical investigation aimed at discovery of new knowledge, with the objective that such knowledge may be useful in developing new products, processes or services, or in bringing about a significant improvement to existing products processes or services.”

The terms themselves suggest that the EU expression refers to activities that take place earlier in the R&D process (ie. the reference to “basic” industrial research); the terminology used within the definitions tends to confirm this and implies that the GATT reference to “industrial research” covers activities that are closer to the marketplace than those targeted by the EU framework. Consideration of the earlier draft of Article 8.2 of the Agreement supports this view. Interestingly, the Dunkel Draft referred to “basic industrial research” and defined this in terms identical to those of the EU rules except that it referred to the laws of science and engineering “as they might *eventually* apply to an industrial activity” [emphasis added]. In practice, however, from discussions with EU competition and trade policy officials, the two definitions seem to be viewed as covering substantially the same activities.

The Community framework on State aids for R&D provides a lengthy definition of the terms *applied research and development*:

> “The Commission considers that the former covers investigation or experimental work based on the results of basic industrial research to acquire new knowledge to facilitate the attainment of specific practical objectives such as the creation of new products, production processes or services. It could normally be said to end with the creation of a first prototype. Development is considered to cover work based on applied research aimed at establishing new or substantially improved products, production processes or services up to but not including industrial application and commercial exploitation. This stage would normally include pilot and demonstration projects and such further development work as necessary, culminating in the production information package or equivalent.”

The GATT definition of *pre-competitive development activity* is also lengthy:

> “The term ‘pre-competitive development activity’ means the translation of industrial research findings into a plan, blueprint or design for new, modified or improved products, processes or services whether intended for sale or use, including the creation of a first prototype which would not be capable of commercial use. It may further include the conceptual formulation and design of products, processes or services alternatives and initial demonstration or pilot projects, provided that these same projects cannot be converted or used for industrial application or commercial exploitation. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, services, and other on-going operations even though those alterations may represent improvements.”

Again, it is interesting to note that the earlier Dunkel Draft of the GATT Code had largely adopted the EU terminology and definition. The Dunkel Draft had made reference to “applied research” in Article 8.2, although any mention of “development” was conspicuously absent from the draft. Applied research was defined in identical terms as under the EU rules quoted above.

The subsequent extension of the scope of Article 8.2 appears to be primarily a consequence of the change of administration in the US in 1992. Following the election of Clinton to the Presidency, a new US policy emerged, involving the encouragement of partnership between government and industry to develop strategic technologies and enhance the international competitiveness of US manufacturers. This involved a significant policy shift away from the traditional US position that takes for granted the negative aspects of subsidies and towards a situation in which “the Clinton Administration attempted to eliminate potential multilateral constraints on its domestic policy agenda” (Kleinfeld and Kaye, 1994).

Clearly, the wording of the two texts differs; however, as with the definition of industrial research, the scope of the two provisions seems to be viewed as substantially the same by competition and trade officials. The most obvious exception concerns prototypes; in the GATT rules support for prototypes that are capable of commercial cannot be sheltered in the green light category while the EU rules do not exclude this.

4.1.2 Eligible Research Expenditures

Eligible expenditures are defined in almost identical terms in both the GATT and the EU rules. Five categories of eligible expenditure are identified. In broad terms these are:

- personnel costs;
- other running costs (materials, supplies, etc.);
- instruments, equipment, land and buildings;
- consultancy and equivalent services, bought-in research, technical knowledge, patents, etc.; and
- additional overhead costs incurred directly as a result of the research activity.

In short, the GATT definition of eligible research expenditure has clearly been derived directly from that under the EU rules. Moreover, and in contrast with the substantial changes in the definition of research activities between the Dunkel Draft and the final agreement, the listing of eligible expenditures under the GATT code remained unchanged between the two texts. There are minor differences in wording between the EU and the GATT rules, but these would appear to be of little consequence; clearly the aim under both sets of rules is to limit eligible expenditure for the purposes of calculating the award ceiling to spending that is directly and exclusively assigned to research and development activities.

4.1.3 Rates of Award

The GATT Agreement establishes allowable levels of non-actionable assistance with reference to the total eligible costs incurred (as defined in the section above) over the duration of an individual project. For *industrial research* the ceiling is 75 percent; for *pre-competitive development activity* the ceiling is 50 percent.

The EU framework on R&D aids indicates that “as a general rule, the level of aid for basic industrial research should not be more than 50% of the gross costs of the project or programme.” No ceiling is set for applied research and development aid, but the framework states that: “As the activity being aided gets nearer the market-place, i.e. covers the areas of applied research and development, the Commission in its examination and evaluation of national proposals will look in principle for progressively lower levels of aid.” In practice, the Commission has set a ceiling of 25 percent of eligible expenditure for applied research and development activity.

In consequence there are substantial differences between the levels of subsidy that are deemed non-actionable under the GATT Agreement and those apparently acceptable under the EU rules; rates of award are 25 percentage points higher under the GATT than under the EU rules for substantially the same project types and expenditures

Here, too, it is interesting to note the changes in the GATT Agreement that took place between the Dunkel Draft and the final text. The Dunkel Draft had clearly adopted the EU approach, setting ceilings of 50 percent for basic industrial research and 25 percent for applied research. Again a shift in US government policy underlies the changes to the GATT Code. While the Bush administration had maintained the US traditional position that research and development subsidies were inherently open to abuse; the Clinton administration concluded that “the Dunkel Text tied our hands when it came to investing in research and development” (Kleinfeld and Kaye). As a result, the US sought not only to expand the types of research activities that could be supported, but also sought an increase in the levels of subsidy that were deemed to be non-actionable.

4.1.4 Recent Developments in EU Competition Policy and R&D Aid

The sensitivity of governments to the subsidy practices of others is reflected in the latest policy twist to the EU research and development aid rules. In December 1995 the Commission announced that a new framework for aid to research and development had been finalised[62]. Full details of the new rules have not yet been published[63] but it is known that they involve two main changes. First, the new rules are to provide that rates of award for research and development aid in the EU may exceptionally be raised to the ceilings allowed under the GATT rules, “when justified by the common interest”; the provision is explicitly intended for circumstances in which it can be shown that a competitor in a third country has received higher rates of assistance than those available in the EU and that it would be in the “common interest” for these rates to be matched. This solution was the culmination of an allegedly “long and stubborn battle” between the Commissioners for competition policy and research[64] reflecting the potential conflict between competition policy and the competitiveness of European industry.

The second change is that the new EU framework replicates verbatim the GATT code definitions of the different phases of the research and development process.

4.2 Subsidies for Disadvantaged Regions

Regional policy was the first area in which the European Commission sought to formalise its approach to the control of State aids; the present EU system for co-ordinating regional aids dates back to the late 1960s. The provisions of the GATT Code borrow heavily from the EU approach to regional aids and share the emphasis on the spatial coverage of regional policy considered permissible.

4.2.1 The EU Approach to Controlling Assistance for Disadvantaged Regions

Within the European Union, the main rationale for action on regional aids was the perceived risk of competitive outbidding between regions for internationally-mobile investment. The Commission first proposed a system for co-ordinating regional aids

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[62] *State Aid for Research and Development: the Commission Proposes to the Fifteen Member States a Transparent and Efficient System,* RAPID database press release Ref.: IP/95/1351; 6 December 1995.

[63] Publication in the Official Journal of the European Communities is expected in early spring 1996.

[64] *Brussels eases R&D aid rule,* Financial Times; 7 December 1995.

in 1968; this culminated in the adoption in 1971 of the first set of principles for co-ordinating regional assistance[65]. These first principles were supplemented in 1975 and 1979[66]. Together these documents addressed a number of issues relating to the control of regional aids, notably: the need to establish maximum rates of award in the problem regions which reflect the severity of the regional problem; the need to establish a common method of assessing the value of aid across countries; the need for transparency of aid; and the need for regional specificity. In 1988, these existing documents were supplemented by a further Communication[67].

These documents together form the basis for the assessment by the Commission of the regional aid policies of the Member States. There are two principal aspects to this: first, the control of the spatial coverage of policy; and second, the stipulation of maximum rates of award that vary with the perceived intensity of the regional problem.

(i) *Commission Control of the Spatial Coverage of Regional Aids*

The Commission methodology for approving the designated areas for regional policy is outlined in the 1988 Communication mentioned above. The methodology makes use of the exceptions from the prohibition of aid provided for in Articles 92(3)(a) and (c) and differs according to which paragraph of Article 92(3) applies.

Article 92(3)(a) provides that “aid to promote the economic development of areas where the standard of living is abnormally low or where there is serious underemployment” may be considered to be compatible with the common market. The 1988 methodology interprets this as regions where *per capita* gross domestic product is equal to or less than 75 percent of the Community average. For the purposes of the methodology, regions are considered to be the so-called NUTS II level units[68]. The GDP figures are expressed in terms of purchasing power standards (to allow for differences in the cost of living between countries) and are averaged over the last three years for which data are available. The result of applying this methodology is that the whole of the territories of Greece, Ireland and Portugal, much of Spain and the south of Italy are approved as assisted areas under Article 92(3)(a).

Article 92(3)(c) provides, among other things, that “aid to facilitate the development of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest” may be compatible with the common market. The interpretation of this provision is more complicated than that for assisted areas under Article 92(3)(a). Moreover, it differs in two substantial respects. First, the analysis is based on the NUTS level III region[69]; and second, the methodology takes account of the situation of a region not only in relation to the Community average, but also in relation to the national average. Designation is

[65] Council Resolution of 20 October 1971 on General Systems of Regional Aid, OJEC C 111; 4 November 1971.

[66] CEC (1979); Communication on Regional Aid Systems, OJEC C 31; 3 February 1979.

[67] Communication on the Method for the Application of Articles 92(3)(a) and (c) to Regional Aid, OJEC C 212; 12 August 1988.

[68] NUTS refers to the Nomenclature of Territorial Units for Statistics established by the Statistical Office of the European Communities. Examples of NUTS II regions are the Spanish Autonomous Communities and the Italian regions.

[69] Examples of NUTS III regions are the German *Kreise* and the Belgian *arrondissements.*

approved on the basis of a two-stage analysis: the first, essentially quantitative; the second, more qualitative.

The first stage involves an assessment on the basis of GDP and unemployment. To qualify under Article 92(3)(c) a region must normally display the following minimum disparity:

- *per capita* GDP/GVA at least 15 percent below the national average; and/or

- unemployment at least 10 percent above the national average.

In order to take the EU context into account, national averages are adjusted on the basis of European indices of GDP per head and unemployment. Using these indices, a formula is applied that determines the threshold that a region must reach in order to qualify for approval under Article 92(3)(c). The net result of applying the formula is that the better the situation of a Member State in relation to the EU average, the greater must be the disparity of a region within the national context for the availability of regional aid to be justified. Thus regions in Denmark and Germany (among the more prosperous nations of the EU) must diverge from the national average to a greater extent than those in Italy and the United Kingdom in order to qualify.

The second stage of analysis under Article 92(3)(c) takes other factors into account. These may include the trend and structure of unemployment, demographic pressures, structure of economic activity, etc. These data are used in a discretionary manner; there is no set formula for analysis.

An important point to note about the methodology as a whole is that neither stage of the analysis is conclusive. Meeting the relevant threshold under the first stage does not necessarily mean that a region will be approved by the Commission; equally, regions excluded on the basis of the first stage may qualify on the basis of the second.

As a consequence of Commission intervention, almost all the northern wealthier EU Member States were forced to cutback on the spatial coverage of their regional aid policies in the course of the 1980s. In contrast, the impact of DGIV intervention on the poorer southern or peripheral Member States has been generally to increase the spatial coverage of regional aids. As a consequence, Commission control of national regional aid maps has become a highly controversial topic and the methodology has been exposed to much criticism from national policymakers (Yuill *et al*, 1994).

(ii) *Commission Control of Regional Aid Values*

The second strand of Commission control of regional aids is to stipulate the maximum levels of assistance that may be offered. In broad terms, the distinction between Article 92(3)(a) and (c) is retained for the purposes of maximum rates of award. In Article 92(3)(a) areas the Commission can authorise investment aid of up to 75 percent net grant-equivalent[70]. In contrast, in Article 92(3)(c) areas the Commission rarely authorises award rates exceeding 30 percent net grant-equivalent. In practice, however, the actual award ceilings approved by the Commission vary very widely.

[70] This refers to the value of the subsidy after tax, irrespective of the form of assistance, according to the "common method for assessing aid" set out in the 1971 Council Resolution. This aims to establish a comparative basis for the valuation of financial assistance.

In general terms, this aspect of Commission discipline of regional aids is much less controversial among national regional policymakers than is its control over the geographical coverage of policy. The main reason for this is that the Commission ceilings tend not constrain regional aid administrators in making award offers. On the contrary, the average awards under the main regional incentive grants are typically between a quarter and a half of the maxima permitted (Yuill *et al*, 1995).

As such, the award ceilings authorised by the Commission are of limited impact in terms of disciplining regional aids. This is principally because these ceilings have been determined by the level of assistance available in certain regions at the time the limits were first introduced rather than by any analysis of the severity of the problem in the various regions (Yuill *et al*, 1980). Moreover, since the early 1980s, regional policy expenditure has tended to decline as most countries have experienced budgetary pressures; a consequence of this is that policymakers have increasingly sought “value-for-money” in making grant offers with the result that the advertised maxima are rarely attained in practice.

Given the highly-evolved, if controversial, approach to approving assisted area coverage, it is surprising that the Commission should apparently have paid so little attention to the modulation of maximum rates of award. Indeed, the general practice of adopting Member States’ advertised maxima as ceilings has resulted in a large number of different authorised ceilings - around 50 different levels according to Marques (1993) - with little in the way of rigour applied to establishing a relationship between the maximum award level and the severity of the regional problem.

This approach has led to a 75 percent net grant-equivalent ceiling in many areas approved under Article 92(3)(a) simply because that was the prevailing rate in the Italian *Mezzogiorno* at the time that the basic principles on aid intensity were first enunciated. When Greece, Portugal and Spain joined the Community, the impact of the competition rules on their regional policies was to *increase* permissible rates of award over the levels of support that had been available previously. This reflected the fact that these new Member States were less prosperous than the EU average and the higher ceilings were intended to maintain the competitive advantage of the problem regions of these countries in attracting mobile investment. In practice, however, these countries lack the budgetary resources to finance regional aids at these levels so that the higher ceilings authorised by the Commission are, in reality, largely theoretical.

(iii) *Recent Developments in European Commission Supervision of Regional Aids*

As noted earlier, Commission control of regional aids has been a major source of controversy in relations with the Member States; the Commission’s highly interventionist approach to approving designated area maps has frequently caused resentment among national policymakers. Moreover, criticism of the Commission was arguably exacerbated by the publication of the 1988 methodology; this had been intended to increase transparency and counter accusations of Commission secrecy in this area.

A number of criticisms can be identified. First, Member States have been concerned at the extent of the discretion available to the Commission in operating Article 92(3)(c) in respect of regional aids, notably the fact that neither the first nor the second stage of analysis is conclusive. Second, many policymakers take the view that reliance on GDP per head and unemployment data is inadequate. Regional level GDP figures often produce anomalous results because of the location of particular activities[71]; nor is unemployment always a reliable guide to the existence of a regional problem - in rural areas, in particular, out-migration can pre-empt high levels of unemployment but contribute to desertification and urban congestion. Third, there has been criticism of the territorial units used as the basis for the analysis. Not only do these vary very widely across the EU in terms of population and size, meaning that they are in no sense really comparable, but also, the focus is on the use of administrative rather than economic units. Last, national policymakers claim that the emphasis on statistical indicators has meant that insufficient account has been paid to the more qualitative aspects of policy and to the geographical dimension (Yuill *et al*, 1995).

Commission awareness of these criticisms coincided with a further source of conflict. The Single European Act had resulted in a substantial upgrading of the Community's own regional policy operated through the Structural Funds; however, the areas designated for the European Regional Development Fund were not, in most countries, the same as those designated for national regional policy purposes. The discrepancies between the two resulted in an acrimonious dispute between DGIV and DGXVI (the Directorate-General for Regional Policy) culminating in the suspension of DGIV's otherwise regular reviews of national regional policies until the expiry of the Commission's own regional development programmes in 1993 (Wishlade, 1993).

As a consequence of the general criticisms outlined above and the conflict over the coherence of national and EU assisted areas, the Commission has, in its recent reviews of the assisted area maps of the Member States moved to a much less rigid application of the 1988 methodology in respect of Article 92(3)(c). This places less emphasis on the GDP and unemployment thresholds and is more flexible about the territorial units used; instead, the Commission focuses more on overall levels of problem region coverage expressed as a proportion of the national population. This is based on the assumption that the greater the level of national prosperity, the lower the coverage of the assisted areas should be. Within a given population ceiling agreed between the Member State and the Commission, national policymakers have greater freedom in selecting areas eligible for assistance (Yuill *et al*, 1995).

A further significant development in Commission control of regional aids resulted from the EU enlargement negotiations with Finland, Norway and Sweden. The treatment of regional aids for competition policy purposes was a difficult issue in this context for two main reasons. First, the relative prosperity of the applicants meant that few, if any, of their existing assisted areas would be approved under the EU methodology. The second cause of difficulty was the focus of the EU methodology on GDP and unemployment; regional policy in the three Nordic countries is not primarily concerned with income and employment, but rather with maintaining population settlements in remote areas characterised by difficult geography and harsh climatic conditions (Wishlade, 1995).

Negotiations culminated in an amendment to the 1988 methodology in order to accommodate the current policies of the applicants[72]. The main feature of the amendment is that it adds a population density test to the methodology as an

[71] For example, in Grampian and Groningen GDP is artificially inflated by the fact that income from offshore oil and gas extraction activities are included in the regional figure.

[72] *Commission notice, addressed to the Member States and other interested parties, concerning an amendment to part II of the communication on the method for the application of Article 92(3)(a) and (c) to regional aid*, OJEC C 364; 20 December 1994.

alternative to the existing GDP and unemployment thresholds. This new test concerns NUTS III areas where the population is less than 12.5 per km^2.

In short, in the early to mid 1990s, there were substantial changes in the Commission's approach to approving the regional aid policies of the Member States. On the one hand, it relaxed the 1988 methodology to afford national governments considerably more flexibility in designating problem regions; on the other, the addition of new Member States to the Union resulted in amendments to the methodology to enable the designation of areas that would not otherwise have qualified.

4.2.2 The GATT Approach to Controlling Assistance for Disadvantaged Regions

Article 8.2(b) of the Subsidies Code agreed under the Uruguay Round provides that the following is non-actionable:

> "assistance to disadvantaged regions within the territory of a Member given pursuant to a general framework of regional development and non-specific (within the meaning of Article 2) within eligible regions provided that:
>
> (i) each disadvantaged region must be a clearly designated contiguous geographical area with a definable economic and administrative entity;
>
> (ii) the region is considered as disadvantaged on the basis of neutral and objective criteria, indicating that the region's difficulties arise out of more than temporary circumstances; such circumstances must be clearly spelled out in law, regulation or other official document, so as to be capable of verification;
>
> (iii) the criteria shall include a measurement of economic development which shall be based on one of the following factors:
>
> – one of either income per capita or household income per capita, or GDP per capita, which must not be above 85 per cent of the average for the territory concerned;
>
> – unemployment rate, which must be at least 110 per cent of the average for the territory concerned;
>
> as measured over a three-year period; such measurement, however, may be a composite one and may include other factors."

(i) *The GATT Rules on Assistance for Disadvantaged Regions: Spatial Coverage*

There are striking similarities between terms of the GATT Code set out above and the approach adopted in the EU. The underlying aim under both systems is to prevent regional development policies from acting as a front for strategic industrial policies. Accordingly, both systems emphasise that assistance must be granted within a general framework for regional development and not "to isolated geographical points having no, or virtually no, influence on the development of a region"[73].

With regard to the definition of a region, the GATT Code echoes the objectives of the EU approach as set out in the 1971 principles. The aims are essentially two-fold: first that regions qualifying for aid should have some "coherence" rather than being a patchwork of isolated areas; and second, that areas should have some "identity", that is, that they should correspond to an administrative or economic entity. This corresponds to the EU approach which imposes the NUTS classification of areas; clearly, however, it would be inappropriate for a categorisation of regions to be imposed at a global level.

With respect to the indicators employed to suggest the presence of regional disparities, the similarities between the terms of the GATT Code and parts of the EU's 1988 methodology are immediately apparent. The GATT provisions are essentially an adaptation of the measures used in the application of Article 92(3)(c) to regional aid. In addition to *per capita* GDP, however, the GATT rules also make mention of income per head and household income per head.

An important point to note in these rules concerns the reference to the "territory of a Member". This makes clear that the thresholds referred to relate to the averages prevailing *in the territory of the Member operating the subsidy*. This is of particular significance in the EU context since the EU rules are wholly (in the case of Article 92(3)(a)) or partially (in the case of Article 92(3)(c)) concerned with EU averages rather than national averages. Application of this approach under Article 92(3)(a) has led the Commission to authorise regional aid *throughout* Greece, Ireland and Portugal (because of their relative poverty in an EU context); under the GATT rules, only aid to areas of these countries that exceeded the *national* thresholds of GDP or unemployment would be deemed to be non-actionable.

A related issue concerns the operation of the EU's own regional policy through the so-called Structural Funds. The European Regional Development Fund can be used to co-finance national government financial assistance schemes in designated Objective 1, 2 and 5b areas. However, the designation criteria for these areas are different from national regional aid policies and do not follow the approach taken under Article 92(3)(c) (Wishlade, 1994). Moreover, the fact that assistance is co-financed with national authorities makes it unclear what the "territory concerned" would be for purposes of the GDP and unemployment averages.

(ii) *The GATT Rules on Assistance for Disadvantaged Regions: Subsidy Values*

As with the EU approach, the GATT Code is almost exclusively concerned with the spatial coverage of policy. This is perhaps surprising insofar as it could be argued that the value of a subsidy has a much more direct impact on trade than do the economic conditions of the regions in which recipient firms are located. Moreover, the GATT rules in relation to research and development and environmental protection are explicit about the maximum rates of subsidy deemed to be acceptable.

The GATT provisions relating to award values are dealt with in a footnote to Article 8.2(b) which states that "regional subsidy programmes shall include ceilings on the amount of assistance which can be granted to each subsidized project. Such ceilings

[73] Footnote to Article 8.2(b) of the GATT Code; Council Resolution of 20 October 1971.

must be differentiated according to the different levels of development of assisted regions and must be expressed in terms of investment costs or cost of job creation."

Clearly the setting of rates of award under a global arrangement would have been problematic. In most EU countries, national regional policies discriminate between areas by operating rates of award that differ according to the severity of the regional problem as viewed from a domestic perspective. However, although the Commission attempts to take an EU-wide view of regional problems, in practice, there has never been any *systematic* attempt to relate award values to levels of development across the Union. Moreover any attempt to do so is complicated by the fact that economic disparities between countries of the EU are generally far greater than regional economic disparities within them[74]. It is presumably the absence of any coherent solution to the issue of setting maximum award values within the EU framework that led to no specific provisions being made within the GATT Code.

4.3 Subsidies for Environmental Protection

The relationship between trade and the environment has attracted increasing attention in recent years. This is reflected in a number of high-profile cases before the European Court of Justice and in growing international interest in the topic involving, among other things, the revival of the GATT Group on Environmental Measures and International Trade (Düerkop, 1994). At the same time, the Single European Act accorded the Community express powers in the field under Articles 130r, s and t. These provisions were upgraded under the Treaty on European Union. Given this background, it is hardly surprising that both the EU and the GATT rules make special allowances for subsidies related to environmental protection.

4.3.1 EU Provisions for the Control of State Aid for Environmental Protection

The current basis for EU policy on controlling environmental aids are the 1994 guidelines[75]; however, Community policy in this sphere dates back to 1974[76]. Under the early rules, the use of State aid was regarded as a transitional measure which would be superseded by the gradual introduction of the "polluter pays" principle whereby firms would bear the full costs of the pollution caused by their activities. However, the 1994 guidelines recognise that the polluter pays principle is not yet fully applied and that in this context "subsidies may be a second-best solution".

As in other areas of EU policy, the aim of the guidelines "is not to encourage Member States to grant aid, but when Member States wish to do so to guide them as to what types and levels of aid may be acceptable".

The guidelines focus on four categories of aid:

- aid for investment;
- aid for information activities, training and advisory services;

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[74] GDP per head in Greece is 28.9 percent of that in Luxembourg. Leaving aside the special case of Germany following re-unification, the widest regional disparities within an EU Member State are in Italy where GDP per head in Calabria is 46.7 percent of that in Lombardia. Calculated from data in EUROSTAT, 1995.

[75] Community guidelines on State aid for environmental protection, OJEC C72; 10 March 1994.

[76] Commission letter to Member States S/74/30.807 dated 7 November 1974 (CEC, 1990b).

- operating aid; and
- aid for the purchase of environmentally-friendly products.

(i) *Investment Aid*

Investment aid concerns assistance for the purchase of land (when strictly necessary to meet environmental objectives), buildings, plant and equipment intended to reduce or eliminate pollution or protect the environment. The rules make clear that general investment cannot be assisted under what is ostensibly environmental protection aid, so that where investment increases capacity as well as environmental protection, the aid must be related to the initial capacity of the plant.

Excluded from the guidelines is aid for relocation for environmental reasons; the Commission proposes to deal with cases on an individual basis rather than approving aid schemes under which such projects could be assisted. Related, the Commission also proposes to consider aid for the rehabilitation of industrial sites on a case-by-case basis; the Commission considers that such aid may not fall within Article 92(1) where the person responsible for the pollution cannot be identified and the aid for the rehabilitation of such sites “does not confer a gratuitous financial benefit”.

With respect to rates of award, the rules on aid for investment distinguish between three types of measure:

- aid to help firms adapt to new mandatory standards;
- aid to encourage firms to improve on mandatory environmental requirements; and
- aid in the absence of mandatory standards.

Aid for complying with new mandatory standards and involving the adaptation of plant and equipment can be granted up to 15 percent (gross) of eligible costs. The aid may be granted only for a limited period and only in respect of plant which has been in operation for at least two years when the new obligations enter into force. These limits are raised in two instances. First, where the investment is located in an assisted area, then the prevailing rate of regional aid authorised by the Commission can be applied to eligible environmental investment. Second, where the investment is carried out by small and medium-sized enterprises (SME), the maximum rate is usually 25 percent of eligible investment; however, for SMEs located in assisted areas the prevailing regional aid rates plus 10 percentage points in Article 92(3)(c) areas and plus 15 percentage points in Article 92(3)(a) areas.

Aid for investment that enables significantly higher levels of environmental protection to be attained than those required by mandatory standards can be authorised up to a maximum of 30 percent of eligible costs; however, the level of aid actually granted must be in proportion to the improvement achieved. Again, higher rates of award apply to SMEs and to firms located in designated assisted areas.

Aid provided in the absence of mandatory standards is subject to the same condition of proportionality as aid for projects that involve going beyond existing standards, but no award maxima are specified.

(ii) *Aid for Information Activities, Training and Advisory Services*

The guidelines indicate that aid for information activities (for example, on selective waste collection or environmentally friendly products) may not fall within Article 92(1) where these activities are so general in scope and distant from the marketplace as not to confer an identifiable financial benefit on specific firms. The guidelines also suggest that even when such activities are caught by Article 92(1), they will normally be exemptible.

Aid for training and consultancy in connection with environmental protection may also be authorised. For SMEs, the rates are up to 50 percent of eligible costs or up to the prevailing aid ceiling in designated assisted areas. For large firms no general ceiling is given, but the prevailing regional investment aid ceiling applies to such expenditure where the firm is located in an assisted area.

(iii) *Operating Aid*

The Commission is usually implacably opposed to operating aids; however, the guidelines indicate that the Commission may make an exception to this principle in certain circumstances. Two such exceptions are cited: waste management and relief from environmental taxes. In the case of waste management, the public financing of the additional costs of selective collection may involve State aid but may be authorised if firms are charged in proportion to their use of the system or the quantity of waste produced. Temporary relief form environmental taxes may be authorised "where it is necessary to offset losses in competitiveness, particularly at international level".

(iv) *Aid for the Purchase of Environmentally-Friendly Products*

The guidelines indicate that measures to encourage final consumers (firms and individuals) to purchase environmentally-friendly products may not fall within Article 92(1) "because they do not confer a tangible financial benefit on particular firms." Such measures are to be assessed on their merits and may be authorised provided that they are applied without discrimination to the origin of the product, do not exceed the extra environmental costs and do not conflict with other provisions of the Treaty.

4.3.2 The GATT Code Rules on Environmental Subsidies

The GATT rules in relation to environmental protection appeared in the Cartland drafts of the Code, were excluded from the Dunkel draft and reinstated in the final text (Stewart, 1993). The final version of the text is similar in scope to the part of the EU guidelines concerned with investment aid to meet new environmental standards. The code provides that the following is non-actionable:

> "assistance to promote adaptation of existing facilities to new environmental requirements imposed by law and/or regulation which result in greater constraints and financial burden on firms, provided that the assistance:
>
> i. is a one-time non-recurring measure; and
>
> ii. is limited to 20 percent of the cost of adaptation; and
>
> iii. does not cover the cost of replacing and operating the assisted investment, which must be fully borne by firms; and

iv. is directly linked to and proportionate to a firm's planned reduction of nuisances and pollution, and does not cover any manufacturing cost saving which may be achieved; and

v. is available to all firms which can adopt the new equipment and/or production processes."

In addition, and like the EU rules, the GATT rules provide (in a footnote) that "existing facilities" refers to facilities that have been in operation for at least two years at the time when new environmental requirements are imposed.

The GATT rules differ from the EU rules in two main respects. First, the GATT Code covers only one type of subsidy covered under the EU rules in referring only to investment aid for firms to meet new mandatory standards; in particular, there is no mention of assistance to exceed the requirements of environmental regulation. Second, the GATT Code provides for higher levels of assistance to be acceptable for investment aid (20 percent as opposed to 15 percent). On the other hand, the EU rules provide for higher levels of assistance to be available to small and medium-sized enterprises and firms in designated development areas; the GATT Code makes no such provision.

4.4 Summary and Conclusions

This section has reviewed the EU State aid provisions and the GATT rules on "acceptable" subsidies taking as its starting point the categories identified as non-actionable in the Subsidies Code.

A clear theme running through the discussion of the three "green light" groups is the extent to which the EU's domestic policy has influenced the content of the rules agreed under the Uruguay Round.

The development of GATT rules on the acceptability of research and development rules is clearly derived from the EU framework on R&D aids. Ultimately, the actual wording and rates of award departed from EU practice. On the other hand, with exception of the reference to prototypes that are not capable of commercial exploitation, differences between the texts appear small and a matter of interpretation rather than real substance. Interestingly, however, the Commission moved quickly to realign internal controls on R&D aids with the GATT provisions. Although not yet published, it is known that the new R&D aid framework replicates the GATT approach to the different phases of the R&D process. In addition, while rates of award under the EU rules generally remain as before, there is provision to raise them to the levels accepted under the GATT Code where justified by the "common interest".

Superficially, at least, the EU and GATT rules with respect to regional development have a number of similarities. Both focus on issues of area designation and the extent of the regional disparity that justifies regional policy intervention being sheltered from the general disciplines on subsidies. Moreover, the GATT rules even borrow some of the Commission's quantitative criteria for measuring disparity. However, the GATT rules incorporate only a part of the EU provisions raising considerable uncertainty about the status of regional aids in those countries where they have been justified on the basis of EU rather than national averages. In addition, EU practice in the implementation of the regional aid methodology departs considerably from the apparently quantitative approach outlined in the 1988 methodology. Moreover, the methodology now makes provision for sparsely-populated areas to qualify for regional aids, a criterion that is entirely absent from the GATT provisions.

With respect to environmental aids, the GATT rules focus on a single type of support; in contrast, the EU rules refer to a wide range of types of assistance. Overall, however, it seems unnecessary that special provision was made for environmental subsidies to be deemed acceptable under the GATT Code. Eligible expenditure is so closely defined that it seems unlikely that such support could have caused “adverse effects” with the terms of the amber light subsidy category.

5. CONCLUSIONS

This paper has considered two separate systems for defining and disciplining subsidies in the international arena: the rules established on the basis of the Treaty of Rome for the regulation of State aids within the European Union; and the Subsidies Code agreed under the Uruguay Round of GATT negotiations with respect to the control of subsidies in a global environment. The principal focus of the paper has been on the definition of measures that are deemed to be acceptable under the two systems. This involves balancing legitimate domestic policy objectives against the potential negative effects of subsidies on other economies. The existence of an *ex ante* regulatory framework setting out the relationship between these interests is a prerequisite for transparency and certainty for governments and firms alike; recent developments in the EU and GATT rules suggest a convergence in the approaches for establishing such a framework. Nevertheless, the scope and content of the rules remain different, a fact which raises some important issues for the European Commission and the Member States in the discipline and in the operation of State aids in the EU.

This final section considers three main issues to emerge from the paper that have implications for the European Union. First, it is argued that there is now little discernible difference between a subsidy under the GATT rules and a State aid in EU terminology. Second, the treatment of support offered by subnational governments is discussed; it is suggested that the outcome of the GATT negotiations makes a significant concession to federal countries, the benefits of which will be most felt outside the EU. Last, the internal policy of the EU in controlling State aids made a visible input into the definition of non-actionable subsidies under the Subsidies Code; however, in practice, it may be difficult for the Member States, and the Commission itself, to comply with the rules that EU policy influenced so heavily.

i. There is now little discernible difference between a State aid under the EU rules and a subsidy under the GATT Code.

Until recently, it would have seemed that State aids under the EU rules covered a wider range of measures than the term subsidy. This was apparent from *Steenkolenmijnen* early in the history of the Communities and from the Commission's arguments in *Fediol*. Recent case law in the EU, together with the definition of "subsidy" which emerged from the GATT negotiations, casts doubt on the distinction between the two terms.

First, both the EU and the GATT rules clearly address measures operated by any public body or any agency acting on its behalf. The main difference between the two is that while measures operated by the EU institutions are subject to GATT discipline, they are not, in general, subject to Article 92.

Second, both definitions are indifferent to the forms of the measure concerned. Article 92 states that it addresses aid "in any form whatsoever", and while the GATT Code lists forms of assistance, the list is clearly intended to be of an illustrative nature.

Third, the EU and the GATT rules seek to distinguish between the standard activities of government and transactions that involve a gratuitous advantage to the recipient. This is evident from the EU emphasis on the "market investor principle" and the GATT requirement that a subsidy involves the conferral of a "benefit".

The key area in which the definitions of the two terms have converged concerns the financial nature of the transaction. The recent *Sloman Neptun* and *Kirsammer-Hack* cases suggest a narrower definition of the scope of an aid in comparison with what might have been presumed from earlier case law. In some respects, these decisions are difficult to reconcile with the existing body of ECJ decisions and further refinement of the notion "through State resources" is required in order to determine the extent to which what might be termed "regulatory subsidies" (ie. financial benefits that accrue to particular firms as a consequence of legislation but which do not involve a charge on the public account) fall within the scope of Article 92. Nevertheless, as matters stand, it is difficult to distinguish between the EU notion of a State aid and the GATT notion of a subsidy as a "financial contribution by government".

ii. The notion of specificity under the GATT rules favours federal countries outside the European Union.

The need to distinguish between general government activity and measures that are targeted at particular firms or groups of firms is an important issue under the EU and GATT rules. Both systems seek to exclude from the scope of discipline subsidies which are "generally available" or not "specific", although in practice, as discussed, the distinction is often not easy to make. The economic justification for such an approach is that if a measure is genuinely available to all producers, regardless of sector, and throughout a country, then its effects are dissipated and will ultimately be reflected in exchange rate adjustments.

However, the scope of the GATT rules creates a loophole for the activities of subnational governments. Its rules on specificity refer to subsidies being generally-available throughout "the jurisdiction of the granting authority". This means that, for example, a job creation grant could be operated by a US state or a Canadian province and that, provided that the eligibility criteria were sufficiently objective and neutral, the subsidy would not be actionable.

This is of concern for two main reasons. First, the economic argument for allowing generally-available subsidies to escape the rules does not hold in the case of subnational jurisdictions which are part of a wider monetary and currency union.

Second, within federal structures, economic development activities are typically one of the functions devolved to the subnational level; in north America, the subnational level, the US states and Canadian provinces, are the key players in the sphere of economic development. Under the approach taken, carefully designed subsidy programmes operated by these jurisdictions would be beyond the reach of GATT discipline. Related, there are signs that the NAFTA, involving as it does the removal of tariff and other barriers to trade, is already resulting in heightened economic development activity and the use of subsidies to attract mobile investment within the new free trade area; precisely the type of activity which Article 92 to 94 sought to restrict from the early days of the European Economic Community. However, unlike the EU, there are currently no provisions for regulating subsidies within the NAFTA, other than GATT disciplines.

Subnational authorities within the EU are disadvantaged by these provisions. Whilst it is true that a generally-available subsidy offered by a German *Land* government, for example, would not be actionable under the GATT, such a scheme would fall within the scope of Article 92 and would have to be judged on its merits. Moreover, it would be assessed against the relevant framework or guideline (or other considerations) as if it were offered by a Member State. Consequently, a generally-available investment grant within a German *Land* would only be likely to be authorised if it met the criteria of the regional aid or SME aid guidelines.

iii. The EU's internal policy for defining acceptable subsidies has visibly influenced the GATT Code, but the EU Member States may have difficulty in complying with its provisions.

In considering the definition of acceptable subsidies, this paper took as its starting point the green list in the GATT Code: aid for research; aid for disadvantaged regions; and aid for environmental protection. Members which operate programmes which conform to the criteria for each of these policy areas are required to notify those programmes to the WTO Secretariat in terms that enable eligibility for the green light category to be assessed.

In considering the green list under the GATT Code, two main issues arise for the EU. First, the range of policy areas for which State aids may be approved by the European Commission under EU competition policy goes beyond the GATT list. Second, in spite of EU influence over the definitions in the non-actionable category, it may be difficult for the subsidy practices of the EU Member States (and of the Commission itself) to conform to those rules in practice.

With respect to the first point, the focus of this paper has, as noted above, been on those policy areas for which the use of subsidies is deemed non-actionable under the GATT Code. However, as part of EU competition policy, the Commission endorses the use of State aids for a wider range of policy areas. In some cases, as for the policy areas discussed, frameworks or guidelines are operated and assistance is typically in the form of aid schemes or programmes. This is true of support for small and medium-sized enterprises. In others, whilst there are guidelines in place, assistance is more likely to be offered on an *ad hoc* basis by Member States; the most obvious example being rescue and restructuring aid. Neither of these policy areas finds a haven in the GATT non-actionable list.

It is true that support for small and medium-sized firms could be designed in such a way as to be non-specific, and therefore non-actionable; moreover, the size of the firms involved make it less likely that specific subsidies to them could be capable of having "adverse effects" on the interests of another Member. Nevertheless, in the case of aid to SMEs, and especially aid to rescue and restructuring, particular vigilance will be required if the Commission is not to endorse aid by Member States which is deemed actionable under the GATT.

The second issue concerns the ability of the Commission and the Member States to invoke Article 8.2 of the GATT. As discussed, if Members consider that a subsidy is non-actionable, then it must be notified in sufficiently detailed terms for its conformity with the criteria set in Article 8.2 to be assessed by other Members.

This paper has shown the extent to which these criteria have been influenced by the internal State aid control regime of the EU. In the area of research and development policy, the GATT rules borrowed heavily from the spirit of the EU R&D aids framework. This means that in practice, aids approved by the Commission, provided that they are operated on the terms approved, should comply with the R&D aid criteria set out in Article 8.2. Similarly, the provisions relating to environmental protection aid echo the terms of the EU rules on investment aid for environmental protection; again, environmental aids approved by the Commission should also comply with the terms of Article 8.2, and those that do not are unlikely to be of sufficient value to be actionable. The main question that arises concerns the EU provisions for higher award maxima for environmental protection investment where firms are located in designated assisted areas. Schemes offering enhanced award rates would clearly fail to meet the environment subsidy criteria and would have to be included within the regional subsidy notification.

In the case of regional aid, the situation is considerably more complicated. As discussed, the GATT criteria borrow from the EU rules to the extent of adopting the same thresholds of per capita GDP and unemployment to determine the existence of regional disparity. In practice, however, it seems likely that there will be considerable difficulties in demonstrating that the regional policy programmes of the Member States, as approved by the Commission, comply with the GATT Code. There are a number of reasons why this is so.

First, the GATT rules require regional development aid to be operated in “non-specific” manner within eligible regions. This means according to criteria “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”. No EU country currently operates regional aid policy in this manner. On the contrary, a key feature of the administration of regional aid is the extent of the discretion exercised by regional policymakers. This discretion is used to favour certain types of activity or sector and the attraction of investment (especially internationally-mobile projects) to designated problem regions.

The second set of issues concerns the areas that qualify for support. In many respects, the GATT rules appear similar to the EU’s methodology for approving assisted areas. In practice, however, there are important differences.

Both sets of rules are concerned that disadvantaged regions should be “clearly designated contiguous geographical area(s) with a definable economic and geographical identity.” In practice, however, the increased flexibility with which the 1988 methodology has been applied has meant that the European Commission has not succeeded fully in imposing this requirement on the Member States. As a result, there are many instances where regional policy maps present a patchwork of areas that lack overall coherence and which involve the designation of only parts of labour market areas or administrative units.

Further, the GATT rules provide that disadvantaged regions be selected on the basis of “neutral and objective criteria….clearly spelled out in law, regulation, or other official document so as to be capable of verification.” Although the criteria referred to are similar to those applicable in the EU, in practice, the EU methodology in relation to levels of GDP and unemployment under Article 92(3)(c) has been applied with increasing laxity in recent years. Following pressure from the Member States and criticism of the constraints imposed by such a quantitative approach, the Commission has increasingly regulated the coverage of designated areas with reference to the proportion of the national population contained within the regional policy map. In consequence, neutral and objective criteria form only a part of the basis for assisted area designation in the Member States. Moreover, such are the political sensitivities involved in the process that few countries make explicit their area designation systems (Wishlade and Yuill, 1995). As a result, it seems likely that many Member States would be not in a position to supply documentation that met the GATT Code requirements.

In addition to the shift away from the strict application of the quantitative criteria, the Commission has added a new set of criteria to its internal methodology; these concern sparsely populated areas. As discussed , this was a concession to the

Nordic countries in the context of the establishment of the European Economic Area and of EU enlargement because few of their assisted areas could meet the GDP per head and unemployment criteria. Applying the new population density test has enabled the Commission to approve the regional aid policies of Sweden and Finland under Article 92(3)(c), but on terms that find no shelter in the non-actionable category under the GATT rules.

As noted earlier, the GATT Code uses the same per capita GDP and unemployment criteria as do the EU rules for the purposes of Article 92(3)(c). However, there are important differences in approach. The reference to the "territory of a Member" means that the thresholds refer to the averages of the Member operating the subsidy. However, in certain EU countries, regional aid is not authorised on the basis of national averages at all, but rather EU averages (ie. on the basis of Article 92(3)(a)). In consequence, all of Greece, Ireland and Portugal qualify under the EU rules, but only parts of these countries would qualify under the GATT rules. Moreover, although regional aid is available throughout these territories, it is not operated in a manner that complies with the Article 2 provisions on specificity; in other words, it is unlikely that the regional aid mechanisms in place could be deemed non-actionable on the basis of being generally-available.

There may be scope to consider the regional aid policies offered in these countries as EU policies (since assistance is jointly financed from the EU Structural Funds); the thresholds applicable would then be the EU averages of unemployment or GDP per head. However, it seems probable that it would be difficult to make a convincing case for this.

These issues present serious practical problems for the Commission and the Member States; there can be little doubt that many of the subsidy practices endorsed by the Commission in its balancing of economic and social cohesion against distortion of competition has resulted in the approval of State aids that could be actionable under the GATT rules. Most ironic of all, the policies that are most exposed to such action are those that are operated in the poorest Member States of the EU.

More fundamentally, however, these issues raise difficult questions about the relationship between competition policy, trade policy and economic and social cohesion in the EU. A wider area for debate is the extent to which regulatory regimes can successfully and meaningfully be transposed from one jurisdiction to another.

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