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REVIEW OF OVERSEAS EXPORT ENHANCEMENT MEASURES
VOLUME 1: REPORT

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CONTENTS

Volume 1: Report

Abbreviations x

Terms of Reference xii

Overview xiii

Recommendations xxiii

1 The inquiry 1

2 Why enhance exports? 5

2.1 The benefits from trade 5
2.2 Determinants of exports 7
2.3 Rationales for export enhancement measures 10
2.4 Concluding comments 16

3 Subsidies and the GATT 19

3.1 Subsidies in theory 19
3.2 GATT provisions 20
3.3 Concluding comments 24

4 Exports subsidies 27

4.1 Use of subsides – an overview 27
4.2 The problem of agricultural assistance 34
4.3 Research and development assistance 36
4.4 Infrastructure 38
4.5 The evidence from countervailing actions 41
4.6 Concluding comments 43

5 **Export finance assistance** **45**

5.1 Export finance agencies 45
5.2 Forms of export finance assistance 46
5.3 International use and cost of export fiance 48
5.4 Why governments underwrite exports 56
5.5 Effects of export finance assistance 58
5.6 Effects on the Australian economy of foreign export finance assistance 65
5.7 Concluding comments 66

6 **Tax incentives** **69**

6.1 Tax incentives to encourage exports 69
6.2 GATT consistency of tax incentives 77
6.3 Comparing the use of tax regimes to encourage investment 77
6.4 Economic effects 81
6.5 Concluding comments 86

7 **Export processing zones** **89**

7.1 Rationale for establishing EPZs 90
7.2 Rationale for investing in EPZs 91
7.3 The performance of EPZs 93
7.4 Growth triangles 97
7.5 Science parks 97
7.6 Concluding comments 99

8 **Export marketing assistance** **101**

8.1 Rationale for government involvement in the provision of information and risk sharing 101
8.2 Types of export marketing assistance 102
8.3 Economic effects 106
8.4 Developing an export culture 108
8.5 Concluding comments 111

9 Trade-related investment measures 113

9.1 Types of export-related investment measures 114
9.2 Use of export-related investment measures 120
9.3 Economic effects 121
9.4 Concluding comments 122

Appendices 125

A Conduct of the inquiry 125
A1 Visits 125
A2 Participants 127

B Australia's export enhancement measures 129
B1 Export subsidies 129
B2 Export marketing 132
B3 Export finance assistance 136
B4 Trade-related investment measures 138
B5 Research and development 140
B6 Recent reviews of programs 141

C GATT provisions 143
C1 Selected Articles from the General Agreement on Tariffs And Trade (GATT) 147
C2 Agreement on interpretation ad application of Articles VI, XVI and XXIII of The General Agreement on Tariffs and Trade (The Tokyo Subsidy Code) 150
C3 Letter from Australia to the United States concerning the Subsidies Code 176

D International agreements on export finance 181
D1 The Berne Union 181
D2 The OECD Arrangement on guidelines for officially Supported export credits 182
D3 The GATT Subsides Code 186
D4 Recent agreements 187

References 189

Text figures

2.1	Volume of world merchandise trade and output: 1960-68	6

Boxes

3.1	Subsidisation and dumping	21
3.2	GATT disciplines on subsides	22
6.1	Examples of tax incentives focusing on exports encourage exports	70
6.2	Types of tax incentives focusing on exports	71
9.1	A typical export performance requirement	114
9.2	An example of foreign exchange restrictions	116
9.3	An example of a manufacturing requirement	117
9.4	A typical technology transfer requirement	117
9.5	An example of a local equity requirement	118
9.6	A trade balancing requirement	118

Tables

4.1	Direct subsidies as a percentage of GDP in selected OECD countries	29
4.2	Budgetary support to manufacturing in the European Community, by measure: 1986-88 averages	30
4.3	Budgetary support to manufacturing in the European Community, by Target group: 1986-88 averages	31
4.4	Export subsidies in selected EC and EFTA countries	31
4.5	Assistance as a share of farm income: selected OECD countries	35
4.6	Average countervailing duty margins, tariff protection and percentage fluctuations in real exchanges rates during the 1980s	41
5.1	Availability of officially supported export finance facilities in selected economies	49
5.2	Officially supported export insurance and guarantee activities in selected economies	50
5.3	Officially supported export credits in selected economies: 1988	52
5.4	Concession levels in medium-and long-term export credits	53
5.5	Annual credit subsidies	53
5.6	Notifications of mixed credit offers	55
6.1	Tax rates and incentives, selected economies	72
6.2	Effective rates of wholesale tax on exports, by industry: 1990-91	76
6.3	The pre-corporate tax required rate of return necessary when the real interest rate is 5 per cent	78
7.1	Activities in selected Asian EPZs	90

7.2 Tax incentives offered in selected EPZs 92
7.3 Exports from EPZs in selected economies: 1990 94
7.4 Aggregate performance of four Asian EPZs 95
7.5 Welfare impact of EPZs, composition of net present value 96
9.1 Types of investment incentives 115
9.2 Developing countries using export-related investment measures 121

A1 Inquiry visits 125
A2 Submissions 128
B1 Summary of Australia’s export enhancement measures 130
D1 Arrangement matrix of interest rate minima: 1990 183

Volume 2: Country Studies

I Introduction
II Hong Kong
III Indonesia
IV Japan
V Korea, Republic of
VI Malaysia
VII Singapore
VIII Taiwan
IX Thailand
X New Zealand
XI The United States of America
XII The European Community
XIII France
XIV Germany
XV The United Kingdom

ABBREVIATIONS

ACM	Australian Chamber of Manufactures
ADB	Asian Development Bank
AEEMA	Australian Electrical and Electronic Manufacturers' Association
AIDAB	Australian International Development Assistance Bureau
AMC	Australian Manufacturing Council
ASEAN	Association of South East Asian Nations (comprises Brunei, Indonesia, Malaysia, Philippines, Singapore and Thailand)
Austrade	Australian Trade Commission
BAE	Bureau of Agricultural Economics (Australia)
BCA	Business Council of Australia
BIE	Bureau of Industry Economics (Australia)
BOTB	British Overseas Trade Board
CAP	Common Agricultural Policy (European Community)
CEPD	Council for Economic Planning and Development (Taiwan)
CETRA	China External Trade Development Council (Taiwan)
CVD	Countervailing Duty
DIFF	Development Import Finance Facility (Australia)
DISC	Domestic International Sales Corporation System (United States)
DITAC	Department of Industry, Technology and Commerce (Australia)
DFAT	Department of Foreign Affairs and Trade (Australia)
DPIE	Department of Primary Industry and Energy (Australia)
EC	European Community (comprises Belgium, Denmark, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain and United Kingdom)
ECG	Group on Export Credits and Credit Guarantees (OECD)
ECGD	The Export Credits Guarantee Department (United Kingdom)
ECIC	(Hong Kong) Export Credit Insurance Corporation
EEG	Export Expansion Grants scheme (Australia)
EFIC	Export Finance Insurance Corporation (Australia)
EFTA	European Free Trade Association (comprises Austria, Finland, Iceland, Liechtenstein, Norway, Sweden and Switzerland)
EMDG	Export Market Development Grants scheme (Australia)
EPZ	Export Processing Zone

FSC	Foreign Sales Corporation (United States)
GATT	General Agreement on Tariffs and Trade
GDP/GNP	gross domestic product/gross national product
IAC	Industries Assistance Commission (Australia)
IC	Industry Commission (Australia)
IMF	International Monetary Fund
XPA	Joint Committee on Public Accounts (Australia)
JETRO	Japanese External Trade Organization
KOTRA	Korean Trade Promotion Corporation
MECIB	Malaysian Export Credit Insurance Berhad
MIDA	Malaysian Industrial Development Authority
MITI	Ministry of International Trade and Industry (Japan)
MNC	multinational corporation
MTIA	Metal Trades Industry Association of Australia
NTB	non-tariff barrier
OECD	Organisation for Economic Co-operation and Development (comprises Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Japan, Luxembourg, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, the United Kingdom, and the United States)
PM&C	Department of Prime Minister and Cabinet (Australia)
R&D	Research and development
SME	small- and medium-sized enterprises
TDB	Trade Development Bank (Singapore)
TRIM	Trade-Related Investment Measure
VAT	value-added tax

Terms of Reference

I, PAUL JOHN KEATING, in pursuance of my powers under Section 7 of the *Industry Commission Act 1989* hereby:

1. refer overseas export enhancement measures for inquiry and report by 8 April 1992;

2. without limiting the scope of the reference, request that the Commission give specific attention to:

   (a) the methods by which Australia's main trading partners promote export and import replacement activities;

   (b) the direct costs and wider economic implications for these economies of these measures;

   (c) the extent to which these measures are consistent with GATT obligations; and

   (d) the economic implications of these activities for Australia.

OVERVIEW

This report looks at how governments of Australia's major trading partners and competitor economies encourage exports; the effects of those measures on the home economy and on the ability of Australian firms' to compete at home and overseas; and the lessons for Australia.

Export enhancement measures are a small and declining feature of world trade. For example, subsidised export credits extended by OECD countries apply to only 2-3 per cent of their exports. However, export enhancement measures are important in agriculture and this sector accounts for 15 per cent of world trade.

Options available to governments to artificially stimulate export performance have narrowed over the last two decades. There are now major constraints on the extent to which governments can subsidise or finance exports directly. GATT rules restrict payment of explicit (or direct) -export subsidies, while other international agreements limit the use of government funds to reduce the costs of export finance. The global trend is to restrict further the opportunities for governments to subsidise exports. As a result, government support for exports is now tending to occur further back in the production chain (eg in the form of investment incentives).

The use of export enhancement measures

Governments employ a variety of measures to enhance exports, ranging from direct subsidies (eg export grants) to much more indirect measures (such as assistance for industrial research and development). Table 1 gives a flavour of the types of export enhancement measures that have been used, along with specific examples.

A feel for the degree, type and extent of government assistance to exports - which varies widely from country to country - can be gained from Table 2 which attempts to summarise the current use of export enhancement measures in selected economies. Some governments hardly intervene at all (eg Hong Kong), while others have applied an array of measures to one or more industries'(eg Singapore).

Table 1: **Types of export enhancement measures** [a]

Type of measure	*Specific examples*
Direct subsidies (export grants)	The European Community and the United States each give massive export subsidies under agricultural assistance schemes.
Finance assistance (export credit and credit insurance / guarantees)	France offers exporters a wide range of services. It is the most active provider of subsidised export credit. It provided insurance and guarantees for over 20 per cent of its exports.
Tax incentives (tax holidays, favourable depreciation provisions, tax concessions)	Tax breaks based on export performance are provided by Malaysia.
Export processing zones (EPZs) special manufacturing areas in which industries receive special incentives such as tax incentives and duty exemptions)	Indonesia's Batam Island, near Singapore, has an EPZ aimed at attracting manufacturing investment to a relatively low-cost location.
Marketing assistance (marketing support, information services, product exhibition support)	The Hong Kong Trade Development Council provides marketing services to local businesses and maintains a network of international offices and agencies.
Trade-related investment measures (export requirements and investment incentives)	An industry development agreement for customer premises telecommunications equipment restricts access to Australia's telecommunications network to firms which achieve certain levels of exports, local content and research and development (R&D).
Indirect assistance (R&D assistance and subsidised infrastructure)	Korean R&D is stimulated by a range of tax incentives and a $US2 billion program to develop 919 high-technology items now imported from Japan. High quality infrastructure developments in 70 Taiwanese industrial parks and EPZs have permitted Development of manufacturing industries. Hsinchu Science Park has extended this concept to reversing a brain drain to California's Silicon Valley.

a The definition of these measures is to some degree arbitrary and inevitably there is some overlap.

Table 2: **A broad summary of current use of export enhancement measures in selected economies [a, b]**

Economy	*Direct Subsidies*[c]	*Finance*	*Tax -incentives*[d]	*EPZ*	*Marketing*	*Infra-structure*	*TRIMs*	*R&D*
Australia	**S**	**G**	x	x	**G**	s	s	**G**
Hong Kong	x	g	x [e]	x [f]	**G**	s	x	g
Indonesia	x	**G**	x	s	**G**	s	x	x
Japan	x	**G**	x	x	g	x	x	g
Republic of Korea	x	**G**	**G**	g	g	**G**	s	**S**
Malaysia	x	**G**	**G**	**G**	**G**	**G**	**G**	**G**
Singapore	x	g	**G**	**G** [f]	**G**	**G**	**G**	**G**
Taiwan	x	**G**	**G**	**S**	g	**G**	**S**	**S**
Thailand	x	g	s	**S**	**G**	**S**	**S**	x
New Zealand	x	x	x	x	**G**	X	x	x
United States	**S** *	**G**	g	x	**G**	X	x	**S**
France	**S** *	**G**	x	x	**G**	**G**	s	**S**
Germany FR	**S** *	**G**	x	x	g	X	x	**S**
United Kingdom	**S** *	**G**	x	x	**G**	X	x	**S**

a This table applies to central, and not state or local, government export enhancement measures.

b *Key* x 'This type of enhancement measure is not used so far as the Commission understands.
G / g Assistance through this measure is generally available.
S / s Assistance through this measure is selective.
Bold upper-case lettering indicates government expenditure (or indirect measures) which involve relatively large amounts of resources.

c Includes direct subsidies to exports and general grants, bounties, export facilitation schemes and other countervailable subsidies. Excluded are tax incentives which are treated in the third column of this table.

d Excludes value-added tax (VAT) refunds and import duty exemptions and drawbacks.

e Hong Kong's general tax regime is lower than most other economies studied.

I It can be argued that the whole economy is an EPZ.

Includes substantial agricultural export subsidies.

Many measures seem to have been tailored to suit the peculiar circumstances of individual economies at a particular time (eg depending on their stage of economic development). For example, the role of export processing zones has largely been to provide access to high-quality infrastructure in countries where the general availability of these services is inadequate. Another key influence on the choice of export enhancement measures is copycat behaviour -- whereby countries which see themselves as competing with one another to attract projects feel bound to match the incentives offered by others, just in case the location decisions of multinational firms eventually turn on such inducements.

The policy environment

Recent economic history and the current policy stances of many successful economies -- especially those in the Asia-Pacific region -- suggest that strong, sustained economic growth has followed a shift from an 'inward' to an 'outward' oriented economy. This makes intuitive sense, since the constraints on achievable growth implied by concentrating on a small domestic market are obvious compared with the potentially far greater opportunities on world markets. Greater competition in the international arena can also enhance productivity.

The clear trend among the faster growing economies in the Asia-Pacific region is to reduce import barriers, as well as to shift away from policies which subsidise exports. Protection is still high in international markets for agriculture. On the whole, global markets for manufacturing are relatively open although pockets of protection still exist in some areas (eg garments and footwear). General levels of protection are higher among developing countries than in OECD countries. But the overall trend among developing countries is to open markets.

Australia has also recognised the benefits of increased trade. Industry policy has moved away from the inward-looking approach, which was adopted through much of the post war period, and import barriers have been steadily reduced. In March 1991, the Australian Government announced a package of industry policy changes which Will see further reductions in Australia's import barriers. General tariff rates of 10 and 15 per cent in 1992 will phase down to 5 per cent in 1996, and significant cuts in assistance will also be made to the more highly protected automotive and textiles, clothing and footwear industries.

Assessing export enhancement measures

A measure designed to stimulate exports can only be judged worthwhile if it leads to increased national prosperity. As conventionally measured, this would mean a sustained increase in gross national product (GNP). To be successful, therefore, an export enhancement measure would have to do more than increase exports of particular products; it is the net effect on economic activity which is important. Thus the costs of such a measure in terms of its effects on other industries and to the public purse needs to be looked at, as well as any direct benefits generated. Such an assessment of net benefits would need to take into account the time needed for export enhancement policies to take effect, since there may be a lag before all costs and benefits work their way through the system.

The likely effectiveness of particular export enhancement measures also has to be considered against the backdrop of a country's stage of development and its government's policies towards such key economic influences as the exchange rate, barriers to imports and the extent of exposure of the economy's financial sector to international capital markets. For example, stimulating exports

in the context of a floating exchange rate will, other things equal, lead to a tendency for the currency to appreciate (thereby partially offsetting the intent of the initiative).

It is difficult to disentangle the effects of export enhancement measures from the influence of the broader circumstances in the economies studied in this report. For example, a sense of national crisis has pervaded many East Asian economies, encouraging a unity of purpose which has doubtless contributed to their success (including their remarkable export performance). Moreover, it is difficult to judge the effectiveness of export-related tax incentives in isolation from overall tax burdens.

Is export success due to government intervention?

While plenty of people hold the view that export enhancement measures are essential and successful in promoting fast, export-led growth, there is remarkably little supporting empirical evidence to back up such judgements. In fact, evidence of the effects of such measures on export growth and economy-wide effects more generally is remarkably difficult to come by. In particular, the key question of whether observed economic growth could have been attained at lower cost in the absence of export enhancement measures is rarely addressed. Ibis is not entirely surprising - governments may be reluctant to analyse their own policies critically in this area, and international institutions with a reputation for undertaking impartial analysis are only just getting into this field (eg the GATT via its Trade Policy Reviews and the World Bank). However, the deleterious effects of the EC's Common Agricultural Policy on member states and of United States' farm support policies on its domestic economy have been well demonstrated.

The experience of Hong Kong challenges the proposition that interventionist industry policy and export success are inextricably linked. The fact is that 'winners' emerge even when they are not picked. Indeed, that is exactly what one would expect where the basic strengths of an economy are allowed to assert themselves. Hong Kong's achievements have come about under a trade regime characterised by no import barriers, no subsidies and no tax incentives or export credits. Its export assistance is limited to marketing and insurance facilities. On the other hand, the structure of Singapore's economy (including its entrepôt character, and its vibrant finance, petrochemical and electronics sectors) has been greatly influenced by government intervention.

Picking winners in the form of government-selected activities which are targeted for export assistance has proved something of a hit-or-miss strategy, with claimed successes and patent failures. Examples of failure can be found in some Korean targeting of heavy industry; and of success in some Japanese targeting of knowledge-intensive industries. In many cases (eg Korea), non-targeted industries (eg semiconductors) have grown just as fast (or faster) than ones singled out for special treatment (eg steel).

With such mixed evidence, it is difficult to establish a causal link between export enhancement measures and any resulting growth in exports (let alone GNP). Clearly, there are many factors at work in addition to government-inspired export enhancement measures.

What attracts investment in export industries?

It is common for governments of developing economies to match policies to woo foreign investors. Competition in the race to lower effective corporate tax rates has been encouraged by potential investors interested in lowering their costs (even though the incentives offered may not in fact have altered their location decisions). In these circumstances, governments may simply be forgoing tax revenues to no purpose. It is noteworthy that the Malaysian Government has recently acted to reduce its tax incentives.

Decisions by firms about where to locate are driven by demand, cost and even strategic considerations. Thus, proximity to markets, the various components of a project's cost structure, and having a 'presence' in an important (or emerging) market can all be key influences when it comes to deciding where to locate a particular production facility. That the availability of export enhancement measures in a particular economy can be of secondary importance when it comes to firms making location decisions is reinforced by surveys which have asked companies why they locate in particular countries and to rank significant factors in order of importance. While rankings tended to vary somewhat (depending for example on the type of activity a firm was engaged in), the answers tend to bring out the following concerns:

- political stability;
- perceptions of the extent to which the host government is 'pro-business'; the availability, skills and cost of labour;
- access to raw materials and other necessary inputs (eg power, plant and equipment) at world prices;
- low tax rates (including export enhancement measures which have tax incentive dimensions) -- since low rates will boost the prospective return on capital, which is an underlying rationale for investing in the first place; and
- access to efficient and appropriately-priced infrastructure and related services (eg good roads, world-class ports and modern communication networks).

The cost of intervention

Governments have come to appreciate that competitive subsidies can be wasteful. This has led to the OECD Arrangement on restricting export finance assistance and the GATT Code to reduce the use of export subsidies. 'There is now an emerging consensus that trade-related investment measures (TRIMs) should also be disciplined. In a similar that trade-related investment measures (TRIMs) should also be disciplined. In a similar vein, some of the current extensive support for

research and development (R&D) activities may, with the benefit of hindsight, be eventually judged to be counterproductive in terms of the net benefits for countries providing such assistance.

Effects on the Australian economy

Export enhancement measures used by foreign governments adversely affect those Australian firms that have to compete against subsidised products on either the domestic or international markets.

The export enhancements which damage Australia most are the agricultural subsidy programs of the European Community and the United States. These measures limit Australian sales of agricultural produce into these regions, and they depress prices in other markets. The Australian Government has consistently pointed out that such policies are counter-productive; and it has protested both bilaterally and in international forums (eg by forming the Cairns Group, created to press for reform of agriculture in the GATT Uruguay Round).

Australian capital-goods producers find that they cannot always compete with exporters from other countries who are able to lower their bids to supply equipment for major projects by drawing on government aid funds. The ongoing mixed credit war between the larger industrialised countries is clearly to the disadvantage of these Australian producers.

A recent worrying development is Japan's use of 'voluntary import expansions' (VIEs). Surplus-induced trade frictions with the United States and EC member states have put pressure on the Japanese Government to increase imports. Early in 1990, it introduced its 'Comprehensive Import Expansion Measures', which included import assistance. These VIEs direct Japanese firms to increase imports from designated countries and provide loans and tax incentives to those that reach specific import targets. The Commission has little information on the extent of the damage being done to Australian exports by these measures (although car parts are one area of concern).

When it comes to the aggregate impact of overseas export enhancement measures on the Australian market, the balance of costs and benefits to producers and consumers is less clear cut. For example, cheap imports (due to overseas export enhancement measures) will hurt domestic producers and represent 'unfair' competition -- thereby inviting some form of countervailing response (eg by invoking anti-dumping procedures). On the other hand, industrial users and other consumers will be advantaged by having access to imports which have been subsidised by foreign tax-payers. In some cases (eg large commercial aircraft) there may be no domestic manufacturer to be disadvantaged. Whether such a situation represents a net benefit to the Australian economy will then depend on the relative magnitudes of the costs and benefits and the time period over which they are likely to persist – something that can only determined on a case-by-case basis.

Policy implications for Australia

A tempting response to the export enhancement measures of Australia's major trading partners and competitor economies is to seek to match them. Doubtless there are many in Australia who would advocate such a course of action. But there is more to it than that. First, the international trend is to reduce the use of these measures. Second, the Australian Government does not have anything like the financial resources it would need to take on the major industrialised nations by matching their export assistance measures. Third, large-scale use of export enhancement measures would invite retaliation from major trading partners like the United States. Finally, mobilisation of resources to expand exports in some Asian countries has been an integral part of social, cultural and political circumstances which do not apply in Australia.

If some Australian exporters, such as wheat growers, were assisted by the Government to offset overseas export enhancement measures, their exports would probably rise. But Australian tax-payers would have -to foot the bill. Unless such assistance were short-term and somehow led to a reduction in the use of export enhancement measures by others (an unlikely event), there would be a net loss to the economy.

In any event, Australia already has significant export enhancement measures - for example, Austrade, the Export Finance and Insurance Corporation (EFIC), the Export Market Development Grants Scheme (EMDG), the Development Import Finance Facility (DIFF) the export facilitation schemes operating in the automobile and textile sectors, and the subsidies provided to pharmaceutical exports under the 'Factor f' scheme.

The Commission accepts that a case can be made for a specialist agency that provides export-related marketing services. However, this does not necessarily mean that taxpayers should fund such a body. Countries organise this function differently. There are examples of successful government-run and funded trade promotion agencies (eg Japan's JETRO and the Hong Kong Trade Development Council), just as there are successful ones which are dominated by private sector interests (eg Taiwan's CETRA).

In assessing Australia's policy response to the export enhancement measures of other countries, it is desirable to discern the motivation for those measures. For example, where measures are introduced to compensate for the effect of tariffs in raising the price of imports which are incorporated into exports, it should be noted that Australia already operates a duty drawback scheme. It is also pursuing the best strategy for countering the taxing effect that protective policies have on exports, namely by reducing tariffs.

Where measures represent an attempt to lure foreign direct investment, the issue is whether, in the context of the capital inflow that we already attract (historically to capitalise on Australia's natural resource endowment which has been beyond our ability to finance from domestic savings), there is any better strategy than removing impediments already identified by the Commission (eg in providing efficient and appropriately priced infrastructure -- railways, roads, ports, electricity, and the like).

More generally, international competitiveness will be affected by any number of government policies, many of which are more influential than schemes focussing on exports. A consistent and stable approach to both macro and microeconomic policy is highly desirable if competitiveness is to be maintained and improved over the longer term. Such a strategy is superior to introducing or boosting specific export enhancement measures in an ad hoc way, because pursuing appropriate economy-wide policies has a more certain (and higher) payoff. Federal and State Government microeconomic reform has the potential to increase prosperity directly through improvements in the efficiency of a range of industries (including industries in the large non-traded goods sector). By contrast, gains from export enhancement measures are limited to those that may be achieved through stimulating export activity in the hope that the benefits will exceed the costs imposed on the rest of the economy.

Fostering a pro-business climate

In the Asia-Pacific region, direct export subsidies are no longer a common instrument to secure increased foreign sales. The emphasis now is on improving competitiveness across the economy. As in Australia, moves to remove regulatory impediments impeding efficiency gains, lower import barriers, put in place efficient and appropriately priced infrastructure, invest in people through education and skills training, and liberalise international trade in services, all hold the prospect of more substantial long-term gains than inventing new ways to encourage exports.

A key component of the policy climate to improve competitiveness is a nation's tax system. A number of economies (eg Hong Kong, Korea, Singapore and Taiwan) offer low corporate tax rates and/or favour investment in high-technology plant and processes through mixes of fast rates of depreciation, investment allowances and special deductions for introducing new technology.

Comparisons of tax regimes among economies are tricky. It is difficult to ensure that like is compared with like. For example, a country may not be attractive to investors if it has low taxes but poor public infrastructure as a consequence.

It is still true that Australia is a high-wage economy compared with most other East-Asian economies. However, in some cases, the gap is closing fast. Several economies are rapidly moving out of low-wage-cost manufacturing and, possibly within five to ten years, investment decisions will be based increasingly on comparisons of the tax regime on industry in Australia compared with the tax regimes in other economies in the region. Some taxes are imposed on Australian exporters that are not matched internationally, especially because of the prevalence of value-added

taxes. The Australian tax system should not reduce export competitiveness more than is absolutely necessary. This means ensuring, among other things, that taxes on inputs used in exports are minimised.

The tax burden on industry should be made as low as possible. To the extent that there is scope to lower taxes for industry (including for exporters), the Commission believes that taxes should be lowered across-the-board, rather than for particular sectors.

Responding to the subsidies of others

Australia cannot hope to win a general export subsidy war against the agricultural subsidy programs of the European Community and the United States. The fact is that most countries lack the means to roll back the distortions that can be imposed on world markets by the major economic powers. Moreover, in a subsidy war, unassisted exporters would suffer reduced competitiveness -- leading to efficiency losses across the economy generally. In all likelihood, the net result would be to depress rather than enhance national income.

All Australian exporters -- our farmers more than any other group -- suffer in third country markets from overseas export enhancement measures. Attempting to match subsidies is neither desirable nor practicable. The primary recourse available to the Australian Government is to continue to press for reform bilaterally and in multilateral forums. Australia can only benefit from stronger international disciplines on export subsidies.

There are some key steps that the Australian Government can pursue in this respect. Its activities in international forums should be directed to the following ends:

- extension of international prohibitions on the use of export subsidies to boost trade in agricultural products;
- adoption by developing countries of the same obligations as industrialised countries not to use export enhancement measures;
- tightening of restrictions among all (particularly OECD) countries on the use of subsidised credit to finance exports; and
- proscription in international agreements of arrangements to subsidise imports, such as the Government of Japan is now employing.

Subsidising export-oriented R&D activities is popular internationally. Moreover, Australia provides a range of support to R&D, including favourable tax treatment. While adopting and adapting new technologies is clearly important to the continuing competitiveness of Australian industry, the Commission has not attempted in this inquiry to assess whether there are grounds for favouring R&D activity further.

Developing an export culture

The final point the Commission wishes to emphasise has to do with attitudes. In the Asia-Pacific economies visited by the Commission during this inquiry, there is strong community awareness of the need to be internationally competitive. There is undoubtedly a growing appreciation of this need in Australia also.

The Commission is aware of the efforts that have already been made to stimulate increased awareness of the advantages of exporting, as well as international benchmarking and the adoption of best practice policies generally. But there is a major benefit to be secured from efforts to intensify in the community an appreciation of the need to be globally competitive and to operate in international markets. It will take continuing efforts to change attitudes in Australia and instil a well-developed export culture throughout the Australian community.

Several proposals on how to do this were put to the Commission in response to its Draft Report. The Commission has not attempted to assess the likely effectiveness of such initiatives.

Recommendations

Federal and State Governments should continue to remove impediments to economic efficiency throughout the economy - particularly import protection -- as a surer way to increase trade and national prosperity than to selectively assist exports.

The Australian tax system should not reduce export competitiveness more than is absolutely necessary. Taxes on inputs used in exports should be minimised.

The tax burden on industry should be made as low as possible to enhance international competitiveness. To the extent that there is scope to lower taxes (including for exporters), the Commission believes that taxes should be lowered across-the-board, rather than for particular sectors.

A stronger export culture should be fostered throughout the Australian community to reinforce the need to become globally competitive.

The Australian Government's activities in international forums should be directed to the following ends:

- extension of international prohibitions on the use of export subsidies to boost trade in agricultural products;
- adoption by developing countries of the same obligations as industrialised countries not to use export enhancement measures;
- tighter restrictions among all (particularly OECD) countries on the use of subsidised credit to finance exports; and

- proscription in international agreements of arrangements to subsidise imports, such as the Government of Japan is now employing.

The Commission draws attention to its comments on:

- using the GATT to encourage countries to calculate the gains from domestic trade reforms (Chapter 3);

- the scope for greater private sector involvement in export finance in Australia, especially short-term credit insurance (Chapter 5); and

- the need to examine whether differences in the taxation of income from overseas sources compared with income from domestic sources under the Australian taxation system unintentionally discriminates against exports (Chapter 6).

CHAPTERS

1 The inquiry

2 Why enhance exports?

3 Subsidies and the GATT

4 Export subsidies

5 Export finance assistance

6 Tax incentives

7 Export processing zones

8 Export marketing assistance

9 Trade-related investment measures

1 THE INQUIRY

In March 1991, the Australian Government announced a package of industry policy changes which will see further reductions in Australia's import barriers. General tariff rates of 10 and 15 per cent in 1992 will phase down to 5 per cent in 1996 and significant cuts in assistance will also be made to the more highly protected automotive and textiles, clothing and footwear industries.

The Government foreshadowed this inquiry in its March 1991 statements in the following terms:

> The measures announced by the Government have as their objective improving the productive capacity of the economy and building an economy that is more competitive internationally. The reforms should ensure that our industries are much better placed to take advantage of opportunities on the world market.
>
> The ability of Australian exporters to realise the full potential gains could in some cases be lessened, however, by policies adopted by other trading nations which enable their industries to compete on a more favourable basis than our own.
>
> The Government will therefore ask the Industry Commission to undertake a review ... [of overseas export enhancement measures] (PM&C 1991, pp. 5.38-9).

The Government referred the matter formally to the Commission on 8 April 1991 for inquiry and report by 31 December 1991, but later extended the reporting deadline to 8 April 1992.

People often ask why the Australian Government does not do more to stimulate exports of goods and services, especially in view of our continuing high current account deficit. Some say that the governments of our main trading partners/competitors offer many more incentives to export and to expand the export base. Those same incentives are often portrayed as obstacles to successful competition by Australian producers, both on domestic and overseas markets.

Over 40 per cent of 1100 Australian manufacturing companies surveyed recently considered that subsidies paid to foreign competitors were an important impediment to Australian exports of manufactured goods (BIE 1990). Another survey of 200 companies and 1200 managers called for greater government export incentives to improve the international competitiveness of Australian industry (Midgley 1990). Nevertheless, this inquiry attracted limited initial interest in Australia when judged by the number of submissions received prior to the Commission releasing a draft of its report -- just 30 from a total of 26 participants. The Commission's Draft Report, however, received considerable media coverage and generated an additional 23 submissions.

What is the inquiry about?

This report examines export enhancement measures that have been used by other countries. However, several participants, such as the Metal Trades Industry Association of Australia (MTIA) and Australian Electrical and Electronic Manufacturers' Association (AEEMA), provided the Commission with specific comments and criticisms about Australia's own export enhancement schemes. As indicated in Appendix B, many of Australia's export enhancement schemes have recently been subject to review, or are to be reviewed shortly. The Commission considered it should not attempt to duplicate these evaluations.

The Commission also received some comments about the import replacement schemes of other countries (eg from AEEMA and Messrs Rattigan and Carmichael). In most cases, an import replacement scheme is not an export enhancement measure. The Commission's views about policies aimed at protecting local industries from import competition, both by tariffs and non-tariff barriers, are well known and accepted by government. The Commission has consistently argued that Australia should continue its present policy of lowering protection levels and that this policy should continue regardless of the behaviour of other countries. For this reason, the Commission has not re-examined this issue in this report and only considered such schemes only in those cases where they were thought to have been used to enhance exports.

What are export enhancement measures?

The Commission interprets 'export enhancement measures' to mean government policies which are directly aimed at increasing exports of goods and/or services. Policies which obviously have the effect of increasing exports, even though they are implemented for other purposes, also interest this inquiry. While general policy settings (such as fiscal and monetary policy) affect exports, the Commission has considered them to be outside its terms of reference -- as it has the removal or reduction of trade-restricting policies like tariffs or voluntary export restraints, or measures to protect domestic markets like anti-dumping policies.[1] Further, the Commission has not dwelt much on intergovernmental efforts to reduce trade barriers or to improve market access to other countries.

Measures definitely under reference in this inquiry include export subsidies, export marketing assistance, export financing (including mixed credits and loan guarantees), tax incentives and concessions for export, export processing zones and trade-related investment measures (so called TRIMS). Other government initiatives arguably under reference include counter-trade, government trading bodies, research and development assistance, and subsidised infrastructure, because the main beneficiaries are often export-oriented activities. The Commission has addressed some, but not all, of these other measures in this report.

[1] Foreign tariff concession schemes have recently been reviewed by the Commission (1991b, Appendix G).

Which economies are under reference?

The terms of reference direct the Commission to focus on Australia's main trading partners. These are the United States, Japan and the European Community member states, which in 1989 -- 90 accounted for 51 per cent of Australian exports and 65 per cent of our imports. New Zealand, Taiwan, the Republic of Korea, China and Singapore are also significant trading partners -- collectively accounting for a further 18 per cent of exports and 15 per cent of imports in 1989 - 90.

In preliminary discussions held with various people and organisations (listed in Appendix A), a common point made was that the terms of reference ought to encompass Australia's main trading competitors. The Commission has accepted the desirability of considering such economies, especially those which are geographically close to Australia. This report therefore also examines export enhancement measures in the dynamic East Asian economies of Hong Kong, Indonesia, Malaysia, and Thailand, whose exports have been increasing at very high rates in recent years.

The Commission visited eight economies in East Asia in an attempt to observe at first hand the benefits and costs of various export enhancement measures. The insights obtained from these visits have contributed to this report, although the Commission found little quantitative analysis assessing the effectiveness of the measures.

What types of exports are under review?

As a further consequence of its preliminary discussions, the Commission has put its main effort into general export enhancement measures, and those which particularly affect manufactured and services exports.

The Commission has left basically to one side certain topics which have been extensively examined and about which there is substantial knowledge in Australia. These include the European Community's Common Agricultural Policy, Japan's agricultural policies, and US agricultural export subsidy schemes. The limited attention paid to these topics in this report should not be taken as an indication that the Commission views them as being of little consequence. On the contrary, the subsidies inherent in these measures cause significant distortions to Australia's export markets - which are likely to be far greater than the combined effects of the other measures examined here.

Adjustments made to financial statistics

All Australian dollar ($A) estimates used in this report are expressed in terms of 1990 Australian prices (1990$A). By so removing the effects of inflation, changes or *growth* in financial estimates to 1990A equivalents also enables *levels* of activity and expenditure to be more readily compared between countries.

GDP deflators have been used to measure inflation and all currencies have been converted to Australian dollars using average exchange rates for 1990.

Structure of the report

Chapter 2 develops the economic context within which governments might decide to promote exports. This sets the scene for Chapters 3-9, which address various export enhancement measures and the international disciplines on them, as well as their likely efficacy in an Australian setting. These chapters are supported by studies in Volume 2 which focus on the export enhancement measures of selected economies.

2 WHY ENHANCE EXPORTS

This report examines the export-enhancing measures used by Australia's major trading partners and competitor economies. After outlining the benefits of trade in broad terms, this chapter looks at the determinants of export activity and examines why governments intervene.

2.1 The benefits from trade

The benefits from international specialisation and trade are well described by Porter in his 'The Competitive Advantage of Nations' (1990):

> International trade allows a nation to raise its productivity by eliminating the need to produce all goods and services within the nation itself. A nation can thereby specialize in those industries and segments in which its firms are relatively more productive and import those products and services where its firms are less productive than foreign rivals, in this way raising the average productivity level in the economy. Imports, then, as well as exports are integral to productivity growth (p.7).

The benefits of trade are greatest when exports are not subsidised and imports are not restricted. Exports which have to be 'enhanced' (subsidised) in order to achieve sales on world markets reduce the benefits from trade as the resources used to produce these exports could have been more productively employed elsewhere in the economy.

Tle benefits of trade may also include the development of efficient and internationally competitive management skills, training of higher-quality labour, achievement of economies of scale (and greater capacity utilisation), swifter embodiment of technological improvements and a steadier flow of imported inputs. Yet other benefits claimed of trade include stimulating companies' internal cost controls and encouraging the absorption of foreign know-how. Exposure to the demands of foreign markets keeps exporters informed of new products, and foreign buyers are an important source of information that can be used to upgrade technology. Growth in productivity, the best proxy for technological change, has accounted for as much as 30 per cent of GDP growth in the East Asian economies (World Bank 1991b, p.88).

While trade is not without its vulnerabilities, a trade-oriented economy may be better placed to ride out the vagaries of economic fluctuations, since there are generally far more alternative suppliers and alternative sources of demand in world markets than domestic ones. The importance of 'openness', and encouraging competition has been increasingly widely realised, particularly in some of the more dynamic economies to Australia's north. Openness to trade, investment, and ideas have been critical in encouraging domestic producers to cut costs by introducing new technologies and to develop new and better products. For example, many exporters told the Hughes Committee how

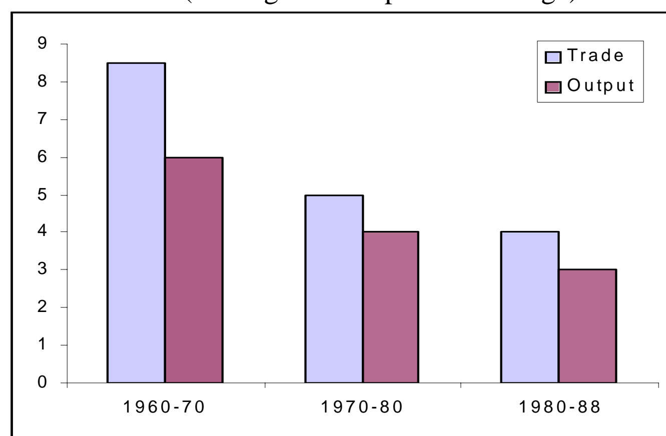
exporting forced them to improve design, lower production costs and improve the timeliness of deliveries.[1]

In some of the world's fastest-growing economies, trade has been regarded as *the* engine of economic growth (see Volume 2 -- Country Studies). For example, Hong Kong's economic growth and prosperity are said to have been built on its ability to participate in world trade (GATT 1990c, p.39). In Indonesia, the Government expects that non-oil exports will act as the economy's engine of growth, as the country comes to rely less and less on oil and gas exports (GATT 1991c, p.13). And, at the start of Japan's long period of economic growth, its 1957 New Long Range Economic Plan focused on export promotion. Similarly, Korea's long export drive dated from the early 1960s.

Australia has also recognised the benefits of increased trade. Industry policy has moved away from the inward-looking approach which was adopted throughout much of the post-war period and import barriers have been steadily dismantled. The Australian community as a whole now understands -- as our farmers and miners have long understood -- that our prosperity depends not on being sheltered from the rest of the world but on opening up our economy, becoming internationally competitive and participating actively in world trade.

Greater acceptance of the benefits of trade are also are reflected its growth in world merchandise trade has out-stripped world output growth. World wide, trade has expanded by more than 6 per cent a year since 1950, which is more than 50 pr cent faster than the growth of output (World Bank 1991b, p. 2). Trade in manufactures has been growing particularly strongly -- by 8 per cent per year over the period 1980-88, compared with 4.5 per cent for all merchandise exports.

Figure 2.1: **Volume of world merchandise trade and output: 1960-88**
(Average annual per cent change)



Source: GATT 1989b

[1] This committee was asked to examine Australia's Export Market Development Grants (EMDG) scheme and the operations of Austrade.

2.2 Determinants of exports

There are large differences in the extent to which particular economies export (see Overview to Volume 2 for details). The United States, for example, is the world's largest trading nation but appears to be almost 10 times less export-oriented than Malaysia. Such differences in export orientation do not mean that some countries are not exporting enough or that their export policies are somehow inadequate. There is no single appropriate level or proportion of exports applicable to all economies. Indeed, much of the observed differences in export orientation are not due to differences in government trade policies but to more fundamental features of their economies. These include differences in size, location, resource endowment and the diversity of their industries. The US economy is far more diverse and over 100 times larger than that of Malaysia.

Exchange rate changes are the primary mechanism by which the supply and demand for foreign exchange are brought into rough balance. An increase in the demand for Australian dollars brought about by additional demand for Australia's exports, will lead to upward pressure on the exchange rate. In turn, this will increase the cost and reduce the demand for Australia's exports generally and increase the demand for imports. The exchange rate will continue to adjust until the demand and supply of foreign exchange are again brought into balance.

This does not mean, however, that a country's exports of goods and services should equal the value of its imports or that its current account should balance. For countries with a floating exchange rate, a current account deficit reflects a situation where domestic investment exceeds national saving and there is a net capital inflow from other countries. Countries which have undeveloped land and other natural resources, such as Australia, tend to have investment opportunities which exceed domestic savings and be importers of financial capital over long periods.

Attempts to boost exports will only affect current account deficits if they also influence the underlying pattern of savings and investment. However, they may well change the exchange rate and the pattern of exports. The better one industry does, the harder it will be for others to become successful exporters. As explained in a recent OECD report:

> While there can be little doubt that export subsidies increase exports of the subsidised goods, all else being equal, the current account as a whole can improve only if national saving less investment increases. An export subsidy will inevitably have repercussions on relative prices and the exchange rate. It is unclear how these second-round effects will affect savings and investment, and therefore the current account, in the long term (Ford and Suyker 1990, p.66).

The pattern of exports

At the broadest level, the pattern of any country's exports is determined by differences in the cost at which that country can supply particular goods and services to overseas markets compared with

other suppliers. To gain maximum benefits from trade, a country should not seek to export all types of goods and services but those in which it enjoys a comparative advantage. As noted by Porter (1990):

> No nation can be competitive in (and be a net exporter of) everything. A nation's pool of human and other resources is necessarily limited. The ideal is that these resources be deployed in the most productive uses possible. The export success of those industries with a competitive advantage will push up the costs of labour, inputs, and capital in the nation, making other industries uncompetitive. In Germany, Sweden, and Switzerland, for example, this process has led to a contraction of the apparel industry to those firms in specialized segments that can support very high wages. At the same time, the expanding exports of competitive industries put upward pressure on the exchange rate, making it more difficult for the relatively less productive industries in the nation to export (p.7)

It is clear that government policies can have a significant impact on the pattern of trade. Australia's protection policies, for example, curtailed imports of many goods (particularly manufactures), enabling domestic industries to produce those goods in an environment sheltered from international competition by high tariffs. Accession to the General Agreement on Tariffs and Trade (the GATT) effectively constrains a government's industry policy by limiting the extent to which businesses can be insulated from world prices (eg the GATT prohibits the use of export subsidies on trade in manufactures).

Industry policies which do not specifically target exports can also have a major impact on the pattern of exports. Governments seeking to protect their agricultural sectors, for example, have generally had a number of objectives in mind. These have been as much social as economic, including:

- maintaining a 'fair' standard of living for their farmers and farm employees (who may together comprise a strong political lobbying force);
- the preservation of a rural way of life, and the appearance of the rural landscape; and
- assuring the security of food supplies.

These reasons have underpinned one of the world's biggest trade distortions: the European Community's Common Agricultural Policy. Over-production associated with farm subsidies often leads to excess supplies being sold (or 'dumped') on world markets for prices far below the cost of production, in the process undermining the competitiveness of efficient producers. Consequently, this type of agricultural assistance constitutes an important export enhancement measure because of the pervasive distortions associated with such practices (see Chapter 4).

What is not clear, however, is the extent to which governments can increase the competitiveness of particular activities such that the country concerned will be better off if it directs more of its

resources to these areas. In his study of the industry policies of many economies, Porter (1990) concluded that the available experience to date suggests that government policy has not been a major determinant of competitiveness.

> More recently, many have argued that competitiveness is most strongly influenced by government policy. This view identified targeting, protection, export promotion, and subsidies as the keys to international success. Evidence is drawn from the study of a few nations (notably Japan and Korea) and a few large, highly visible industries such as automobiles, steel, shipbuilding and semiconductors. Yet such a decisive role for government policy in competitiveness is not confirmed by a broader survey of experience. Many observers would consider government policy toward industry in Italy, for example, to have been largely ineffectual in much of the post-war period, but Italy has seen a rise in world export share second only to Japan along with a rapidly rising standard of living.
>
> Significant government policy intervention has occurred in only a subset of industries, and it is far from universally successful even in Japan and Korea. In Japan, for example, government's role in such important industries as facsimile, copiers, robotics, and advanced materials has been modest, and such frequently cited examples of successful Japanese policy as sewing machines, steel, and shipbuilding are now dated. Conversely, sustained targeting by Japan of industries such as aircraft (first targeted in 1971) and software (1978) has failed to yield meaningful international positions. Aggressive Korean targeting in large, important sectors such as chemicals and machinery has also failed to lead to significant market positions. Looking across nations, the industries in which government has been most heavily involved have, for the most part, been unsuccessful in international terms. Government is indeed an actor in international competition, but rarely does it have a starring role (pp. 3 - 4).

Microeconomic reform

The efficiency which microeconomic reform aims for will make Australian exporters more competitive. Previous work by the Commission, aimed at assessing the consequences of adopting a range of reforms, suggested that aggregate exports would increase substantially and that the mining industry would be the major beneficiary (IC 1990).

The objective of microeconomic reform is to increase the efficiency with which resources are used and to raise living standards rather than to assist all industries in the traded-goods sector. Indeed, GDP would increase substantially as a result of micro-economic reform. The Commission estimated a permanent increase in GDP of over 6.5 per cent -- equivalent to about $2 300 a household in 1985 prices.

Some industries are likely to be disadvantaged by microeconomic reform, in particular those that currently enjoy high levels of government assistance. The pace of reform should not be slowed on their account as to do so would be to forgo the greater benefits that reform would provide to the wider community. In supporting this view, the Business Council of Australia noted that:

> The current recession has encouraged interest groups to seek to obstruct change in the pursuit of self interest. ... Australia cannot afford consensus based reforms restricted to the pace that the slowest will accept (Sub. 53, pp. 2 - 3).

2.3 Rationales for export enhancement measures

A wide variety of reasons are put forward as justification for the use of export enhancement measures. A brief assessment of the more common ones is presented below. Further details are provided in Chapters 4-9 which consider specific export enhancement measures.

Others do it, so we should too

Probably the most common argument put forward to justify export enhancement measures is that others do it, so we should too. In its visits to eight East Asian economies, the Commission noted much 'copycat' behaviour, whereby governments have tended to match the measures put in place by other governments in the region, especially in the area of investment incentives.

It well known and accepted, by both industry and the Australian Government, that various exports are supported by other countries. It is natural to point to the seemingly unfair advantages enjoyed by industries in these other parts of the world and suggest retaliatory action. Failure to match or countervail foreign export subsidies can lead to the demise of domestic industries.

In its support for the view that Australia should take such retaliatory action, Goodman Fielder Wattie questioned whether it is:

> ... really in our national interest to sit tight on principle while aggressive competitors use every trick in the book to either cut us out of export markets or undermine us in the domestic market ... and to ignore the logical consequences of this behaviour, which is further worsening of our balance of payments as Australia loses vital export receipts and absorbs higher volumes of imported product (Sub. 50, p.3).

Kodak (Australasia) also stated that the Australian Government provides it with bounty assistance 'as an expedient' to provide a partial counterweight to the disadvantage of internationally uncompetitive rates of taxation on export earnings (Sub. 29, pp. 3 - 4).

The direct benefits to favoured sectors from retaliatory action tend to be much more visible than the broader costs that subsidies impose on other domestic economic activities. The question that needs to be addressed is whether these costs exceed the more obvious benefits received by beneficiaries. In a recent current affairs program, the Prime Minister pointed out that:

> ... you're only cheating yourself if you run policies which have scarce national savings going to the wrong places ('Sunday' program 9 Feb 1992).

If some Australian exporters, such as wheat growers, were assisted by the Government to offset overseas export enhancement measures, their exports would probably rise. But Australian

taxpayers would have to foot the bill. Unless such assistance were short-term and somehow led to a reduction in the use of export enhancement measures by others (an unlikely event), there would be a net loss to the economy.

There are obvious problems with retaliatory export subsidies.

- Matching subsidies may help targeted industries retain and even win back market share. However, such subsidies also penalising others in the home economy, be they tax payers or other industries, via the direct costs of inefficient resource use.

- As with any subsidy, it can be difficult to identify offsetting cuts to government spending that are socially acceptable. Yet the alternative is to impose indirect costs through a blow out of public debt or increased taxes (or other imposts).

- Even for governments which decide their taxpayers can afford it, emulation of other nations' subsidies may precipitate a spiral of wasteful distortion (as in shipbuilding), or arguably misguided investment in seemingly promising technologies (as in supersonic aircraft).

It is also unclear whether the export enhancement measures of one country will produce similar results if applied in another country. For example, and as the Commission confirmed in its visits to various East Asian economies, the willingness of industry to support national goals can vary considerably from country to country (see Volume 2 for details). The World Bank has also observed that:

> ... if some East Asian governments have intervened successfully, it is not clear whether most developing countries could emulate their administrative capacity, the ability of their firms and governments to co-operate closely in pursuit of agreed economic goals, or the degree of competition in their domestic markets (1987, p.71).

While many export enhancement strategies do not appear to anticipate the likely responses of other governments, there are some exceptions. In the United States, for example, proponents of export subsidies have come to rely on 'second best' arguments. The Commission understands that the philosophy of the US Eximbank is that:

> Eximbank is to focus its resources on those export transactions that 'need' government support due to foreign government competition or the private sector's inability to provide such support for creditworthy transactions (Eximbank 1991).

To offset the anti-export bias of other government policies

Export enhancement measures are sometimes used to compensate for the adverse effects of other government policies on the ability of industry to export. This argument is frequently raised with regard to protection which raises the cost of imported equipment and materials used by industry, including export activities.

Two broad groups of policy measures are used to compensate export industries for the taxing effects of import duties (tariffs) on their activities. First, duties are commonly refunded on imported inputs incorporated into exports (via duty drawback schemes).

Taiwan has recently announced the termination of its duty drawback arrangements, now that its tariffs are becoming insignificant. The Commission has devoted little of this report to such schemes, since they are more compensatory than 'enhancing' of exports, although it did recently review Australia's and several other countries' schemes (IC 1991b).

Second, some measures attempt to recognise that a general policy of protecting domestic industries necessarily translates into a tax on every exported good or service. Ibis economy-wide view is said to provide a *general* justification for export enhancement measures. The Ferris Report (1985) argued for such a course of action when Australia was still pursuing a policy of promoting import substitution through relatively high tariff barriers, including quantitative restrictions on some imports.

Today, the Australian Government provides import 'credits' to exporters of passenger motor vehicles (including parts) and to exporters of textiles, clothing and footwear these being the only products still subject to relatively high tariffs. Such credits are provided in line with export performance and can be used to reduce liability to pay customs duties, for example, enabling a motor vehicle exporter to import a motor vehicle for sale on the Australian market free of duty. Kodak (Australasia) suggested this type of scheme be extended to other manufactures (Sub. 29).

There are a number of concerns about using export enhancement measures as a form of 'tariff compensation':

- it is difficult to design such a scheme to ensure that it is both consistent with Australia's GAT-F obligations and would not cause tension with major trading partners (see Chapter 3 and Appendix Q; the overall level of assistance to Australian industry would be increased;

- the implicit export subsidy in such schemes is distributed selectively on the basis of prevailing tariff rates, that is, it plays to the economy's weaknesses;

- further costs would be imposed on efficient exporters and the overall efficiency of resource use could be adversely affected, that is, it would be at the expense of the economy's strengths;

- a new clientele would be created, the viability of whose exports could depend on the maintenance of import tariffs; and

- administrative costs would be imposed both on the Government (and therefore taxpayers) and on businesses, and there may be considerable scope for manipulation.

Garnaut (1989) has also drawn attention to problems with using export enhancement measures in this way:

> One, it is never provided uniformly on either the export or import side, and some potential export industries are victims of arbitrary discrimination. This wastes opportunities for growth in itself, and the waste is compounded by the lobbying that enterprises undertake to ensure that they are favoured. Two, export subsidies have to be paid for from taxation (or inflationary finance). This raises taxation rates, with associated negative effects on efficiency in resource allocation. Three, the administrative system for imposing protection, collecting taxation and paying out subsidies imposes high deadweight costs on the economy, including on export-oriented enterprises.

Nevertheless, he concluded that if there were no better prospect of removing protection, compensating export subsidies would be better than continued 'inward' orientation.

In any event, Australian tariffs on manufactures -- other than passenger motor vehicles and textiles, clothing and footwear -- are being phased down to modest levels, so that the perceived need for tariff compensation will progressively become less of an issue.

To broaden the export base

One of the recurring themes in the ongoing debate about the future direction of Australia's trade and industry policy is what more, if anything, can or should be done to reduce still further our reliance on commodity exports.

Australia has a few relatively sizeable exports. These are mainly primary products and their manufactured derivatives (eg wool, wheat, coal, aluminium, meat), though tourism is also a substantial export earner. According to one study (Pappas *et al* 1990), elaborately transformed manufactures account for only 11 per cent of exports - well down on corresponding proportions for other industrialised countries.

Over the 1980s, however, there has been a significant broadening of Australia's export base. Over the 10 years to 1990-91, exports of manufactures have increased at an annual average rate of 6 per cent in real terms, while the corresponding annual growth in exports of primary products has been just over 1 per cent (DFAT 1991b).

One problem with having an export profile more typical of a developing country is that prices for primary commodities exhibit greater volatility than manufactures and have been falling in real terms.[2] Although there have been several commodity 'booms' in the post-war period, Australia has had to contend with mostly adverse movements in its terms of trade (the ratio of export to import prices).

Diversifying Australia's export base could be expected to reduce the volatility of export returns. Export diversification can bring benefits to an economy by insulating it from downturns in a

[2] According to the World Bank (1991b, p.106), between 1900 and 1986, the non-fuel commodity terms of trade - the ratio of non-fuel commodity prices to the prices of manufactures -- declined by an average of 0.6 percent a year. However, the Bank pointed out that the decline has been much smaller if different end points are chosen (eg between 1920 and 1986 the fall was less than 0.3 percent per year). Also, changing prices take no account of possibly offsetting increases in trade volumes or profitability due to changes in productivity. Indeed, the Bank pointed out that 'despite significant declines in the relative price of non-fuel commodities since 1973, revenues from commodities have stayed relatively constant in relation to those from manufactures'.

limited range of markets. As prices tend to be more volatile in commodity markets, there is often a presumption that exports of manufactures and services (such as tourism) should be developed.

If the effect of such diversification is to displace scarce resources from their most productive use, then Australia will necessarily sacrifice some of the gains to be had from specialisation and trade. Over time, the returns from trade will be less if industry activity is distorted in this way.

To achieve economies of scale

Many countries have domestic markets that are just too small to justify the production of certain goods and services on a scale necessary to minimise unit costs. As a result, much of a firm's output would have to be exported if it is to take advantage of available economies of scale.

The Commission was told by the Thai Ministry of Commerce that scale economies in that country can only be achieved by exporting. Probably the best examples of small domestic markets though, are the city states of Hong Kong and Singapore (see Volume 2 -- Country Studies).

The existence of scale economies can provide a powerful reason to export, but not necessarily for governments to assist exports. Whether or not to install large-scale plant is a matter properly left to investors to decide. It is the investor who reaps the benefits in terms of reduced unit costs of production and therefore it is the investor who should determine whether the commercial risks and costs of undertaking the required investments are justified.

Large-scale facilities can entail substantial capital outlays, usually necessitating substantial borrowings. It has been argued that government has a role to play in subsidising or underwriting such investment, in order to help smaller firms put larger scale facilities in place. But unless there are impediments to the efficient operation of capital markets which would prevent or reduce the prospects of commercial loans for this purpose, such as the tax laws, this does not provide a justification for government to become involved. Even where such impediments are identified, the appropriate course of action would be for the government to seek to remove the source of the distortion directly, rather than subsidise large-scale export operations.

To offset exchange rate distortions

Many countries have liberalised their exchange rate regimes in recent years. Before that, fixed exchange rates were common, usually because the weight of informed opinion was that this would promote economic stability.

Manipulating exchange rates was also seen as a particularly effective way of assisting import-competing and exporting industries. Countries which tried to run an undervalued exchange rate faced import shortages and inflationary pressures, while those which attempted to run over-valued exchange rates (and so favour imports) tended to be short of foreign currency, which put a premium on export receipts. In these circumstances, export enhancement measures were argued to be useful to offset the consequences of policy inflexibility elsewhere.

Some governments have also sought to promote exports to obtain foreign currency because of foreign indebtedness. BHP noted in this inquiry that the governments of developing countries have often acquired high levels of foreign debt and openly encourage export growth "at any cost" in order to boost foreign revenue (Sub. 20, p.2).

Where it is constrained from borrowing, the government of a low-income economy (especially one with limited natural resources) could be expected take a very favourable view of exports, since such activity may be seen as the only sustainable method to acquire necessary foreign currency with which to purchase imports. Japan, Korea and Taiwan have been in this predicament at various stages in their economic development, and it currently applies to many other economics. CSR commented in its submission, for example, that the Indian Government is prepared to provide very large export subsidies because of a chronic shortage of foreign exchange (Sub. 3, p.3). Further, the Canned Fruits Industry Council of Australia suggested that China subsidises its exports because its policy settings place the earning of hard currency ahead of recovering reasonable costs (Sub. 5, p.3).

To assist 'infant' exporters

It is also argued that government support is justified until an industry (or just a particular firm) can accumulate sufficient experience or size in export markets to shake off the inherent weakness of infancy. Such government support will involve a net cost to the community during the period until adulthood can be achieved -- costs which are expected to be more than offset by subsequent gains.

Is there is a case for short-term support until the companies concerned can export without assistance? For example, it is normal business practice in most areas to carry a loss for a period until an investment starts to be profitable (or until the firm attains what has been termed a 'critical mass').

The evidence on assistance to infant export industries suggests that support for such a policy is questionable. Taiwan provided substantial export assistance to the clothing and textile industry in the 1950s and 1960s -partly to encourage resources out of its highly protected agriculture sector. But has the net cost of export subsidies been recouped, in view of the fact that subsidies continued to be paid to the clothing and textile industry in the 1970s and 1980s -- well after the dynamics of international competition had clearly locked into that industry.

It is doubtful whether these subsidies were necessary, particularly as textiles and clothing are characterised by considerable dynamism and large numbers of small manufacturers. For example, Hong Kong was able to achieve high net gains through development of a globally competitive textiles industry without resorting to export subsidies during its so-called infancy.

Care is clearly needed when generalising about the applicability of infant-export arguments to individual economies. Many factors need to be taken into account when resolving debates about the appropriateness such policies. In almost every case in East Asia, it is possible to argue that significant special factors have also applied.

Evidence from some countries (and Australia is a good example) shows that once given, assistance to infant industries has been difficult to remove. Where the infant fails to grow out of its dependence on government, and support is not withdrawn, the cost to the economy grows. In contrast, a key characteristic of industry policy in Korea has been that assistance was always seen as being temporary. Thus the Government was able to cut its losses when fortunes turned against favoured sectors. Clearly, the strength of political will is a vital factor in the success or failure of support for infant industries in individual countries.

In the case of export industries, an important 'infant marketing' argument applies as well as the traditional 'learning-by-doing' arguments. Opening export markets requires investments in collecting information, exploring export opportunities, and in learning the business of marketing - including negotiating advantageous sales contacts (Chapter 8). Some argue that businesses undertaking such investments should be subsidised temporarily; they are 'infants' in marketing exports, and they should be assisted while they are growing up. Governments may also have a role to play in developing and nurturing an export culture, including initiating those unfamiliar with the advantages to be gained by selling on foreign markets.

2.4 Concluding comments

From the point of view of society as a whole, a measure designed to enhance exports can only be judged to have been worthwhile if it leads to increased national prosperity.

To be successful, therefore, an export enhancement measure would have to do more than increase exports of particular products; it is the net effect on economic activity which is important. The costs of such a measure, in terms of its effects on other industries and to the public purse, needs to be looked at, as well as any direct benefits generated. Such an assessment of net benefits would need to take into account the time needed for export enhancement policies to take effect, since there may be a lag before all costs and benefits work their way through the system.

The case for export assistance needs to be assessed on a case-by-case basis. The question that should be answered is: Will the proposed export enhancement measure lead (over time) to a net increase in GDP? The combination of international trade disciplines (such as the GATT) and the necessity of adopting an economy-wide approach to the issue of net gains is making it increasingly difficult to respond with an unequivocal 'yes', but much depends on the particular export enhancement measures contemplated.

3 SUBSIDIES AND THE GATT

This chapter discusses what is meant by `subsidy' and then turns to the links between subsidies and the General Agreement on Tariffs and Trade (GATT):

- what does the GATT say about subsidies?
- what types of subsidies are permissible?
- remedies to subsidies -- countervailing duties (CVDs) and anti-dumping measures.

3.1 Subsidies in theory

Governments provide assistance to exporters in three basic ways:

- by directly subsidising the costs of an industry or activity -- for example, through concessional tax treatment, exemption from government charges, reimbursement of charges at more than 100 per cent, government equity participation, paying a bounty on output, or free provision of market information;
- indirectly, by subsidising the costs of inputs to an upstream industry -- for example, by subsidising domestic industries which provide material inputs to an export industry (such as tax exemptions to the steel industry selling to shipbuilding), or by subsidising the infrastructure used by industry (eg by under-recovering the cost of port services); and
- by subsidising consumption -- such as by providing export credit at less than commercial rates or underwriting risk so that more favourable rates can be obtained than would otherwise be the case.

Export subsidies, in a broad sense, are government measures which allow a firm, or an industry, to sell in an export market at a price below the total net private costs of production for that market; or which allow customers in an export market to buy at a price below the costs of supplying that market.

A subsidy works by making the subsidised product more attractive (cheaper) to consumers. Consumers may then buy more, allowing subsidised producers to increase production.

There are many potential beneficiaries from subsidies including:

- the owners and employees of the industry producing the subsidised output;
- the owners and employees of firms supplying goods or services to that industry; and
- consumers of the subsidised product.

There are also losers. Industries competing with the subsidised product and those that compete with the subsidised industry for inputs lose profits and market share. Taxpayers pay for the subsidies. The community as a whole loses when the subsidy diverts resources to industries where the output of those resources is worth less (as valued on the international market).

3.2 GATT provisions

It seems that many potential Australian exporters have only a limited understanding of the role of the GATT in regulating export subsidies. This is not their fault -- GATT disciplines have some serious weaknesses. There are several forms of assistance which the layman would easily identify as subsidies but which are permitted under the GATT. Pre-eminent in this category are subsidies to many primary commodity exports and certain domestic subsidies -- such as those directed to lowering the costs of infrastructure to industry. Developing countries are permitted much greater latitude in providing subsidies.

It is important to note that although a subsidy may be allowed under the GATT -- in the sense that it is not proscribed -- it may still be `countervailable' in an export market. The more closely a subsidy can be identified with the activity of exporting, the more likely this is to be the case. The difference between anti-subsidy and anti-dumping procedures is explained in Box 3.1.

GATT members have never been able to agree on a comprehensive definition of a subsidy, preferring to formulate rules that emphasise the undesirable effects of subsidies. Domestic subsidies are tolerated, while most disapproval is reserved for sector-specific export subsidies. There are two bases for taking action under the GATT against subsidies. First, a subsidy is illegal if it is proscribed in the GATT Subsidies Code. Second, if it causes or threatens to cause `material injury' to a producer in an importing country, then countervailing duties may be imposed.

The principal sections of the GATT dealing with export subsidies are:

Article VI: Anti-dumping and Countervailing Duties; and

Article XVI: Subsidies.

The disciplines which the GATT imposes on government policies and reactions to the policies of other governments are outlined in Box 3.2. The basic GATT Articles and the Subsidies Code are reproduced in Appendix C, along with a brief resumé, of current Uruguay Round proposals.

The Subsidies Code has many interpretative difficulties, and the dispute-settlement mechanism has not proved effective. GATT members differ regarding the definition, scope and measurement of subsidies, and the application of countervailing duties.

Box 3.1: **Subsidisation and dumping**

Duties can be imposed on imports which are subsidised or dumped.

A *countervailing duty* may be levied by the government of an importing country to offset a subsidy paid directly or indirectly by another country's government to an exporter. GATT rules require that the subsidy is injuring (or threatening to injure) domestic industry. The United States does not apply the injury test unless exporting countries subscribe to the GATT Subsidies Code.

An *anti-dumping duty* may be imposed by an importing country when the exporter is supplying a product at a price below its normal value (or below the price of a similar product sold in the exporting country), and the product injures (or threatens to injure) domestic producers. Anti-dumping processes are usually invoked when the subsidy is being provided by the exporter. However, they can equally apply if the subsidy is provided by government.

The position in Australia is further complicated for the layman because both types of action are examined by the Anti-dumping Authority.

One source of disagreement relates to the application of the `injury test' in determining the need for countervailing duties. Some (for example, European Community member states) apply the injury test to all countries, while others (such as the United States) apply it only to signatories to the Subsidies Code (and to non-signatories that have entered into bilateral agreements to exercise discipline over their use of subsidies). For example, there is a 1985 accord under which the United States must apply an injury test to imports from Mexico.

> Before the pact, US industries could demand countervailing tariffs simply by proving that the imports had benefited from subsidies; they did not have to show that their business had suffered from the competition. From the US vantage point, the accord secured long-sought pledges from Mexico that it would phase out certain low-cost credits and discount energy supplies to its exporters. In the five years prior to the 1985 accord, US industries lodged 25 subsidy complaints against Mexican products; since then, there have been only two such cases (GATT 1988, p.57).

Signatories are supposed to notify their use of subsidies to the GATT. According to the GATT Secretariat, however, `only a small number of contracting parties have complied' (GATT 1991a, p.6). Notifications are inadequate, partly because of insufficient data and partly because governments do not want to publicise their subsidies, to avoid countervailing duties.

Box 3.2: **GATT disciplines on subsidies**

GATT disciplines on subsidies are aimed almost entirely at those which assist exports. Subsidies to overcome import competition do not get much attention and the Agreement permits many forms of domestic subsidy.

The GATT constrains OECD countries and some developing countries from providing subsidies aimed explicitly at increasing exports, except in the case of primary products and except for export credit subsidies falling within a separate agreement. The important section is Article XVI (4), where the `contracting parties' (that is, the members of GATT) agree to *`cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for like product to buyers in the domestic market.'*

Under Article XVI (1) a contracting party which grants any subsidy (including any form of income or price support), which directly or indirectly helps exporters (or import competitors), must notify other contracting parties. Upon request, it must discuss the possibility of limiting the subsidy. If an importing country can demonstrate that imports are being subsidised, that the import price is less than in the country of origin and that the subsidised imports are hurting (or threatening to hurt) a domestic producer then, under Article VI, countervailing duties may be imposed. The exporting country must not hinder the investigation and must permit factory visits and the like.

Under Article XVI (2), contracting parties agree that subsidies should not unduly affect the commercial interests of another contracting party. Article XVI (3) provides that subsidies on primary products should not be used to win more than an `equitable' share of world markets.

As part of the GATT's Tokyo Round (1973-74), a number of agreements (termed Codes) were reached to further regulate certain areas of international trade. One of these Codes, *an Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade,* is commonly known as the Subsidies Code. There are now 25 signatories to this Code (the European Community counting as one -- see Appendix C).

Box 3.2: **GATT disciplines on subsidies,** cont.

The Subsidies Code is an attempt to define the rules a little better. It sets out in detail how countervailing investigations are to be conducted and how `injury' is to be determined. There are mechanisms for dispute settlement, in case countries are unable to agree, and to handle complaints by one country that another is subsidising export sales to a third.

In particular, the Code:

- requires that the GATT be notified about all subsidies;
- prohibits industrialised signatories from using export subsidies on non-agricultural products;
- condones export subsidies on agricultural products provided they do not secure more than an equitable share of world markets;
- permits export credit subsidies providing they are within the OECD Agreement (see Appendix D);
- permits developing countries to use export subsidies on industrial products but urges them to reduce or eliminate the subsidies where they are inconsistent with their competitive and development needs;
- recommends that domestic subsidies should not distort trade; and
- permits the use of countervailing duties only if material injury to domestic producers can be shown (or threatened).

Neither the GATT nor the Subsidies Code define an export subsidy. However, the Subsidies Code has annexed to it an Illustrative List of export subsidies. Strengthening the Subsidies Code -- and the GATT disciplines generally as they apply to subsidies -- has been a major agenda item for the Uruguay Round.

Countervailable and acceptable subsidies

Not all the signatories to the Subsidies Code levy countervailing duties (CVDs) against subsidised imports. Australia, Canada, Chile, New Zealand and the United States have been the most frequent users of the CVD mechanism in recent years. The United States has been by far the largest, initiating more than 250 investigations since 1980. Many of these cases were terminated when trading partners acceded to requests to negotiate bilateral agreements, particularly for many steel and textile products. Neither Japan nor EC member states have made much use of the CVD mechanism. Anti-dumping duties seem to be a preferred approach in Brussels.

The threat of countervailing or anti-dumping duties in itself may act as a powerful remedy. In the United States, the costs of defending an anti-dumping action have been estimated at up to several million dollars (in 1988). Defences against countervailing duty cases are cheaper, but may still cost over $US 1 million (GATT 1990, p.289).

3.3 Concluding comments

For all its problems, the GATT and its Subsidies Code have clearly had a significant influence on the forms in which governments have provided subsidies, including export subsidies. In the absence of the GATT, there would very likely have been far more use of export subsidies by industrialised economies. Among developing economies, there are a number of examples of subsidies being withdrawn prior to their acceptance of GATT obligations. Taiwan has done so as part of its preparation to apply for GATT membership. The Indonesian Government withdrew its cash compensation measures in 1985 prior to adhering to the Subsidies Code.

Whatever conclusion might be drawn about the theoretical underpinnings or practical efficacy of subsidies, there is no doubt that governments continue to find them attractive. Regardless of all the international agreements and undertakings not to subsidise exports, there is a continual search for new measures that might sneak past the borders separating `illegal' from `not-illegal' subsidies.

Such circumstances can frustrate exporters who see opportunities lost to assisted competitors. There are those in industry who would have the Australian Government abandon its strong support for the GATT and, presumably, play without any international rules.

The Commission considers that a small trading nation like Australia, playing without rules, would be completely at the mercy of larger economies. Recent experience, particularly in the agricultural sector (but also in the manufacturing and service sectors), has shown how vulnerable Australia is to the subsidy policies of the very large economies. Resource constraints and economic self-interest preclude Australia participating in a subsidy competition, especially one without rules.

The Commission concludes that Australia's interests are best served by continuing to press for stronger international disciplines on export subsidies; in particular, for their extension to agriculture and services, and to all GATT members regardless of their stage of economic development.

The GATT, however, is potentially a much more important ally for Australia. Messrs Rattigan and Carmichael (Sub. 46) pointed out that many of the countries that have import barriers do not appreciate sufficiently the costs that they impose on their own economies. The Commission agrees

with them that Australia should use the GATT Trade Policy Review Mechanism to expose these costs, encouraging nations to calculate potential domestic gains from trade liberalisation.

4 EXPORT SUBSIDIES

This chapter focuses on subsidies which involve direct budgetary outlays rather than on less direct measures, such as when governments forgo revenue through special tax exemptions (sometimes referred to as tax expenditures). Most of the chapter relates to subsidies generally, rather than export subsidies in particular, for two reasons. First, most subsidies (including those which encourage exports) are provided to assist industries generally, rather than applying only to exports. Measures which effectively subsidise infrastructure or encourage firms to undertake research and development (R&D) are typical examples. Many of these subsidies spill over into exports and may be countervailable. Second, the definition of an export subsidy is still evolving in international trade negotiations. Part of this process will involve resolution of subsidies to agriculture which, for the moment, are not illegal but which are certainly the main topic in any discussion of export subsidies.

The major conclusion of this chapter is that, excepting the massive export subsidies for agriculture and subsidised export credit and insurance (both of which are permitted under GATT), industry-specific export subsidies are not very important or prevalent. As a general observation, subsidies now tend to be indirect, or available to all industry.

4.1 Use of subsidies -- an overview

It is difficult to arrive at a comprehensive estimate of the level and incidence of subsidies. There are several problems:

- subsidies are nearly always shown in average terms, rather than as changes in prices at the margin -- a subsidised exporter is unlikely to lower prices in markets where the firm is competing successfully, preferring to concentrate the subsidy in more difficult markets;
- in many cases, the data for a particular year show the costs of past subsidies (for example, losses on insurance of exports) rather than the level of subsidisation now available;
- certain aspects of home price maintenance schemes (such as those which support the prices of agricultural products in the European Community) do not appear in national accounts;
- many subsidies are hidden, or at least not direct - two examples are that defence R&D may benefit other industries, and the final incidence of transport subsidies can be difficult to determine; and

- in many instances, subsidies are in terms of government charges forgone rather than payments from the other side of the ledger. (For the United States, tax concessions at the Federal level are about three times as large as current grants).

Over all this, there is often an air of secrecy about the existence of subsidies:

> Recent efforts by the European Community and the OECD to compile information on subsidies have additionally met with resistance by their members to provide sector-specific information that may trigger countervailing duty investigations (Kelly *et al* 1988, p.16).

Subsidies in the industrialised world

OECD governments have supported industrial activity in pursuit of a variety of policy goals -- nurturing new industries, propping up old ones, encouraging specific activities like R&D, equalising regional incomes, attempting to correct current account imbalances and increasing employment. However, direct subsidies in pursuit of these objectives have not been large (Table 4. 1).

OECD national accounts show that, for the industrialised countries in aggregate, subsidies have accounted for less than 2 per cent of GDP, but have risen over the last two decades. The second part of the table shows the share of this assistance going to industrial activities.

Table 4.1 understates the true level of support as the OECD data do not include subsidies such as tax concessions. In Germany, total tax concessions to enterprises averaged about 1.8 per cent of GDP annually over the period 1975-85, while in the United States Federal tax concessions to industry were equivalent to roughly 1.5 per cent of GDP during 1975-87 (Kelly *et al* 1988, p. 124). Similar data are not available for other economies. Nevertheless, it seems reasonable to conclude that subsidisation is widespread across both countries and industrial sectors. Subsidies to industry account for the bulk of total subsidy expenditure by OECD governments, although the average subsidy rate for the industrial sector is typically lower than the rate for the agricultural sector. Nonetheless, in some countries industrial subsidies, comprehensively measured, have amounted to over 10 per cent of industry value-added. Moreover, some sectors, especially declining industries such as coal mining and steel, enjoy extremely high subsidy rates.

Table 4. 1: **Direct subsidies as a percentage of GDP in selected OECD countries: 1970-88**

Country	*1970-74*	*1975-79*	*1980-84*	*1985-88*[a]
All subsidies as a share of GDP				
Australia	**1.1**	**1.3**	**1.7**	**1.5**
France	2.1	2.5	3.8	3.0
Germany FR	1.8	2.1	2.0	2.2
Japan	1.2	1.3	1.4	1.1
New Zealand	1.6	2.3	1.9	0.6
United Kingdom	2.2	2.7	2.3	1.7
United States	1.5	0.4	0.5	0.7
Total OECD	1.2	1.5	1.6	1.6
OECD Europe	1.9	2.5	2.7	2.7
Industrial subsidies as a share of sectoral GDP [b]				
Australia	**1.0**	**1.2**	**1.6**	**1.6**
France	na	3.0	3.2	na
Germany FR	1.6	1.9	1.8	1.8
Japan	0.5	0.8	1.1	1.0
New Zealand	1.6	2.1	1.2	0.8
United Kingdom	na	2.7	2.6	1.9
United States	0.3	0.4	0.5	0.5

na not available.
a For industrial subsidies the data relate to 1985 - 86.
b Total subsidies excluding only subsidies to agriculture- and food processing.

Sources: *OECD, National Accounts* (various years); Ford and Suyker 1990, pp. 43-5

Manufacturing subsidies in the industrialised economies tend to be concentrated in four types of measures -- grants, tax concessions, 'soft' loans and government equity participation. The balance between the measures varies markedly from country to country, as indicated in Table 4.2 (which relates only to EC member states).

In the EC grants are clearly the overall favourite -- but there are wide variations across European economies. Austria, Denmark and France have favoured capital market instruments -- such as equity participation, soft loans and guarantees.

Table 4.2 says nothing directly about export subsidies. However, the guarantee Component of the final column is associated with export credits. For the EC, this is estimated to be 5 per cent of total subsidies; and for the European Free Trade Association (EFTA) nations, 8 per cent. Export credit subsidies and guarantees have generally accounted for only a small part of total subsidies to industry. These subsidies are dealt with in more detail in the next chapter, and also in Volume 2 -- Country Studies.

Table 4.2: **Budgetary support to manufacturing in the European Community, by measure: 1986-88 averages**
(Percentage of total support)

	Grants	*Tax concessions*	*Equity*	*Soft loans/ guarantees*
Belgium [a]	61	11	6	22
Denmark	70	0	0	30
France [a]	33	16	18	34
Germany FR	30	63	0	7
Greece [b]	88	0	9	3
Ireland	52	37	6	5
Italy	54	36	7	3
Luxembourg	68	9	5	18
Netherlands	64	30	0	6
Portugal	26	60	12	2
Spain	78	0	19	3
United Kingdom	69	6	16	9
EC [c]	**49**	**30**	**9**	**13**

a For France and Belgium loan guarantees were particularly important, being 19 and 10 per cent respectively.
b The EC Commission warns that the data for Greece are unreliable. Tax concessions are included with grants.
c The EC averages are unweighted.

Source: EC 19%, p.25

There are wide variations too in the way in which budgetary support is targeted. Table 4.3 shows how the manufacturing support recorded in Table 4.2 was targeted by EC member states to specific regions, sectors and end-use.

Eleven per cent of EC assistance to manufacturing was for 'trade/exports' and presumably some of the other types of assistance also aided exports. The EC source for this table provides no further detail other than to comment that any aid granted within the Community must be in conformity with GAIT rules (EC 1990, p.3).

Table 4.1: **Budgetary support to manufacturing in the European Community, by target group: 1986 - 88 averages**
(Percentage of total support)

	Sector-Specific	*Regional Assistance*	*Generally available measure*				
			R&D	*SME* [a]	*Trade / export*	*General investment*	*Other*
Belgium	9	21	9	25	13	12	10
Denmark	0	9	51	1	22	0	18
France	41	9	10	6	28	7	2
Germany FR	4	60	18	8	2	1	7
Greece [b]	20	39	6	4	32	0	0
Ireland	14	39	5	6	31	0	0
Italy	11	55	5	10	7	3	9
Luxembourg	0	56	6	21	3	15	0
Netherlands	4	15	24	26	2	13	7
Portugal	24	5	2	3	2	62	2
Spain	78	3	8	2	1	5	2
United Kingdom	24	37	11	10	10	7	1
EC	**20**	**39**	**11**	**9**	**11**	**5**	**5**

a SME denotes Small and Medium Enterprises.
b The EC warn that the data for Greece are unreliable.

Source: EC 1990, p.30

Some earlier data relating directly to export subsidies in EC and EFTA countries is shown in Table 4.4, once again pointing to the very low level of direct export subsidisation by the governments of industrialised nations.

Table 4.4: **Export subsidies in selected EC and EFTA countries a**
(per cent)

	Share of all Subsidies	*Share of export value*
France	13	1.5
Germany FR	1	0.1
United Kingdom	8	0.5
EC-10	7	0.5
EFTA	9	0.0

a For the EC the data related to 1981-86: for EFTA countries, to 1984-87

Source: Based on Ford and Suyker 1990, p. 65, with some updating

Among the industrialised economies examined by the Commission in Volume 2, only the United States appears to provide direct export subsidies other than to agriculture or through permissible export credit/insurance arrangements. The United States provides help, which is restricted to exporters, through its Foreign Sales Corporation (FCS) scheme. It is possible there are other, less obvious, subsidies at the state and local government levels, but the Commission has not had the resources to examine this matter.

Declining industries have received a large share of overall support in industrialised economies. The evidence suggests such policies have not avoided employment losses in industries facing long-term decline, but have simply delayed the inevitable adjustment of those industries.

One of the most studied examples of subsidisation in the industrialised economies is the European consortium, Airbus. After reviewing this case, subsidies to other aircraft projects around the world, to fast trains and to semiconductor industries, Ford and Suyker (1990), concluded that:

> ... subsidisation can indeed promote entry into markets characterised by large returns to scale, but that the costs tend to outweigh the benefits, even when these are calculated on a narrow national basis. However none of the studies ... considers spillover, or external effects that might be captured by related industries in the subsidising country ... their importance has often been asserted, but there has been little quantitative substantiation (p.59).

Voluntary import expansions

Japan has for some years now had a number of programs aimed at increasing imports in an attempt to reduce its trade surplus. A recent worrying development in Japan is a move from multilateral objectives to more closely linking these programs to trade with the United States and the EC. A large trade deficit with Japan has created great domestic pressure on the Government of the United States to pursue special policies aimed at correcting the imbalance. One response has been to reach accommodations with the Japanese Government whereby Japan will increase its imports from the United States, albeit at the expense of imports from other nations.

Early in 1990, Japan introduced its 'Comprehensive Import Expansion Measures'. For the 1992 fiscal year the Japanese import promotion budget has been set at ¥10.1 billion (about $A100 million), up from ¥7.2 billion in 1991. Major elements of the program are the establishment of offices in the United States and Europe to locate import opportunities, training for potential exporters to Japan, tax incentives for Japanese companies using manufactured imports and low-interest loans for import expansion. Most of the low-interest loans have been associated with imports from the United States.

According to Japan's Ministry of International Trade and Industry (MITI) (1992):

> During the three-year period between 1987 and 1990, Japan's imports from the United States increased by more than 70% ... as a result of various import promotion measures. Japan's trade surplus with the US steadily decreased. Japan continues to further its efforts to make itself an "Import Superpower" (p.10).

The Australian Chamber of Manufactures (ACM) objected to the Commission's Draft Report proposal that the Australian Government should seek an international proscription on arrangements to subsidise imports. It claimed that Japanese programs have provided opportunities for Australian companies:

> Over the past twelve months ACM has worked with [JETRO] to assist over 90 Australian companies to exhibit their products in Japan. From the Australian perspective the program provides an ideal opportunity for companies to refocus their thinking to potential foreign markets. A number of orders have resulted from the program and evaluation of the products by Japanese buyers is continuing. It is somewhat ironic that for these companies, many of them small to medium sized, the Japanese Government has done more to encourage export development than has the Australian Government. While it is possible that such programs could be used to disadvantage access to particular markets (if Australia was not included), such problems, if they arose should be dealt with on a bilateral basis (Sub. 36, pp. 8 - 9).

Japan's programs for subsidising imports may create opportunities for Australian exporters. However, they will reduce Australian exports to Japan when the programs favour imports from the United States or other countries with which Japan runs a trade surplus -- Japan runs a large trade *deficit* with Australia. The Commission has little information (other than press reports) on the extent of the damage being done to Australian exports by these measures. However, it appears the activity most affected to date is the export of car parts.

The Commission considers such bilateral arrangements can only be to the detriment of the open international trading system upon which small nations such as Australia rely. It recommends that Government should press in international forums for the proscription of such agreements and other bilateral arrangements which favour certain nations at the expense of the international trading community generally.

Subsidies in the developing economies

It might be expected that direct budgetary assistance for exports would be less common in developing economies, simply because of the small tax base from which to finance it. Moreover, the use of export subsidies by developing economies creates some special problems for those with little bargaining power. They are particularly exposed to antidumping and countervailing actions and may lose any special privileges, such as access to the Generalised System of Preferences.

Rather than using direct export subsidies, the more common approach by developing economies appears to be to seek foreign investment, especially that which will increase the availability of foreign exchange by expanding exports or replacing imports. Special tax incentives, relief from local charges and regulations and the creation of export processing zones have been used for this purpose.

However, export subsidies have been used by some developing economies, especially for strategic' industries and in the hope of overcoming current account deficits and debt servicing problems. To the extent that rational judgements have been made, the subsidies have sometimes been framed to compensate for the costs imposed on exporters by import-replacement policies.

For the East Asian economies discussed in Volume 2, direct export subsidies are now rare, although most provide some infrastructure assistance as discussed in section 4.4. Thailand has a scheme to provide concessional finance to exporters once the product is shipped. Taiwan, which used to provide direct export subsidies and other subsidies through exemption of exports from port charges, has withdrawn these measures. The Commission understands this initiative was related to Taiwan's application to join the GATT.

China is said to have a complex system of export incentives, with exports often heavily subsidised to offset the costs of import protection. Levels of compensation have often been arbitrary so that Garnaut (1989, p.216) concluded 'Most Chinese exporters would be better off with a move to complete free trade and payments, without export subsidies'. China is reported to be reducing the level of its export subsidies.

The Government of the Republic of Korea has in the past used preferential loans to support export activities. For example, in 1978 the average interest rate on such loans was 10.6 per cent, compared with an ordinary commercial lending rate of 19.0 per cent (Nam 1990, p.175). The availability of such loans was removed for all but ' small firms in 1988. Nam estimated the average effective subsidy rate for export sales from Korea was between 14 and 18 per cent for all industries in 1978, the most highly subsidised sector being consumer durables *(ibid* p.179).

4.2 The problem of agricultural assistance

Of all current areas of industry support, export assistance for agriculture is undoubtedly the most contentious. Agriculture is assisted in many ways -- via market support prices, supply restrictions, subsidisation of inputs, and subsidisation of consumption domestically and on export markets. The OECD Secretariat has estimated that the agricultural policies of OECD countries generated total transfers from consumers and taxpayers of around $A380 billion in 1990; including $A170 billion in the twelve EC member states, $A95 billion in the United States and $A75 billion in Japan (OECD 199 1, pp. 137 - 8).

This estimate covers all assistance associated with all production, processing and distribution of food in the OECD economies, and thus takes account of the higher prices that consumers have to pay for food and the part of their taxes spent in supporting agriculture. However, it excludes a very important cost, the distortionary effects in terms of loss of efficiency for the subsidising economies. For the producers themselves, the OECD Secretariat estimated a Producer Subsidy Equivalent (PSE) of about $A225 billion *(ibid* p.115). While the component of this assistance directly associated with export subsidies is not clear, it must be substantial.

Table 4.5 indicates that EC producers derive half their income from subsidies of one sort or another. In 1985, the Bureau of Agricultural Economics estimated that, since 1973, the direct

Budgetary cost to the EC of agricultural support have been around 0.3 per cent of GDP each year. In most years, support from consumers through artificially high prices has been even greater, estimated at $A50-65 billion annually (BAE 1985, pp. 113-4). Since that time, as can be seen from Table 4.5, the level of support has frown considerably.

A 1991 study, 'Are you paying too much?' (Australian Government 1991a) estimated that:

- household expenditure on food in EC economies is at least 19 per cent higher than it need be if trade were free -- for the low-income households this penalty is 32 per cent;
- household taxes are, on average, between 7 and 27 per cent higher than they might otherwise be in order to pay for producers subsidies; and
- 60 to 70 per cent of the whole EC budget is now committed each year to agricultural support.

Table 4.5: **Assistance as a share of farm income, selected OECD countries** (Per cent)

	1979-86 average	*1990 est*
Australia	12	11
Canada	32	41
European Community	37	48
Japan	66	68
New Zealand	25	5
United States	28	30
ALL OECD	37	44

Notes: (1) Assistance is measured in terms of Producer Subsidy Equivalents. These measure the value of the monetary transfers to farmers from consumers of agricultural products and from taxpayers as a result of agricultural policy.
(2) There were 10 EC countries in the years 1979-85 and 12 in 1986-90
(3) The products covered by the table are wheat, coarse grains, rice, oilseeds, sugar, milk, beef and veal, pigmeat, poultrymeat, sheepmeat, wool and eggs.
(4) PSEs do not take into account the costs of inputs and thus make no allowance for the taxation effects of support policies which alter the prices of those inputs.

Source: OECD 1991a, pp. 115, 315-6

More information about the most damaging agriculture export subsidies is provided in the sections of Volume 2 dealing with the United States and the EC.

For the EC in particular, assistance to agriculture is proving a costly luxury. Up until this year, agriculture has expanded well beyond the capacity of the EC member states to consume and the surplus has had to be exported at a n ever-growing cost to EC taxpayers. The root cause of this failure is that the Common Agricultural Policy (CAP) measures have, in the main, been directed at rewarding producers on the basis of their output. The more they produced, the more they were subsidised, regardless of market requirements.

This has had a deleterious effect on employment. Stoeckel (1988, quoted in Kelly et al 1988, p.2) has estimated that the EC agricultural policies have reduced overall employment in France, Germany, Italy and the United Kingdom by a net 2-3 million.

The CAP is coming under increasing pressure for reform. Intervention prices are being lowered and incentives to withdraw land from production are being offered. These changes are expected to lead to a reduction in agricultural production in the EC. However, even with these reforms, the budgetary cost is expected to increase during the next few years.

The Australian Dairy Industry Council (Sub. 19) told the Commission that Australia's dairy industries were particularly vulnerable to the policies of the EC and the United States, but Japan, Canada and some European countries outside the EC also protect their producers from import competition and (with the exception of Japan) subsidise exports to clear surplus production. The Council believed that first-round gains from liberalisation of world dairy trade would bring Australia $A600 million in increased exports.

* * *

The preceding pages have covered what might be described as direct assistance to exports. The next two sections discuss two areas of (generally) indirect subsidisation. Section 4.5 then looks at the evidence for the existence of subsidies to exports from countervailing actions.

4.3 Research and development assistance

Undertaking R&D is a means of improving the technological basis of production, as well as creating new products and opportunities which can contribute to the growth of businesses and the economy as a whole. R&D can be important to trade in two ways: first, new products and intellectual property (eg in the form of licences to use new production proceses) can be sold on international markets; and second, firms which have already benefited from introducing new technology into the production process may become more internationally competitive.

There are three main economic reasons why there might be an 'inadequate' level of R&D and therefore why governments might provide assistance to boost such activity:

- non-appropriability -- those engaged in R&D may not be able to appropriate sufficient of the benefits to make the activity worth undertaking;

- risk -- R&D can be a high-risk activity, and individuals or firms may be less able to bear the costs of risks than is society; and

- indivisibilities -- there can be threshold levels of inputs associated with much R&D activity which puts its performance beyond the capabilities of many individual firms.

Another common argument advanced for government intervention in support of R&D is that it is required to enable a country to 'catch up' technologically with others.

Governments have in fact been an important source of funds for R&D in many countries. Often, this assistance has been intended to boost exports through indirect (GATT-permissible) means.

Forms of R&D assistance

Assistance for R&D can be provided in several ways -- directly to firms by subsidising their R&D expenditures, or indirectly by government-financed R&D undertaken in public institutions. Grants and tax incentives are the usual forms of R&D assistance offered to private businesses. Other forms of assistance include the provision of infrastructure (such as science/technology parks) where companies can set up research facilities; 'soft' loans to fund private research; funding for education and training in research-intensive activities; and indirect assistance through government procurement. research

Government procurement policies may enhance exports. They are often suggested as providing a basis for economies of scale for R&D programs and for the subsequent penetration of international markets, although there is not much empirical evidence of these outcomes. In some cases, governments use procurement policies to develop a specific industry. The Australian Electrical and Electronic Manufacturers' Association said that the EC, and the Governments of Canada, France, Italy, Japan, Korea and Sweden use procurement policies to increase the level of R&D in their telecommunications industries. Referring to the results of a Canadian study, the Association told the Commission (Sub. 27) that:

> ... those firms that started with a strong supplier relationship with government agencies [through unsolicited proposal programs for R&D projects, through specific R&D contracts, or through direct public sector procurement contracts for goods and services] were better organised, more export oriented and made better use of technology than those that did not have the same relationship (p.10).

The United States Government commits R&D funding primarily through research contracts with private firms. In the United States, France, and the United Kingdom the level of co-ordination among different public institutions is quite low. By and large, in these countries each department is left to decide how much it needs to spend on R&D. In Germany, by contrast, the Ministry of Research and Technology is specifically responsible for co-ordinating all federal R&D expenditure. In Japan, private enterprises are involved in government decisions to a large extent and direct R&D subsidies are very limited. Instead, indirect measures such as tax credits and low-interest loans are preferred for stimulating innovative activities in the private sector.

In a similar vein, Korea and Taiwan, although targeting particular technologies, do not favour one project or company over another; assistance is in the form of tax incentives, increased training and the provision of infrastructure -- rather than direct government grants. These incentives are aimed at improving the international competitiveness of industry.

The overall effect of R&D assistance on export performance is far from clear. Some general ways of assessing technological success include the numbers of patents granted, the levels of productivity achieved, and the shares of new products in sales. Another often-used indicator is the export/import ratio in high-technology products. A study by Klodt (1987), comparing export-import ratios in high-technology products against government R&D subsidies for France, Germany, Japan the United Kingdom, and the United States found that 'the most successful exporter of high-tech products (Japan) has achieved the lowest level of government subsides' (p.55). Klodt also found a *negative* impact of R&D subsidies on exports of research-intensive goods. Although not directly related to exports, Nelson (1984) reviewed several studies on the effects of government financed R&D and came to similar conclusions. A recent Australian report (Industry Research and Development Board 1990, vol. 2, section 3.1) commented:

> It is sometimes claimed that R&D is associated with export orientation. However among OECD nations there is no clear association between aggregate export propensities and R&D ratios.

The overall economic effects and the export-enhancing effects of international R&D assistance has not been quantified by the Commission in this inquiry. Indeed, such an exercise is intrinsically difficult. However, the Commission's research and visits and some of the submissions have given a clear impression that many governments are assisting R&D to increase or maintain export competitiveness. In some cases, like the assistance to the passenger aircraft industry in the EC and the United States, it appears that inter-governmental subsidy races have mainly benefited consumers. In other cases, where such government competition is less obvious or not yet fully developed, there may well have been some beneficial impacts on exports -- for example at the Hsinchu Science Park in Taiwan (Chapter 7, Box 7.1) -- although whether there are net benefits to the economy remains to be seen.

4.4 Infrastructure

Infrastructure services are frequently provided by governments due to their perceived natural monopoly' and 'public good' attributes. For example, electricity distribution is often considered not amenable to a competitive market structure, and therefore is usually run as a public monopoly. Similarly, full cost recovery on road networks is, in general, not feasible due to their public good attributes.

Direct subsidisation of infrastructure for export activity takes a variety of forms. For example:

- according to BHP, iron ore in India is given priority on the rail system, and rail freights are generally lower for export tonnage (Sub. 20, p. 11);

- harbour charges in Hong Kong were not levied on exports until recently; and

- cheap utility services are common in export processing zones (see Chapter 7).

In recent years, governments have increasingly concentrated on providing a broad range of high-quality infrastructure to promote general industrial competitiveness, rather than to confer advantages on the export sector. For example, considerable effort was put into the development of Japan's port handling facilities after they proved inadequate to handle the country's mushrooming trade needs in the late 1950s and early 1960s. Five year plans were introduced in 1961 and 1966 to upgrade these facilities to world standards. Singapore has invested heavily in ports, roads, industrial estates and communications, over the past three decades. More recently, several programs along these lines have been implemented in other Asian economies:

- Under Taiwan's Six Year Plan (1991- 96) around $A380 billion will be invested in infrastructure and research programs aimed at augmenting Taiwan's international competitiveness. The program will channel funds into the development of transport, telecommunications and education infrastructure. This program comes on top of investment in roads, rail and ports during the 1980s.

- Similarly, Malaysia's Sixth Plan (1991-95) focuses in part on the development of the country's transport and communication services, and education infrastructure. Large sums will be directed into these sectors, with the aim of improving labour and infrastructure support of private industry so as to promote increased economic growth and to diversify Malaysia's industrial base.

A further category of infrastructure incentives are those that have regional development objectives that also affect export industries. In Thailand for example, infrastructure rebates are used to promote the competitiveness of regional industry, so these firms have access to export markets at similar cost to establishments located nearer to port facilities.

Apart from such across-the-board approaches to infrastructure development, there is evidence that several governments offer special infrastructure 'deals' to attract investment. BHP's submission (Sub. 20) referred to this measure:

> A significant incentive that is offered by some Governments of other countries, to competitors of “further processed” Asia Pacific products (ferro alloy and EMD) is the provision of subsidised energy costs either in the form of..
>
> - low energy base rates; or
>
> - energy rates that move in line with the price of the commodity to provide subsidies in times of low commodity prices (p.5).

Finally, the Federated Tanners' Association of Australia told the Commission of a scheme operating in Brazil under which preferential financing is available for construction of export storage facilities (Sub. 13, p.110).

In cases of concessional pricing of infrastructure to exporters, the revenue forgone must be recovered from elsewhere in the economy. Typically, it is obtained either via the taxation system or

through cross-subsidy pricing. The economic effects of the subsidy depend on which of these approaches is used. In essence, taxation funding of infrastructure services promotes the use of the service in question, while it reduces income and incentives in other parts of the economy. Cross-subsidies involve excess charges (prices greater than the cost of supply) being paid by some users in order to subsidise other users of the same product (who face prices that are less than the cost of supply). This inevitably results in allocative inefficiency; those whose consumption is taxed restrict their use of the product, even though they may value the consumption of additional units more than the cost of producing them. Consequently, there is a welfare loss. Conversely, those who are subsidised are encouraged to expand their use of the product beyond the point where the value they derive from the good is equal to its cost of supply. Again, there is a welfare loss.

The distortions caused under either of these approaches can lead to follow-on effects on upstream and downstream markets, as well as on the consumption and production of complementary and substitute products.

The Commission has not been able to locate much empirical work on the overall use of subsidised infrastructure to favour exports, nor of its effects on the overall growth of Australia's main trading partners and competitors. However, there seems to be consensus about the importance of providing *adequate* infrastructure services to attract investment. Businesses view the provision of basic services as essential to competitive export operation. For example, differences in transport costs can outweigh labour cost disparities between many locations. In a survey of Hong Kong multinationals, the provision of good infrastructure rated fifth out of eighteen locational decision criteria, after political stability and the availability of land and labour (Currie 1985, p.224).

The limited empirical evidence suggests that the provision of subsidised infrastructure can result in net losses for home economies, but it is not possible for the Commission to reach a general conclusion, as case-by-case analysis is necessary to evaluate the economic impacts of infrastructure subsidies. Counterbalancing this concern is the real possibility that inefficient pricing of infrastructure may actually penalise export industries. After examining Australia's energy generation and distribution system earlier this year (IC 1991c, pp. 2 - 3), the Commission concluded that:

> The failure of electricity and gas prices to reflect accurately the cost of supply is indicative of pricing inefficiency. Cross-subsidies between different classes of users, and between urban and country users, exist throughout the nation. While initially advantaging residential consumers, they penalise most industrial users (particularly those located in metropolitan areas) and reduce job opportunities. Few tariff structures take into account adequately the variations in the cost of supply over the day, the week and the year.
>
> These inefficiencies have cost us dearly. The costs have not been quarantined to the electricity and gas supply industries themselves. They have been borne by users and taxpayers generally.

4.5 The evidence from countervailing actions

one approach to examining the incidence of subsidies which affect export prices is to look at the countervailing duty actions initiated in the major economies. This can be no more than a partial guide, as many national governments do not pursue countervailing actions, and indeed many welcome imports of subsidised goods.

countervailing actions in the United States are a particularly useful source of information as in the United States it is not necessary for a local industry to demonstrate injury unless the exporting nation is a signatory to the GATT Subsidies Code (or has another bilateral arrangement with the United States). During the first part of the 1980s, there were 138 cases in the United States against developing economies and 74 against imports from industrialised economics.

Nogués (1989) examined this information to estimate the level of subsidisation by Latin American economies. His calculations are reproduced in Table 4.6, but note that the countervailing duty margins calculated are an upper limit. The incidence for the whole export sector must almost certainly be lower than shown, unless all exports were equally subsidised.

Table 4.6: **Average countervailing duty margins, tariff protection and percentage fluctuations in real exchange rates during the 1980s**
(Per cent)

Country	*Average CVD Margins*		*Average Tariff Rates*	*Fluctuation in RERs*
Argentina	*5*	*(4)*	*28*	*244*
Brazil	*12*	*(11)*	*51*	*135*
Chile	*12*	*(1)*	*15*	*223*
Colombia	*7*	*(3)*	*52*	*189*
Costa Rica	*17*	*(2)*	*24*	*152*
Mexico	*10*	*(19)*	*< 25*	*204*
Peru	*25*	*(6)*	*>57*	*131*
Venezuela	*69*	*(3)*	*34*	*224*

Notes: *Figures shown in brackets are the numbers of affirmative CVD findings by the United States on which the calculations are based. The CVD averages are estimated for the years 1980-87; the tariff averages relate to 1987-88. For Columbia, Costa Rica, Peru and Venezuela. the averages are unweighted.*

Source: Nogués 1989, p.53

Nogués concluded that:

> ... except for Venezuela, the simple average subsidy margins are lower than average tariff rates ... In reality, the anti-export bias is even higher ... First, average tariff rates do not incorporate the protective effects of NTBs (non-tariff barriers), which in general benefit heavily protected industries. Second, the structure of protection behind average tariff rates is far from uniform. In the economies under consideration, tariff rates protecting manufacturing industries are usually the highest, and always higher than those on non-produced goods and efficient primary sectors. This is important, because in general it is precisely the exports undertaken by protected manufacturing industries which have been heavily subsidized (p.52).

Another study of United States countervailing cases over 1980 - 85 throws some light on the levels and sorts of subsidies being used. Nam (1987) found that 2.5 per cent of developing country exports to the United States (and 1.4 per cent of industrial market economy exports) were subject to countervailing actions in 1985.

> Mexico and Brazil are far out in front, followed by South Africa and the Republic of Korea. For the newly industrialising countries, the average CVD rate varies from 2.4 per cent for Korea to 14.1 per cent for Brazil. Peru is the only country in which the average CVD rate has exceeded 20 per cent. Almost all major OECD countries have frequently been countervailed, however, most notably France, Italy, Spain and Canada ... Seventy percent of the US CVD actions were directed against steel and agricultural products from industrial market economies and against textile, steel, and metal products from developing countries (pp. 735 - 6).

By looking into the detail of the countervailing cases against imports from Mexico, Brazil, South Africa and the Republic of Korea, Nam was able to establish that:

> In Korea and Mexico, domestic subsidies have provoked more CVD actions than export subsidies. Export subsidies are provided mostly through preferential loans at below-market rates or direct tax exemption or reduction, whereas domestic subsidies are provided through much more diverse channels. These include direct tax exemption or reduction, accelerated depreciation allowances, duty exemption on imported capital goods, preferential loans or credit guarantees, preferential pricing of public utilities, and government equity participation on terms inconsistent with commercial considerations. The average export subsidy rate per CVD case varies from 1.32 percent of export value in Korea to 9.82 percent in Brazil, while the average domestic subsidy rate ranges from 0.35 percent in South Africa to 4.72 percent in Mexico *(ibid* p.740).

One of Nam's major conclusions was that United States countervailing actions were heavily concentrated on those industries in which comparative advantage had already been established in favour of developing economies.

At the end of 1990, the United States had only 71 (product- and country-specific) countervailing duty orders in effect against imports from 28 economies. A further 12 undertakings not to subsidise were in effect. The duties imposed varied enormously, for example, a trivial 0.12 per cent against leather apparel from Uruguay and almost 95 per cent against new steel rail from Canada (GATT 1991b).

In Australia, there have been several countervailing cases in recent years. France has been found to be subsidising brandy, Italy pasta, and Denmark, the Netherlands and Ireland have subsidised canned ham -- all through the medium of the CAP. Israeli exporters of sodium tripolyphosphate have been found to benefit from subsidised export insurance arrangements. None of these cases has led to significant disruption of the Australian economy. Malaysia was found, in January 1991, to have subsidised exports of batteries to Australia through the use of an export credit refinancing scheme. The subsidy was considered too small to have caused any injury to the Australian industry.

The Federated Tanners' Association of Australia (Sub. 13) told the Commission that leather exports from Australia had been affected by subsidies in several other nations. Argentina, for example, had been assisting its tanners by prohibiting the export of raw hides. In September 1990, the United States imposed a 15 per cent countervailing duty against Argentinian leather exports to offset this subsidy.

4.6 Concluding comments

There is no doubt selective export subsidies can expand exports from targeted industries. It has been suggested that government subsidies have been the key component in the price-competitiveness of sectors such as international construction and engineering and significant in sectors such as steel and aerospace. But the fact that industries which are subsidised increase their sales does not necessarily mean that it is a successful policy from the point of view of the economy as a whole (Chapter 2).

Subsidies have been used by many governments, and for many reasons. In the industrialised nations, the major objective has been to support industries facing heightened competition. Governments of developing countries have more often than not used subsidies as part of a package of measures to compensate exporters for the costs of assistance to import-replacing activities. For many of the Asian economies discussed in Volume 2, it is clear that subsidies -- especially directed at R&D and the provision of adequate infrastructure -- have been important in encouraging the development of new industries.

Except in the case of agriculture and export finance (discussed in the next chapter), the use of direct export subsidies appears to be low. What assistance there is tends to be concentrated in specific sectors and to have little consequence for world trade generally. There is virtually no evidence that these subsidies have been successful in achieving net economic growth or improving overall community welfare.

Nevertheless, assistance to agriculture undoubtedly causes massive distortions in world trade in these products. There is no evidence that it has been successful; but growing evidence of the enormous costs it is imposing in subsidising countries and in more efficient primary producing countries (including Australia).

In summary, the Commission finds that direct export subsidies are now seldom used; GATT disciplines restrain the governments of industrialised countries; and budgetary constraints put a brake on governments in developing countries. Subsidies, where they exist, tend to be further back in the production chain and (at least nominally) available to industry generally. While there is no unequivocal evidence that subsidies have helped countries as a whole, clearly there are links between subsidies (especially to infrastructure) and the expansion of new areas of manufacturing in the developing countries. Agricultural subsidies have been (and still are) used to a very significant extent by certain countries, notably EC member states, Japan, Canada and the United States. In this case there is unequivocal evidence that they have harmed their own economies, world trade in general, and Australia in particular.

5 EXPORT FINANCE ASSISTANCE

Most countries use officially backed finance agencies to promote exports. The traditional role of these agencies is to provide exporters with insurance against the risk of non-payment by customers for political or commercial reasons. In the 1970s, however, agencies' resources were stretched by ever-increasing demands for extended and special services (for example, insurance against exchange rate fluctuations and natural catastrophes).

By 1980, in addition to their traditional insurance services, agencies often found themselves providing subsidised credit and a range of supplementary schemes which would have been unthinkable in 1970. Services expanded further during the early 1980s, but agencies began to accumulate heavy losses. The search for a solution to this problem led to a strengthening in 1983 of the OECD 'Arrangement', or 'Consensus' as it is often known (see Appendix D). The Arrangement governs the terms of export loans -- and hence limits the subsidies -- participant countries can give their exporters.

The impact of the OECD Arrangement seems to have been short-lived, however. The late 1980s witnessed a resurgence of subsidised export finance activity, spurred by the expanded use of foreign 'aid' to provide mixed credits, which are seen by some as a way around the disciplines imposed by the Arrangement. Agency losses are again on the rise.

5.1 Export finance agencies

The organisational structure of export finance agencies varies considerably between countries. In particular, there is considerable divergence in the form and extent of government backing, which allows some agencies to offer greater subsidies to exporters. Agencies can be loosely grouped into three categories: government departments (eg the UICs Export Credit Guarantee Department); government corporations (eg Australia's Export Finance Insurance Corporation; and private companies (eg Germany's Hermes and New Zealand's State Insurance Ltd).

This breakdown, however, only identifies an agency's legal status: it gives little real indication of the degree of government involvement. For example, many private or part-private agencies have access to government reinsurance for some or all of their activities, without which they could not operate.

Agencies usually operate two accounts on which they conduct their business: a commercial account, through which they carry out most of their activities, and 'attempt' to operate on a profitable basis; and a government or 'national interest' account, which is used for large or high risk transactions which could not be covered under normal circumstances, but which the government determines are beneficial to the domestic economy.

Official agencies operate in two distinct areas of business, with strongly differentiated markets, prospects for financial stability, and managerial requirements.

Comprehensive cover is typically of a short-term nature of up to two years. In practice, comprehensive policies rarely exceed 180 days, with a high proportion being of 90 days or less. There is usually no link with the provision of credit, although guarantees may be given to support borrowing.

Comprehensive cover is usually provided for trade with industrialised countries and is typically characterised by a large number of transactions for various sectors and markets, and a large number of policy holders and buyers. These aspects give this cover a comparatively low incidence of political risk, a good measure of financial stability, and reasonable prospects of breaking-even. Comprehensive services provided by official agencies are often in direct competition with facilities offered by the private insurance market.

Specific (or project) cover is typically concerned with credit and insurance for periods of two to ten years. Contracts are normally individually negotiated, often involving formal competitive tendering. Delivery periods typically cover several years during which goods are manufactured, often to individual specification, and frequently include erection and assembly on site. Project cover is usually linked to the provision of credit, often on preferential terms through an official agency or a mixed credit scheme.

Project cover is largely with developing countries and is often in areas of relatively high political risk. Hence there is less overlap with services offered by the private sector. Project cover makes up nearly all the business conducted on an agency's government or national interest' account.

5.2 Forms of export finance assistance

Export insurance

Insurance provided by export finance agencies comes in two main forms and provides cover for two main types of risk:

- Commercial risk -- of non-payment by the purchaser for commercial reasons, for example, default due to bankruptcy.

- Political risk -- arises when decisions by the importing country's government prevent the exporter from being paid, for example, blocking of funds, cancellation of an import permit, and armed conflict.

Insurance comes in two main forms: pre-shipment insurance, which covers losses that occur after contracts are signed but before the shipment of goods; and post-shipment insurance, which covers losses that occur after the shipment of goods.

Agencies differ in the cover they supply. Some only provide limited cover against commercial and political risks, while others offer a broad range of policies covering all types of risk.

Export guarantees

To promote private participation in export credit, some government agencies offer guarantees that enable financial institutions to recover loans in cases of default. A variety of guarantee programs exist with different objectives. Pre-shipment (supplier) credit guarantees are provided to institutions which advance production finance. Post-shipment (buyer) credit guarantees are given to financial institutions which extend credit to overseas buyers to make purchases.

Export credit

Governments provide official export credit support in two ways, either directly or indirectly:

- Loan programs -- extend credit *directly* to borrowers, often in association with private financing;
- Subsidy programs -- operate *indirectly* by extending preferential refinancing and interest subsidies to private lenders, who then lend to exporters.

In each case the credit may be provided to the exporter, the importer or their financiers.

Loans to exporters

Exporters can be subsidised through the provision of pre-shipment loans, for initial, working or developmental capital. Alternatively, exporters are subsidised when the government takes an equity position in a company and requires a return below that which would have been demanded by private capital markets. France, for example, channels a relatively large proportion of its subsidies through equity participation.

Credit to importers

Credit is provided to importers when a foreign purchaser of exported goods or services is allowed to defer payment. It is normal practice for exporters to provide long-term credit (ie for more than five years) to buyers of capital goods; and short-term credits (less than two years), or medium-term credits (two to five years), for other goods.

There are two types credit provided to importers:

- *Supplier credit* is made available to importers by the exporter, who agrees to accept deferred payment from the buyer.
- *Buyer credit* is extended directly to importers or indirectly via 'financial credits' or 'bank-to-bank loans'.

Mixed credits

Most OECD countries provide aid-supported loans to other countries for the purchase of capital goods and project-related services. These so called 'mixed credits' are usually tied to the procurement of goods and services from the donor country.

5.3 International use and cost of export finance

Most of the economies being reviewed by the Commission have official export insurance and guarantee facilities (Table 5.1). However, some countries (eg Hong Kong and Singapore) do not provide 'national interest' cover. The New Zealand Government does not provide commercial insurance or guarantee facilities, although a 'national interest' account is operated under contract by the private sector. Most countries also have official export credit facilities while only developed countries typically offer mixed credits.

The demand for export finance declined following the onset of the debt crisis in the early 1980s. In part, this was a result of reduced demand for imports as many governments cut back on public sector investment in response to balance of payment difficulties. In addition, agencies moved to restrict the availability of insurance cover as many developing countries experienced debt service difficulties. Export credits were reduced further in the mid-1980s when a sharp fall in export revenues led to a decline in imports by oil exporting countries (Johnson *et al 1990).*

In the main, reschedulings triggered by the debt-servicing difficulties of many developing countries resulted in increased losses for agencies over the second half of the 1980s. In addition, a pick-up in insurance activity and associated subsidies set the scene for increased future losses. By the end of the decade activity was again growing strongly: for fiscal year 1989-90, the Berne Union reported a 29 per cent increase in the total amount of insured business by its members (Carnevale 1991).

Table 5. 1: **Availability of officially supported export finance facilities in selected economies**

	Insurance and guarantee			
Economy	*Commercial*	*National interest*	*Export credits*	*Mired credits*
Australia	**Yes**	**Yes**	**Yes**	**Yes**
France	Yes	Yes	Yes	Yes
Germany FR	Yes	Yes	Yes	Yes
Japan	Yes	No	Yes	Yes
New Zealand	No	Yes	No	No
United Kingdom	Yes	Yes	Yes	Yes
United States	Yes	No	Yes	Yes
Hong Kong	Yes	No	No	No
Korea, Republic of	Yes	Yes	Yes	Yes
Indonesia [a]	Yes	Yes	Yes	No
Malaysia	Yes	Yes	Yes	No
Singapore	Yes	No	Yes	No
Taiwan	Yes	No	Yes	No
Thailand [a b]	No	No	Yes	No

a All export credits are provided by commercial banks and refinanced through the Central Bank.
b Thailand does not currently have an official export finance agency. However, the Commission understands that and Export Import Bank will be established soon to provide both insurance and guarantees.
Sources: ADB 1990; Ball and Knight 1990-, ECIC 1990; Japan Eximbank 1991; MECIB 1990; MIDA 1991; OECD 1990; Price Waterhouse 1987,1988b, 1989b.

Insurance and guarantees

Table 5.2 indicates a wide variety in the extent to which insurance and guarantee facilities are used, with the proportion of exports insured -- ranging from over 20 per cent in France and Japan to less than 5 per cent in the United States, Germany, and many Asian economies. Interestingly, economies that have recently been very successful in terms of export growth (eg The Republic of Korea and Taiwan) are among the smallest users of export insurance and guarantee facilities.

The extent of insurance and guarantee subsidies can be gauged by the difference between income (eg premiums, revenues and investment income) and expenses (eg claims and operating costs). However, this measure alone will not indicate the true economic viability of an agency. Provision should also be made for the payment of dividends on government-provided equity capital.

Table 5.2: **Officially supported export insurance and guarantee activities in selected economies**

Economy	*Exports insured* *1989*	*Share of total exports* *1989*	*Profits/loss* *1985*	*Profits/loss* *1989*	*Cumulative Profit/loss* *1985-89*
	$b	%	$m	$m	$m
Australia	**6.2**	**13**	**22**	**16**	**-369**
Austria [a]	10.7	23	200	166	404
Belgium	5.7	3	-72	-166	-722
Canada	5.2	4	19	-226	-192
Denmark	8.3 [b]	25 [b]	-5	28	4
Finland	1.2 [c]	4	-26	-112	-226
France	45.6 [c]	23 [c]	375	-2508 [c]	-6000 [f]
Germany FR	24.5	4	-408	-171	-3697
Italy	17.1	7	-1087	-990	-4998
Japan	76.5 [b]	21 [b]	-525	-1097 [c]	-4000
Netherlands	21.2	13	-192	-237	-1001
New Zealand	0.8	7	3	1	9
Norway	1.1	4	-41	-63	-370
Spain [c]	5.3	10	-213	na	-2500 [f]
Sweden	2.2	4	-52	-104	-421
Switzerland	2.1	3	-153	-245	-1037
United Kingdom	38.7	19	-2804 [d]	-1150	-6000 [f]
United States	5.8	3	-64	-30	-180 [f]
Hong Kong	1.9	2	0	1 [c]	9
Indonesia	0.1 [c]	..	na	na	na
Korean, Republic of	0.4	..	na	na	na
Malaysia [e]	0.1	..	na	na	na
Singapore	0.3	..	na	na	na
Taiwan	0.4	..	0	1	4
Total	**281.4**		**-5023**	**-6881**	**-31 289**

na Not available.
.. Less than 1 per cent.
a Exports insured figure is for new guarantees only.
b Figure for 1987.
c Figure for 1988
d Figure for 1986.
e Insurance only.
f Estimate only. Data were not available for some years.
Source: Ball and Knight 1990; ECIC 1990; IMF 1990; Industry commission estimates; MECIB 1990; *Trade Finance* 1991.

Insurance and guarantee facilities have generally operated with substantial losses. These losses have been particularly high for the larger agencies: for example the French agency CoFACE has posted losses approaching the equivalent of $A2.5 billion in a single year. Table 5.2 shows cumulative losses by OECD countries of about $A30 billion for the period 1985 - 89. In particular, France, Germany, Italy, and the UK have all recorded large losses over the period.

Losses in Australia over this period total some $A370 million, despite small profits in some years (due almost entirely to large losses on the National Interest account). By comparison, the losses of the US Eximbank / FCIA were only around $A180 million. This is a result of the US policy of using export finance more as a defensive weapon in the face of export finance competition from other countries, rather than the more generous attitude towards the availability of support in some countries, notably France.

It is also striking that losses have again begun to increase since 1985. Annual losses by all OECD agencies on insurance and guarantees increased from around $A5 billion in 1985 to about $A7 billion in 1989. The inclusion of credit subsidies would make annual losses significantly higher.

Export credits

Export credit assistance is used primarily to promote capital goods exports. Activity is heavily concentrated in six main sectors: telecommunications, transport (ships, aircraft and railway equipment), electric power generation, mining and construction, plant and machinery, and computer control systems.

The use of export credits declined substantially over the mid-1980s, mainly in response to tighter international disciplines. Total official support by OECD Arrangement participants for export credits of over one year fell 43 per cent from 1982 to 1987 and credits with a duration of more than five years fell 66 per cent (Ray 1991). Credit activity turned around in 1988, after which new medium-and long-term export credits rose significantly towards the end of the decade.

According to the IMF, 'the downward trend in new commitments appears to have ended in 1988. [The] general sentiment [among agencies] indicated that the post-1982 decline had come to an end' (Johnson *et al* 1990, p.3). While new commitments dipped back in 1990 to 1988 levels, several of the larger agencies have reported significant increases in new offers and commitments, and others indicate an increase in applications that have not yet been translated into offers. The US Eximbank in particular saw a resurgence in activity, although the upturn owed more to guarantees than to outright lending (Carnevale 1991).

According to Carnevale (1991, p.28):

> Two significant trends continue to influence the structure of export credit and export credit insurance activity: the growth of short--term business with more developed markets, and the increase in medium-to long-term credit and insurance support for projects in less developed markets.

The importance of officially supported export credit in terms of total goods exported is shown in Table 5.3. These figures are only averages, however. The proportion of credit activity to exports is much higher within the capital goods sectors -- the main beneficiaries of export credits. Of the countries shown, Thailand stands out as the most extensive user of export credits, with about 30 per cent of exports supported compared with less than 3 per cent of most other countries (including Australia). Among developed countries, France is by far the largest user of export credits.

In simple terms, the subsidy a borrower receives equals the difference between the finance agency's subsidised rate and the higher rate charged in the private market for the same type of loan and borrower. This difference measures the cost of society of granting the export credits.

Table 5.3: **Officially supported export credits in selected economies: 1988**
(1990 $A)

Economy	*Value*	*Share of total exports*
	($Am)	(%)
Australia	**949**	**1.9**
Belgium	641	0.8
Canada	1 902	1.2
Finland	1 404	4.5
France	16 606	7.3
Germany FR	6 783	1.5
Italy	4 866	2.6
Japan	7 060	2.0
Netherlands	293	0.2
Norway	209	0.7
Sweden	1 297	1.8
Switzerland	668	0.8
United Kingdom	5 289	2.5
United States	11 366	2.5
Korea, Republic of	609	0.7
Malaysia [a]	72	0.3
Thailand [b]	7 103	31.0

a Figure for both loans and guarantees.
b 75 per cent of export credit was in the form of pre-shipment finance.
Sources: ADB 1990; Ball and Knight 1990; IMF 1990; Industry

Table 5.4 shows concession levels worked out under a similar method. The impact of the 1983 strengthening of the OECD Arrangement can be seen in the fall in concession levels between 1981 and 1990.

Table 5.4: **Concession levels in medium-and long-term export credits** [a]
(Per cent)

	Category II	*Countries* [b]	*Category III*	*Countries* [c]
Country	*1981* [d]	*1990*	*1981*	*1990*
United States	-5.70	0.97	-6.32	-0.13
France	-9.15	-0.55	-9.77	-2.00
United Kingdom	-5.92	-1.68	-6.54	-3.80
Canada	-6.68	-1.52	-7.30	-2.62
Italy	-11.42	-1.92	-12.04	-3.02
Germany FR	0.50	0.40	0.50	0.70
Japan	0.34	1.46	0.34	1.46

a Concession levels are based on the difference between OECD Arrangement minimums and secondary market yields on medium and long-term government bonds. Negative figures indicate a subsidy. Positive figures result when a country's secondary market yields are below the Arrangement minimums.
b Under the Arrangement classification, these are intermediate income countries.
c Relatively poor countries.
d Before the move to more market-related rates under the strengthened 1983 OECD Arrangement.
Source: US Edrnbank 1991

Due to information constraints and the complexities of calculating credit subsidies, estimates of the cost of these subsidies vary. The size of the subsidies shown in Table 5.5, however, indicate that the cost of export credit programs has been extremely high.

Table 5.5: **Annual credit subsidies**
($A billion: current prices)

Countries	*Year(s)*	*Subsidy*
Most countries	1970-75	small
G7 countries [a]	1980	1.3-3.0
OECD	1980-82	5
OECD	1981	6
OECD	1985	1.4

a Canada, France, Germany, Italy, Japan, the UK and US.
Sources: Carey 1987; Fleisig and Hill 1985; Moravsik 1989.

The profit and loss position of export credit agencies is obscured by uncertainties as to the ultimate recovery of arrears and restructured claims. For these reasons, cash flow figures need to interpreted with considerable caution. A significant problem arises because the accounting methods used by most agencies do not provide an accurate picture of their financial situation. The US Comptroller General commented on the way in which Eximbank prepares its financial statements in the following terms:

> In our opinion, because of the material effect of not establishing an allowance to reflect the amount of estimated losses on its direct loans, accrued interest receivable, and rescheduled insurance and guarantee claims, the financial statements [of Eximbank] do not present fairly, and in conformity with generally accepted accounting principles, the financial position of the bank (Eximbank 1987, p.38).

Although precise figures on export finance losses are difficult to determine, Fitzgerald and Monson (1989, p.101) argued that: 'Industrial countries' export credit and insurance programs have been expensive, difficult to control, and subject to political and economic pressures that have tended to subvert their objectives'.

Mixed credits

In the early 1980s, industrialised countries sought to maintain their exports in a shrinking market brought on by the debt crisis and world recession. As all had subscribed to the GATT Subsidies Code, officially supported credits were one of the few legitimate tools available. Some reacted by increasing their tied-aid grants -- the value of which rose sharply. Mixed credits -- the combination of aid and export credits were seen as a way of circumventing the OECD Arrangement. Both exporters and importers actively sought such aid.

On the use of mixed credits in international trade, EFIC stated:

> The measure of the success of this practice (mixed credits) in assisting exports is the persistence of the mixed credit "war" among OECD countries.
>
> The US Government, perhaps the most outspoken critic of the practice, last year resumed its mixed credit programme in view of the lack of success in limiting mixed credits within the OECD group of export credit agencies.
>
> Recent efforts to ... limit the trade distorting effect of this practice have been unsuccessful due to the reluctance of European governments to forego this form of export enhancement (Sub. 28, p.6).

As observed by EFIC, European governments were the first to spend large amounts of money subsidising mixed credits and are still the main 'culprits'. According to the US Eximbank (1989, p.21):

> ... the US government soon became increasingly concerned that the use of tied aid credits (particularly by the French) constituted a significant loophole in the agreement [OECD Arrangement] and undermined the effort to impose greater discipline on export credits.

Mixed credits are still a relatively small part of total officially supported credit. Their use by OECD countries increased over the 1980s, but appeared to fall somewhat towards the end of the decade (Table 5.6).

Table 5.6: **Notifications of mixed credit offers**

Economy	*1984*	*1986*	*1987*	*1988*	*1989*	*1990*	*Share of exports 1990*
	($m)	($m)	($m)	($m)	($m)	($m)	(%)
Australia [a]	na	106	753	229	526	308	0.6
France	2 646	1 240	3 223	2 871	3 219	3 375	1.2
Germany FR	1 850	2 323	1 943	2 471	1 561	1 453	0.3
Japan	250	3 831	4 629	3 829	3 639	2 678	0.7
United Kingdom	2 055	2 680	3 275	3 223	2 290	411	0.2
United States	139	364	294	27	118	636	0.1
Total	**6 940**	**10 544**	**14 117**	**12 650**	**11353**	**8 861**	

a 1987 and 1988 figures are for financial years 1987 - 88 and 1988 - 89 respectively. All other figures are for calendar years.
Sources: US Eximbank 1989; Industry Commission estimates

Governments have responded in two main ways to the increasing trade distortions created by mixed-credit activity. One approach has been to use mixed credits sparingly while encouraging further discipline through multilateral negotiations. The UK position has been characterised as:

> ... opposing export credit subsidy in principle and seeking to avoid or minimise (its use by the UK) but subject to the overriding need to maintain the competitiveness of British exports in the world marketplace (Kemp 1989, p.34).
>
> ... in order to reduce the costs of such support the Government will continue to press hard internationally for multilateral agreement aimed at eliminating subsidies which distort export credit and aid (ECISD 1990, p.3).

A second approach has been to join in the so-called mixed credit 'war' between many developed countries. This involved the heavy use of subsidies, mainly by European governments. The United States initially tried to avoid getting caught up in the 'War', but through the 1980s it became increasingly aggressive in its attempts to force other countries into serious negotiations to limit the use of mixed credits.

On the use of its 'war chest' for this purpose, Eximbank stated:

> With the backing of the Administration and the Congress, Eximbank has pursued an aggressively targeted campaign against competitor countries' use of foreign aid funds for commercial purposes. …efforts were strengthened by the enactment of a tied aid credit fund 'War Chest'.

On the use of its 'war chest' for this purpose, Eximbank stated:

> The War Chest has served a useful purpose as a negotiating tool. It was not intended to be an ongoing defensive program unrelated to negotiations (1987, p.1).
>
> Eximbank has aggressively utilized the 'War Chest' to help reinforce its negotiating position in the current round of OECD Tied Aid Negotiations. Consequently, Eximbank no longer merely matches competitors' offers, but is actually initiating many mixed credit offers in strategic markets and sectors where this type of support has become most problematic. One example ... is the implementation in 1990 - 91 of a $500 million [$A640m] program to finance developmentally sound capital projects in the 4 spoiled' markets of Indonesia, the Philippines, Thailand, and Pakistan ... (1991, p.24).

The Commission was told during its visit to Eximbank that the approach of 'picking markets' identified above was currently being used, although there was an explicit attempt not to discriminate between sectors.

5.4 Why governments underwrite exports

Insurance

The Commission found statements from various countries on the benefits obtained from governments offering export insurance assistance. They relate mainly to 'filling the gaps' in the private market.

The Opposition view was put recently in the Australian Parliament as follows: 'EFIC undertakes ... in many instances insurance that would not naturally be attractive to the commercial market' (Downer 1991a, p.1385). On the provision of 'national interest' cover, the responsible Minister said: 'EFIC also undertakes transactions which the Government considers to be in the national interest. These are usually high risk and involve important industry, trade or political considerations' (Free 1991b, p.1295).

On the provision of export insurance in the United States, Eximbank (1989, p.13) stated that it:

> ... does not compete with private sector export credit financing sources. Rather, its programs are designed to fill gaps left by the private sector ... [that is] risk that the private sector rinds unacceptable.

The New Zealand Associate Minister for External Relations and Trade gave 'the nonavailability of private sector cover' as a reason for providing 'national interest' insurance in that country (Maxwell 1990, p.8).

Export credit

Several reasons are offered in support of government assistance via export credits. Like insurance, the main argument is that government agencies fill a perceived gap in the private capital market.

The Australian Government's view is that EFIC's role is to 'fill a market gap by providing services which are not normally available from the private sector' (Free 1991b, p.1295). Similarly, during visits in the course of this inquiry, the Commission was told that Japan's Eximbank lends to supplement Japan's private banks.

Another argument is the need to match the widespread use internationally of credit subsidies, in order to be competitive in the marketplace. This was expressed recently by the shadow Australian Minister as follows:

> ... EFIC in principle has a very important role to play in contributing towards the competitiveness of the Australian economy in the international marketplace ... as long as other countries are doing it, it leaves us in a position where, if we did not provide that concessional finance consistent with the OECD guidelines ... we would lose market share, particularly in terms of capital goods (Downer 1991a, p.1385).

Observing the situation facing UK exporters, Kemp (1989, p.98) said: 'In fact, a competitive credit offer is usually necessary to reach the starting point for serious consideration of bids'.

The United States' Eximbank (1991) has also supported this objective:

> An active, competitive Eximbank can help ensure that all U.S. exporters compete in a level-playing field (p.i). ... Eximbank is to focus its resources on those export transactions that 'need' government support due to foreign government competition (p.9) ... the primary objective of Exim's fee system is to be competitive with other ECA's [Export Credit Agencies] (p. 18).

Some developing countries use credit subsidies discriminately to broaden the export base. For example, Indonesia's export finance system favours non-traditional exports, even though they are considered by the financial community to carry higher risks. In the Philippines, the rediscount facility operated by the Central Bank favours the non-traditional over the traditional sector (ADB 1990). A similar discrimination, in effect, generally applies to the capital goods exports of developed countries, given that this sector is the main recipient of export credits.

Mixed credits

One of the main arguments advanced in support of mixed credits is that, because of similar support provided by competitor countries, they are needed to win large contracts in developing countries. According to EFIC (1990, p. 13):

> ... mixed credits, or soft loans, help establish Australia's presence in a large market for projects in the developing world where loan packages on internationally competitive soft terms are necessary if the project is to utilise Australian capital goods and services.

This point was also made by BHP in its submission:

> In the area of aid finance and subsidies from AIDAB, the funds available at $A100 million pa are clearly less than that of other developed countries, although on a per capita basis the comparison

narrows somewhat. If greater funding were available, Australia's performance in difficult markets would certainly be enhanced (Sub. 20, p.30).

Mixed credit schemes have both aid and commercial objectives. According to the Australian Prime Minister, the DIFF scheme is used:

> ... to provide substantial support to developing countries, enabling them to obtain better credit terms for essential imports, and to selected Australian firms, enabling them to increase the penetration of Australian exports (Keating 1992, p.80).

5.5 Effects of export finance assistance

The effects of concessional financing on industry development and overall economic welfare are complex and difficult to measure. This may be one explanation of the dearth of quantitative analysis of the effects of export finance subsidies.

Removing distortions in world trade

That distortions exist in world markets is undeniable, but it is arguable whether export finance subsidies are the best way of dealing with the problem. For example, it has been argued that the use of subsidised credit is an inefficient response because a large part of the subsidy goes to the foreign buyer, rather than to the subsidising country's exporters. An analysis of the distribution of export credit subsidies between buyer and seller by Fleisig and Hill (1985, p. 14) concluded that:

> Given available information on supply, demand, and market organisation in the markets receiving subsidised export credit ... [it is] estimated that borrowers receive between 50 and 100 per cent of the subsidy.

These concerns were shared by Fitzgerald and Monson (1989, p.97):

> ... much of the benefit of postshipment credit accrues to the importing country, while the export country bears the costs. ... the exporting country never gains; at best, it breaks even.

On reducing the distortions in world trade, Byatt (1984, p.170) described the effect on the UK in the following terms:

> There is obviously a cost involved in copying the practices of others because subsidies on capital-goods have to be paid for by higher taxes on the rest of the economy. ... as a large part of the subsidy ... is likely to go to the foreign importer, they tend to reduce the real income of UK residents as a whole.

Subsidised export finance has the effect of further distorting user-country trade patterns. Developed country export finance activity is heavily concentrated in trade with developing countries. The higher risk of exporting to these countries focuses both credit and insurance activity towards them, while mixed credits are naturally directed at developing countries. One consequence may be a divergence away from traditional trade patterns.

Distortions to trade flows will have an effect on the efficient use of a country's resources. It is argued that matching credit subsidies offered by other governments will insure that they are no longer a deciding factor in the purchase decisions of buyers, neutralising their impact. This argument lies behind comments made to the Commission by the Australian Dairy Industry Council (Sub. 51, pp. 4-5):

> Clearly, if a distorted international trade policy criteria is accepted, then market signals that make Australia employ resources correctly for production of internationally traded commodities will not be forthcoming. ... This means resources would be over-employed in the country of production at the expense of a country that has a comparative advantage in such production.

However, if domestically imposed non-market forces shape trade flows, the structure of the economy will change, reducing productivity as resources are shifted to non-market determined (second-best) uses.

Industry development

Effects on resource allocation

Concessional financing can significantly distort industry development. For example, reporting on the provision of export insurance in the UK, Kemp (1989, p.95) commented:

> ... if the market judges certain risks to be unacceptable, action by the Government to insure them, even at what may pass for a fair market price, must produce a bias in favour of the sector for which the Government provides facilities, ie in this particular case exports, and thus result in a suboptimal allocation of national * resources. ... if there is a positive financial subsidy, the distortions to the economy will be greater and more direct.

In some developing countries, resources are deliberately reallocated into non-traditional industries in an attempt to broaden the export base. For example, Indonesian export credit has been available only to non-oil exporters in recent years. Yet a World Bank study (1991a) found that this initiative had done little to broaden the export base.

The subsidisation of capital as an input through the use of pre-shipment export credit can also lead to distortions in resource use: it encourages capital to move into export industries rather than into import-competing ones; subsidisation is greater for relatively capital-intensive export industries; and export industries are induced to use more capital-intensive techniques, adversely affecting employment.

In a central bank study on export financing in the Republic of Korea, Lee (1985, pp. 90 - 2) argued that the heavy use of export credit had a number of adverse effects:

> ... over-borrowing on the part of certain exporters, ... an undesirable effect on the allocative efficiency of resources, ... [and] export was executed mainly in view of maximisation of producers' profits, ... so that the consumers' ... welfare has been more or less neglected.

In evaluating the French experience with export credit subsidies, Melitz and Messerlin (1987, p.167) concluded that they:

> ... are likely to be distortionary in ways which more than offset any macroeconomic advantage which they allow. The case for such subsidies is not persuasive.

Effects on employment

Reporting on the employment arguments sometimes used to justify export credit, Byatt (1984) concluded that any substitution of capital for labour due to artificial support provided to the former may lead to lower employment levels, or, if unemployment already exists, to downward pressure on wages.

After comparing the cost of export credit activity and the number of jobs subsequently created, Byatt (*ibid,* p.175) concluded that:

> ... there was no doubt that export credit subsidies are an extremely expensive way of reducing unemployment.

The Commission understands that the US Eximbank does not evaluate the impact of its export credit activity on others (ie recipients or competitors). In terms of the effect on the United States, it seems some simple analysis has been undertaken of the impact of Eximbank intervention on job creation, although this has not produced any solid conclusions.

According to Fitzgerald and Monson (1989, p.96), any benefits to employment may be short lived because of the effects of export credit subsidies on the exchange rate.

> Even if export credit and insurance were temporarily to increase exports and employment, the exchange rate would appreciate, imports would increase and employment in import-competing activities would fall to offset the temporary improvements.

Effects on industry concentration

In many cases, mixed credit programs do not offer widespread benefit to industry, being concentrated on the export of a narrow range of capital goods from a small number of large and influential firms. This diverts limited resources into a relatively small number of capital goods sectors. Supported sectors include construction and civil engineering, telecommunications, heavy electrical equipment and mining technology.

Commenting on the use of mixed credits by the UK, Kemp (1989, pp.96-7) observed that:

> ... the number of ... companies undertaking export contracts for major projects is very small, with the implication that the benefits of Government support ... is accordingly concentrated upon a very narrow section of industry.

And in the United States, Eximbank (1989, p.95) has commented on:

> ... the very heavy concentration of aid and credit in these sectors [telecommunications, power generation, construction and mining, and railroad equipment] ... Although these four sectors account for ... five per cent of exports, they account for ... 44% of mixed credit notifications.

In the case of Thailand, the Asian Development Bank found that, within the sectors favoured by export finance subsidies, there is also often a concentration of funds towards the larger more established firms. As to export promissory notes provided through the Bank of Thailand's rediscount scheme, the ADB (1990, p.272) found that:

> ... the funds have become clustered among major exporters whose finances are already well managed. ... to continue to increase the funds granted to those businesses ... would be detrimental to the nation's financial stability. Therefore, it is necessary ... to improve procedures ... in order that the limited funds are distributed more equitably.

The automatic granting of export credit has also had adverse effects. In Thailand, a large share of export credits is delivered under its 'packing credit' facility. The ADB (1990, p.288) cited an analysis of this facility:

> [There is] a strong argument against subsidised packing credit facility especially in the agricultural sector. The study indicates that none of the low-interest assistance ... was passed on to farmers, other producers, or consumers because the privileged companies which received a large share of the facilities did not need to compete for credit. The study disputes the claim that packing credit increases the volume of Thai exports ...

Economy-wide effects

On the more general welfare effects of credit subsidies, Carmichael (1987) found that, under the current system of setting subsidy rates, governments may not create any positive welfare effects through export credit programs.

While commenting on the effects of subsidised export finance on the Canadian economy, Raynauld et al (1983, pp. 56 - 64) observed:

> ... it is still an open question whether the subsidies applied to export credit provide a real marginal benefit - that is, whether they have a net effect on exports, promote the proper exports, and at the same time do not go too far in this direction. ... [It] is at best a compensatory measure and at worst a measure that adds more distortions to the efficiency losses already caused by tariffs. ... as an instrument for stabilisation or job creation, export finance assistance is very discriminatory compared with monetary or fiscal policy. ... a long-term export financing program has nothing to do with economic stabilisation.

Financial market development

In recent years the private sector has expanded the facilities it makes available to exporters. Some institutions are now willing to provide cover of up to three years for political risk and five years

for commercial risk. For medium- to long-term business with OECD Arrangement Category 1 countries, for which interest rate subsidies are not allowed, some banks are even prepared to offer longer repayment terms than are allowed under the Arrangement. There is also private sector interest in insuring exports to some Category II countries, in particular the more developed Asian economies (Johnson *et al 1990).*

Studying the UICs official export finance agency ECG1), Kemp *(1989, p.iii)* argued that the existence of government-backed agencies may stifle activity in the private market, exacerbating the lack of facilities offered to exporters.

> For risk insurance (mainly in the short-term field), direct Government backing is not essential ... It is believed by some that the private-sector market could do more, even in the medium-term field, given the opportunity.

Trade Indemnity Australia Ltd (Sub. 52, p.1) made similar comments regarding the potential for greater private sector participation in export insurance.

> In Australia it would seem beneficial to separate the long and medium term financing activities of EFIC into an Export Bank and either retain the credit insurance arm as a separate organisation, or move this section out of government altogether by a privatising program or sale to private enterprise.

In its submission, Scottish Pacific (Sub. 49, pp. 1 - 3) commented on the ability of private sector institutions to provide facilities similar to those extended by export finance agencies:

> ... Export Factoring ... [has] potential in assisting the small to medium sized exporter to compete in the international market place. ... This type of financing is rapidly gaining popularity in Australia as a flexible and attractive method of financing sales to overseas customers.

Commenting on the overlap between government export finance agencies and similar facilities provided by the private sector, the American Home Assurance Company (Sub. 33, p.2) stated:

> The private market generally speaking does not believe that government agencies should be in the business of providing short term credit insurance. The private market can do this perfectly adequately and with its ability to instil cost disciplines, dollar savings should be made.

There is also a belief that the existence of subsidised official agencies stifles private sector activity. According to Raynauld *et al (1983, p.34):*

> In the field of long-term export financing, the very presence of government agencies ... appears to prevent the banks from playing a significant role.

In a study of the UK's ECGI), Kemp *(1984, p.96)* also concluded:

> ... if the Government were to withdraw from the scene, the private sector would be stimulated to accelerate its expansion, it would quickly respond to meet demand over a wide area of British exports,

> and what lay beyond the limits of such expansion must by definition constitute a field in which by the acid test of a freely operating market risks were too great to be acceptable. Result: a better allocation of national economic resources.

Similar arguments were made by Raynauld et al (1983, p.61) in an analysis of Canada's Export Development Corporation (EDC):

> ... the very presence of the EDC may pose an insurmountable obstacle to the industry [private finance institutions].

On its ability to compete against government-supported export insurance in the Australian marketplace, the American Home Assurance Company (Sub. 33, p. 1) stated:

> ... the private market tends to see government support for agencies such as EFIC as continuing to allow EFIC to be unrealistic in the terms that it offers. The private market attempts to provide insurance at 'market rates' and if EFIC is enabled to provide coverage at below market rates, then clearly we have difficulty in being competitive.

On the impact of government involvement on the availability of private export finance in Indonesia, the ADB (1990, p.122) stated:

> As long as funding at a preferential rate is available from the central bank, commercial banks will have no desire to finance export credit.

Foreign aid

The use of mixed credits has increasingly become seen as a way around the disciplines imposed on traditional export credits by the OECD Arrangement. However, apart from the trade-distorting effects of mixed credits, there has been debate on whether commercially tied aid produces the best results from a developing country's point of view. For example, in its submission the Metal Trades Industry Association of Australia (Sub. 43, p.6) stated that the 'MTIA strongly supports an increase in the proportion of the aid budget constituted by DIFF. DIFF has proven to be developmentally sound aid'.

From an aid perspective, however, the combination of export promotion objectives and official development assistance has the potential to reduce the value of foreign aid and direct it away from areas where it is most needed.

In its submission, Austrade (Sub. 42, Attachment C, p.71) commented on the use of mixed credits in the UK:

> ... the British government has been criticised for holding 'slack' development standards in cases where tied aid and/or mixed credits have been used. ... Mining has ... been a sector where significant British tied aid/mixed credits have flowed into although this sector is not considered to have developmental significance.

According to US Eximbank (1989, p. 17):

> ... there is a substantial risk that through blended financing ... resources may well be diverted from development oriented uses in poorer recipients to trade and competitive-oriented uses in middle income countries. ... [For example], creditworthiness limits on export credits precludes many poorer countries from receiving blended aid.

Other distortions identified by Eximbank include:

- a bias towards large capital equipment projects with a high import content in areas of particular export interest to the donor;
- a corresponding bias against projects and programs with low import content that focus on alleviating poverty, such as rural development projects;
- donor reluctance to co-operate and co-ordinate their aid activities with other donors who may be seen as competitors; and
- impaired credibility of donors in policy dialogue with recipients.

As to the value of mixed credit support for exporters, Eximbank (1989, p.222) stated that:

> ... analysis does not find that the facts available on tied aid credit practices and effects establish a clear case of need for priority call on public expenditure. While foreign tied aid practices may be costing the US several hundred million dollars of lost exports ... few would advocate indefinitely spending 35 cents of taxpayer money per one dollar of 'reclaimed' export.

In its submission, Austrade (Sub. 42, p. iv) referred to the findings of a survey of DIFF recipients, as well as some econometric modelling, carried out by the National Institute for Economic Industry Research (NIEIR). On the basis of these pieces of work, Austrade stated that there was a 'strong trade and employment creation and significant industry development impact of DIFF outlays'. Neither the NIEIR's survey nor its modelling work have been released publicly.

While this report has not sought to evaluate the DIFF scheme, the Commission was able to examine on a confidential basis some of the material available to Austrade. Unlike the survey results, the modelling suggested quite minor outcomes in terms of the net national benefits of DIFF expenditure. Unlike Austrade, therefore, the Commission is hesitant to draw a conclusion on the value to Australia of the DIFF scheme based on this evidence.

Because EFIC is constrained by limited capital, another effect of DIFF is less export finance and insurance support for non-DIFF exporters. DIFF also locks a major component of EFIC and National Interest exposure into higher-risk markets. This has an adverse effect on portfolio diversification and hence a negative impact on EFIC's ability to limit risk -- EFIC's portfolio risk is likely to increase.

5.6 Effects on the Australian economy of foreign export finance assistance

Other countries' export finance assistance measures are likely to have two direct effects on the Australian economy:

Australian consumers may benefit from imports at lower prices; and

- Australian producers may face stiffer competition in their home and international markets.

- While no submissions commented on the first point, several participants addressed the second.

Wilson Transformer Company Pty Ltd identified concessional finance as 'a major factor in the capital goods and services markets of India and S.E. Asia' (Sub. 26, p.3). According to Wilson, Australian bids have been unsuccessful in winning projects because of the integral part export finance arrangements have played in packages offered by competitors. In particular, the use of mixed credits by the UK was cited:

> One of the most outstanding examples is the award of Malaysia's Pergau 600 MW hydro-electric project to British contractors. Britain's Overseas Development Agency has provided a soft loan totalling Stg 305.4 million [$A426m] in support of 75 per cent of the Stg 417 million [$A580m] project. The interest rate is reported to be 0.809 per cent payable over 14 years with a 6 year grace period.

In another case, Wilson's bid for a project in Thailand was beaten by 'exceptionally low priced offers from Belgium.'

> The Thai electricity authority concerned claimed that no form of subsidy was involved but the Belgium firm, with whom we have had direct contact, confirmed that they had virtually unlimited access to Belgian Government aid funds (Sub. 26, p.3).

In other instances, contracts were awarded to manufacturers from Romania, China and India, which:

> ... all won orders because of their exceptionally low prices. At the price levels quoted none of these manufacturers could have covered their costs of production (p.3).

The submission concluded from these large price discrepancies, 'that heavy government subsidies have been used to support these manufacturers in winning export work'.

Wilson listed several other electrical engineering projects in South East Asia, carried out by developed countries -- in particular France, Germany, Japan, the UK and US -- that had been won through the use of export credits or mixed credits. On the basis of this evidence Wilson argued that some form of government subsidy -- in its case DIFF finance -- is essential in winning contracts in these markets.

A survey of DIFF recipients, carried out by Mr Peck of Wilson, found that the main reason they need government support is to counter mixed credit subsidies available to competitors. The survey of 22 firms revealed that:

> 73% felt that they would be internationally competitive if soft loans were unavailable to their overseas rivals (Sub. 35, p.2).

OGM Engineers also identified competition in the area of export finance as disadvantaging Australian exporters (Sub. 32, pp. 2-3). According to OGM, an offshore oil development contract it had won in Vietnam was subsequently lost to a Korean/Italian joint venture by default, because OGM was unable to obtain finance. OGM stated that the Italian company involved was able to obtain Government credit at about 4 per cent per annum. OGM further advised it was aware that:

> In Malaysia there is an Export Development Bank which provides [pre-shipmentl finance to companies at 6%. Insurance is provided for the full amount for about 1% of the value. Companies are simply required to prove they are capable of performing, no security is required (p.3).

Competition in the area of export finance was also cited as a problem by the Australian Shipbuilders Association Ltd (Sub. 30, p.14):

> The critical area of difference in Government support for ship building between Australia and most overseas countries is the provision of finance to ship owners. ... Until Australia develops the expertise and will to compete in this area of financial packaging, it is unlikely that Australian shipbuilders will be competitive on commercial vessels.

5.7 Concluding comments

Export credit agencies face a contradiction: the tension between an agency's institutional need to be self-financing (and therefore to limit its exposure to risk) and its fundamental purpose as a public institution undertaking activities that the private sector considers too risky or unprofitable. The increasing uncertainty of the international financial environment in the 1980s made this dilemma more acute. The inevitable outcome of this contradiction was the accumulation of heavy losses.

Although the use of export finance by government agencies started to decline after the strengthening of the OECD Arrangement in 1983, it appears that the activities and losses of agencies are again on the rise. Much of this growth is in the area of mixed credits, which are increasingly leading to distortions in international trade and have led to new agreements among OECD countries to limit mixed credit use further.

In recent years, most agencies have come under political pressure to put their operations on a more commercial footing. Agencies have responded to their deteriorating cash flow positions by adjusting their premium schedules to better reflect risks and by introducing more differentiated policies. The scope of these changes has varied widely and the trend toward more differentiated premium structures still has some way to go.

The corruption of world markets by export finance subsidies means that many governments consider such assistance to be a necessary 'evil' to compete against the support provided by other countries. Given this reality, the minimisation of agencies' losses is essential to reap the greatest

benefit from public expenditure. The more realistic the pricing of risk premiums, the better placed agencies will be to achieve this objective. The more cross-subsidies are eliminated, the more scope there is to offer cover (at a price) for high-risk countries, while at the same time competing more effectively for business in low-risk markets.

In some countries (eg Thailand and Singapore), the role of government in the provision of export credit and insurance services is increasing. However, in others, there is a tendency towards the privatisation of public export finance agencies. The short-term comprehensive business arm of the UK's ECGD has been privatised, as has New Zealand's Export Guarantee Office (EXGO). Various other models provide examples of how private involvement in the government provision of export finance can be achieved. In Germany, for example, the government uses a private sector agency (Hermes) as a manager.

Private sector involvement can have a number of advantages:

- competitive disciplines keep overhead costs down;
- the need for government to carry contingent liability and incur costs can be minimised; and
- if the private agency has other insurance business, both partners benefit from an ability to spread overheads.

If there is a strong belief that governments need to be involved in the provision of export finance - and that is the belief across the political spectrum in Australia - the government's role should be kept to a minimum and generally restricted to the area in which private sector services are absent or seriously inadequate. Such an approach will ensure that the call on public resources is kept to a minimum, providing also that a prudent approach to risk is followed. A smaller government scheme requires fewer staff, less money, and fewer facilities; and it means the government will carry a smaller contingent liability. It may also be seen as a sound compromise between the benefits of private sector involvement and running the risk of losing competitiveness in those markets spoiled by subsidised export finance. Such a policy also gives the private sector the maximum incentive to develop the range and quality of its products so that, over time, the demand for its services will increase and the role of government can be wound down.

Developments in the area of private participation in export finance in other countries (eg New Zealand and the UK), and comments made to the inquiry by private insurance companies in Australia, indicate to the Commission that there is scope for greater private participation in the area of export finance in Australia, particularly in short-term export insurance.

Even if Australia could match the export finance subsidies of foreign competitors, the benefits of these subsidies are not clear cut. Australia's EFIC has performed well above average in terms of losses on its own 'commercial' account. However, large losses have been made on the government or 'national interest' account. Government subsidies to enhance exports are of little use if repayments are never made.

As to mixed credits, Australia really has no choice. To increase DIFF funding makes little sense. EFIC (Sub. 28, p.7) stated:

> Australia has little chance of competing in an open-ended mixed credit war against the substantial budgetary resources that the major industrialised countries can apply to the enhancement of export credits in this way.

The distortions to world trade caused by subsidised export credit is not large. Only about 2-3 per cent of most OECD countries' exports are affected by either export credits or mixed credits. The concentration of this support in capital goods sectors means that the impact on other areas of trade (eg other manufactured exports) is even smaller. In addition, the continued strengthening of international disciplines in this area should further limit the subsidies governments are able to offer.

The best course of action for Australia is to continue its efforts, along with countries such as the United Kingdom and the United States, to seek even greater disciplines in this area.

6 TAX INCENTIVES

Governments use a variety of tax strategies to encourage exports. Some tax incentives clearly target exports. Others are more subtle. Indeed, given the variety of tax instruments available to most governments, it is possible to target selected activities (eg export-oriented industries), even though favoured tax treatment is ostensibly available to all firms, irrespective of where products are to be sold. This chapter considers a range of tax incentives to export, their use internationally and their effects.

6.1 Tax incentives to encourage exports

Most frequently, tax-based export incentives involve selective corporate tax concessions or rebates. Favoured application of indirect taxation (for example, the waiving or rebate of import duties on goods incorporated into exports) is another common export enhancement measure -- although the aim is often to attempt to offset the adverse effects other imposts have on exports (so use of the term export-enhancement measure in such a context is something of a misnomer).

Box 6.1 lists examples of tax incentives commonly used to attract foreign direct investment and/or encourage existing exporters. Not all measures constitute an export enhancement in their own right; some need to be combined to produce the desired effect. For example, tax holidays may confer negligible benefits unless combined with loss-carry-forward provisions, as many businesses do not make a profit in their initial years. Sometimes a particular activity is primarily export-oriented, perhaps because domestic demand for the product is small. Extending concessions to this industry will therefore constitute an export enhancement measure, even though exports are not explicitly targeted.

The extent and range of tax incentives offered by governments vary widely. For example, Japan has used the tax incentives listed in Box 6.1 only sparingly. On the other hand, Korea and Taiwan have employed many of them as major export enhancement initiatives at various stages of their economic development. Then again, Hong Kong's combination of a low corporate rate and high standard depreciation rates would qualify as a significant incentive in other economies. While a detailed comparison of tax regimes was considered to be beyond the scope of this inquiry, Table 6.1 illustrates a range of tax incentives commonly used to promote exports internationally. Distilling the complexity of existing tax arrangements into a simplified comparative table (such as has been attempted in Table 6.1) is a particularly difficult task. Nonetheless, the Commission felt that a snap-shot should be attempted. Further details of tax incentives used in individual economies studied in this report are given in Volume 2 (Country Studies).

Box 6. 1: **Examples of tax incentives commonly used to encourage exports**

Tax holidays are exemptions, usually on corporate income tax, made available to certain activities for limited periods. They may apply to a wide variety of activities (eg all of manufacturing), but detailed eligibility conditions often narrow the focus to favour export-oriented industries. Tax holidays are frequently a feature of export processing zones (Chapter 7).

Loss-carry-forward provisions allow companies to transfer the benefits of tax concessions and exemptions to future years. This is particularly important in the case of tax holidays. In the absence of loss-carry-forward provisions such 'holidays' are of little value to firms that make initial losses.

Double taxation agreements exempt businesses from having to pay tax twice -- once in the country of operation and again in the country of residence. Under such agreements, income earned in other countries can be set aside in assessing tax liability in the home country.

Tax sparing is a form of double taxation agreement, whereby if the foreign tax rate is lower than that applying in the home country, the firm is spared the burden of paying the difference in the country of residence. This allows the tax benefit to remain intact and effective.

Favourable depreciation provisions, a popular measure, can permit capital outlays such as expenditures on buildings, plant and equipment to be offset against revenues to a greater extent by favoured activities than in other areas of the economy. For example, capital goods could be depreciable in targeted activities but not in others, or depreciation could be accelerated in selected cases. Accelerated depreciation can take several forms. For example, assets may be allowed to be fully depreciated during their initial years of operation (which favours long-lived assets), the service life of each new asset may be artificially reduced (which usually favours short-lived assets), or existing rates may be increased by a constant proportion. While none of these approaches reduces the total amount of tax payable, timing considerations mean that such favoured tax treatment is equivalent to an interest-free loan or subsidy.

Indirect tax concessions commonly involve, in the present context, waiving or rebating taxes on inputs to exports (eg value-added taxes).

Tax-based strategies used to encourage exports can be broadly categorised as: industry - specific tax incentives; general tax incentives; and *de facto* tax incentives apparently designed to promote general industrial development, but whose incidence focuses on exports (Box 6.2). Elements of each approach may have to be combined to achieve the desired effect. For example, all firms may be eligible for general incentives, with other measures offered selectively.

Box 6.2: **Types of tax incentives focusing on exports**

Industry-specific tax incentives: Industries considered important for economic development (or which qualify as special in terms of other criteria) are targeted for export growth. Tax and other incentives are then used to encourage firms in the favoured industries to expand exports.

General tax incentives: Broad-based rather than selective incentives are used to promote exports in general, rather than from targeted sectors. Thus, incentives may be available to industries across all of manufacturing (or across the economy generally), rather than to those making specified products. However, to qualify for these incentives, firms may also have to satisfy other non-industry-specific criteria.

De facto incentives: These are domestic tax-based incentives apparently designed to promote general industrial development, rather than to target exports. However, their incidence is such that exports are favoured. In economies such as Hong Kong and Singapore, the export orientation of industry is such that new investment usually results in export growth. In this sense, it can be difficult to distinguish measures aimed at encouraging exports from those aimed at encouraging economic development generally.

Industry-specific tax incentives

Industry-specific tax incentives aimed at encouraging exports directly are no longer widely used. This approach was employed extensively by both Korea and Japan. Export promotion is now tending to become more broadly based, although some countries still target particular activities. Malaysia and (to a very limited extent) Singapore provide abatement of corporate income tax for certain export activities.

- As an incentive to Malaysian construction companies to venture abroad, half of the profits from a construction project located outside Malaysia and which commences between October 1988 and December 1993 is exempt from tax, so long as the resulting profits are remitted to Malaysia within five years from the date of the project's commencement.

Table 6.1: Tax rates and incentives, selected economics

	Unit	**Australia**	*France*	*Germany*	*Japan*	*New Zealand*	*United Kingdom*	*United States*
Maximum company tax rate	%	**39**	42	56	51.4	33	35	39[a]
Dividend imputation? [if Yes then Full (F) or Partial (P)]		**Yes(F)**	Yes(P)	Yes(F)	No	Yes(F)	Yes(P)	No
Tax incentives for foreign corporations at 30 June 1990								
Tax holiday period	years	**0**	0	0	0	0	0	0
Loss -carry -forward period	years	**Indefinite**	5	5	5	Indefinite	Indefinite	15
Import duty exemptions?		**Yes**	Yes	Yes	No	Yes	Yes	Yes
VAT zero-rating for exports?		---	Yes	Yes	Yes	Yes	Yes	---
Accelerated depreciation?		**No**	Selective	No	Selective	No	No	Yes
Direct export subsidies?		**No**	No	No	No	No	No	No
Domestic (D) and resident (R) corporate tax base								
Same for domestic and resident taxpayers?		**Yes**	Yes	No	No	Yes	Yes	Yes
All income regardless of where earned?		**Yes**		Yes(D)	Yes(D)	Yes	Yes	Yes
All domestic and repatriated income?			Yes					
Only domestically -earned income?				Yes(R)	Yes(R)			
Non-resident corporate tax base								
All income regardless of where earned?								
Only domestically -earned income?		**Yes**				Yes	Yes	Yes
Withholding tax only?			Yes	Yes	Yes			

Continued

Table 6.1: **Tax rates and Incentives, selected economies *(continued)***

	Unit	*Hong Kong*	*Indonesia*	*Korea, Republic of*	*Malaysia*	*Singapore*	*Taiwan*	*Thailand*
Maximum company tax rate	%	16.5[b]	35	-50	35	31[c]	25	35
Dividend imputation?		No	No	No	No	No	No	No
Tax incentives for foreign corporations at 30 June 1990								
Tax holiday period	years	0	0	5	5-10	5-10	4-5	3-8
Loss -carry -forward period	years	Indefinite	5-8	5	Indefinite	Indefinite	5	5
Import duty exemptions?			Yes	Yes	Yes	Yes	Yes	Yes
VAT zero-rating for exports?			Yes	Yes	---	--- [d]	Yes	Yes
Accelerated depreciation?		No[b]	No	Selective	No	Yes	Selective	Selective
Direct export subsidies?		No	No	No	Yes	Yes	No	Yes
Domestic (D) and resident (R) corporate tax base								
Same for domestic and resident taxpayers?		Yes	Yes	No	Yes	Yes	Yes	No
All income regardless of where earned?			Yes	Yes(D)			Yes	Yes(D)
All domestic and repatriated income?					Yes	Yes		
Only domestically-earned income?		Yes		Yes(R)				Yes(R)
Non-resident corporate tax base								
All income regardless of where earned?						Yes		
Only domestically -earned income?		Yes	Yes	Yes	Yes		Yes	Yes
Withholding tax only?								

na Not available.
--- Not applicable.
a Federal tax only. State taxes of 3-12 per cent and city taxes of 1-9 per cent also apply.
b Hong Kong's standard depredation and corporate tax rates would qualify as incentives inmost other jurisdictions.
c 30 front 1992-93.
d A White Paper on a comprehensive GST and enabling legislation am expected to be tabled in Parliament later in 1992.
Sources: Arthur Andersen 1990-, Australian Government 1991b; CEP15 1990; Price Waterhouse 19811a, 1990cd, 1991.

- Under Singapore's Export of Services Incentives Scheme, local firms are eligible for a 5 year exemption from tax on 90 per cent of export earnings in the case of services provided to offshore customers. The assistance is available to a wide range of service activities.

Generally, participants did not advocate industry-specific tax incentives. For example, the Business Council of Australia (BCA) stated:

> Taken in general, the Business Council does not favour industry or enterprise specific taxation arrangements but rather believes that tax measures aimed at enhancing competitiveness should be broadly based and generally neutral between enterprises (Sub. 53, p.7).

General tax incentives

Broadly-based tax policies aimed at promoting exports are used in several economies. Typical of the range of policies are:

- Corporate tax exemptions on the export profits of firms in certain countries. The United States' Foreign Sales Corporation (FSC) scheme enables a US firm registered offshore to avoid some income tax. In Korea, permanent tax exemptions are available on reserves set aside to cover export losses, and international market development costs are deductible against corporate tax liability. Thailand also offers some deductions when export income increases;

- Tax holidays for exporters in Korea, Taiwan, and Thailand -- typically linked with minimum export requirements and usually applying to a variety of taxes (eg income, corporate, withholding and luxury taxes);

- Export processing zones, in which tax concessions or exemptions are allowed on inputs in the case, for example, of such zones in Indonesia, Korea, Malaysia, Taiwan and Thailand (Chapter 7);

- Double deductions for the cost of export credit insurance premiums in Malaysia; and

- Double deductions or cash grants for export marketing activities, for example, in Singapore.

Favouring exports by exempting them from indirect taxation is also common. For example, most OECD countries (but not Australia) and several East Asian economies have some form of broad-based consumption tax (eg a value-added tax or VAT).[1] As Hagemann *et al* (1987) noted:

> The main arguments in favour of VAT are, first, that it can more easily exclude business inputs and exports from tax (thus avoiding distortions of production decisions and ensuring neutrality with respect to international trade flows) and, second, that it is less vulnerable to evasion. For the same tax collected, the amounts due at each stage

[1] A value-added tax is a multi-stage sales tax on goods and services levied on the amount of value added (roughly equal to the value of outputs less material inputs) at each stage of the production and distribution process.

> are smaller under VAT than under a retail sales tax, and so is the incentive for evasion. There is also an element of self-policing because buyers and sellers at intermediate stages have opposite interests, and the administration of VAT creates a chain of invoices, which facilitate control. ... The main arguments against VAT are its greater administration and compliance costs (at least in smaller firms). Administration costs are comparatively high because firms at all stages of production, not just the final one, are involved and because the need to verify claims for credits and to monitor invoices. The substantial fixed component of these costs suggest that VAT should not be set at a very low rate, or used intermittently. Compliance cost can be substantial, especially for smaller firms, and so VAT systems generally exempt small firms (p.35).

VAT zero-rating for inputs to export production is available in, for example, Indonesia, Korea, New Zealand, Taiwan, Thailand and throughout the European Community.

Some participants in this inquiry favoured special tax arrangements which would be made available to all exporters. Examples included:

- The Australian Electrical and Electronic Manufacturers' Association (A.EEMA) which considered that:

> ... income derived from export activity should be taxed at a lower rate than normal company tax, thereby encouraging increased attention to the penetration of international markets. Tax concessions should also be provided for increased investment (Sub. 27, p.13).

- The Chemical Confederation of Australia which reckoned that:

> …a close study of incentives being offered by competing countries should be undertaken with a view to their adoption. GATT rules do not appear to impede these practices, many of which have been m place for years (Sub. 22, p.5).

- and Kodak which noted that:

> Australia is vulnerable to withdrawal of manufacturing operations in favour of off-shore alternatives while taxation of export earnings remains internationally uncompetitive ... [and urged] that the tax exemptions provided on export earnings by the Government of the United States through its Foreign Sales Corporation legislation be examined by the Industry Commission with a view to similar provisions being adopted in appropriate measure by Australia (Sub. 29, p.4).

Others commented adversely on Australia's indirect taxation system. For example, the Australian Chamber of Manufactures (ACM) believed the cost burden of the tax system -- particularly payroll and wholesale sales tax -- to be an underlying problem in achieving a substantial increase in manufacturing exports. The Chamber drew attention to the non-uniformity of the payroll tax system across Australia and even within States, and noted that it biases the choice of production inputs away from labour.

The BCA (1990) estimated effective rates of wholesale sales tax on exports, by industry for 1990-91; and found that, on average, the effective rate of taxation of those imposts was 1.9 per cent. Table 6.2 reproduces their figures for Australia's major export industries.

Table 6.2: **Effective rates of wholesale tax on exports, by industry: 1990-91**[a]

Industry	*Estimated indirect tax paid on inputs to exports 1990-91* [b]	*Estimated exports by industry 1990-91* [c]	*Effective rate of taxation* [d]
	($Am)	*($Am)*	*(%)*
Mining	363	13 953	2.6
Transport, communications	192	10 192	1.9
Agriculture	95	7 598	1.3
Basic metal and metal products	101	7 374	1.4
Meat and milk products	99	5 751	1.7
Wholesale, retail trade	52	3 613	1.4
Food products nec	47	2 695	1.7
Petroleum and coal products	28	2 211	1.2
Total	**1 190**	**62 232**	**1.9**

a Only the 8 largest export industries are detailed in the table.
b Estimates based on 1982-83 input output tables and 1987-88 taxation statistics.
c 1982-83 share of exports, by industry, are applied to 1990-91 estimates of total exports. Estimate of total exports is from ABS estimates for 1988-89 multiplied by 1.075 (the previous year's growth in exports) for both 1989-90 and 1990-91.
d Estimated tax borne divided by estimate exports.
Source: BCA 19%, p.25

De facto incentives

General investment incentives whose incidence is primarily on exports are important elements of industry policies in many countries. Examples of investment incentives with export implications include:

- Singapore's 'pioneer industry' incentive, which aims to promote the development of promising industries. Industries are selected as eligible for this program on their development potential. Qualifying firms are granted five-year tax holidays from income tax on the profits of their pioneer activities;

- In Malaysia, firms granted pioneer status receive an income tax abatement of 70 per cent for 5 years, the balance being taxed at the corporate rate of 35 per cent. However, investments involving heavy capital expenditure or involving high-technology industries enjoy full tax exemption;

- Korea offers a range of concessions, exemptions and loss deductions available to research and technology investment; and

- Thai businesses can realise 5 -- 8 year corporate and withholding tax holidays with loss carry-forward as part of the provisions of the *Investment Promotion Act* on Investment Promotion Zones.

One frequently used indirect export enhancement measure is tax incentives to support research and development in economies with significant high-technology exports (or those which hope to encourage them). Such measures are available, for example, in
Korea, Taiwan, and the European Community (Chapter 4).

6.2 GATT consistency of tax incentives

Export-specific tax incentives, such as some of those proposed by AEENIA, are specifically prohibited under the GATT Subsidies Code -- at least in the case of developed countries -- on grounds that they distort price relativities and constitute direct export subsidies (Chapter 3 and Appendix C). As early as 1960, a GATT Working Party agreed that the concept of export subsidy, as defined by GATT Article XVI, included 'the remission, calculated in relation to exports, of direct taxes or social welfare charges on industrial or commercial enterprises.' On the other hand, duty drawback (ie the waiving of liability to pay tariffs on imported inputs) and indirect tax concessions accorded exports, such as the rebating of VAT obligations, are specifically allowed under the Subsidies Code.

Territorial arrangements, such as the United States' FSC scheme, which allow foreign subsidiary income to be exempt from tax, are not addressed by the Code. Also, GATT rules do not outlaw general tax measures aimed at promoting investment or production generally, on grounds that proscription would constitute interference in what is essentially a domestic policy issue.

6.3 Comparing the use of tax regimes to encourage investment

The OECD has recently estimated, with many caveats, effective tax rates for manufacturing in member countries (OECD 1991b).[2] The report attempts to calculate, from the perspective of both domestic and foreign investors, 'the pre-corporate-tax rate of return necessary to earn a given post-corporate-tax return'. Table 6.3 details the OECD's 'base case' results for the member countries studied in this report.

Without pronouncing of the adequacy of the OECD's methodology, it is clear that changes to depreciation allowances foreshadowed in the Government's February 1992 'One Nation' statement will reduce the required pre-corporate- tax rate of return for investors under the OECD's base case

[2] Effective tax rates attempt to take into account not only the statutory corporate rate, but also other aspects of the tax system which determine the amount of tax actually paid; as well as other measures impinging on the profitability of an investment - such as capital allowances (eg depreciation) and any special tax treatment of inventories. Calculating effective rates may also require consideration of personal taxes, including the manner, if any, in which the corporate and personal tax systems interact (eg Australia's tax imputation system). Inflation is also a consideration, as effective tax rates will depend on how the tax system calculates taxable profits in the presence of rising prices.

scenario. Further, when account is taken of Australian imputation arrangements, Australian resident investors would face tax rates which are lower than the OECD average.

Table 6.3: **The pre-corporate-tax required rate of return necessary when the real interest rate is 5 per cent**

Country	*Average for each source of finance*			*Average for each type of asset*			*Overall average*	*Standard deviation*
	Retained Earnings	*New equity*	*Debt*	*Buildings*	*Machinery*	*Inventories*		
Australia	9.0	9.0	3.6	7.0	6.4	8.9	7.1	2.8
France	7.3	3.1	3.2	5.4	4.5	7.6	5.4	2.4
Germany	9.5	1.6	0.6	5.9	5.1	6.2	5.6	4.5
New Zealand	8.3	8.3	3.9	6.7	6.3	8.0	6.8	2.2
United Kingdom	7.7	4.6	3.5	5.7	5.2	7.8	5.9	2.3
United States	7.6	7.6	2.6	6.6	5.2	6.1	5.8	2.5
Average	**7.9**	**6.1**	**2.8**	**6.0**	**5.2**	**7.5**	**5.9**	**2.7**

Note: The figures take no account of personal taxes and assume an average inflation at 4.5 (consult source for further details).
Source: *OECD* 1991d, p.99

The OECD (1991b) commented on the results of its study as follows:

> Within the limitations of the methodology used [to determine effective tax rates], all countries appear to discourage outward investment compared to domestic investment by their resident companies. They also place a higher effective tax rate on inward investment by foreign companies compared to domestic investment by resident companies. Further, this result holds irrespective of the means of financing the subsidiary chosen by the parent, unless the subsidiary merely retains its earnings. This difference in tax burdens is lessened by the existence of tax treaties. ... The return required by a subsidiary of a parent company in one country depends crucially on where that subsidiary is located. This suggests that there is considerable incentive for companies to choose tax-favoured locations for their investments which may not be the most favoured locations in the absence of tax. To the extent to which companies respond to such incentives, the tax system therefore creates a global misallocation of resources as activities may be undertaken in high-cost locations because they are tax favoured (pp. 158-9).

Most inquiry participants who commented on tax issues addressed Australia's tax regime generally, rather than focusing on export-oriented tax incentives. A number -- including the Taxation Institute of Australia, the Metal Trades Industry Association (MTIA) and the BCA-- queried the usefulness from an Australian perspective of the OECD study. For example, pointing to significant omissions from the study from Australia's point of view, the Taxation Institute stated that the trend to internationalisation meant that 'the playing field now includes our neighbours in the Asia Pacific region' (Sub. 39, p. 4).

Several participants compared Australia's tax regime adversely with those of Australia's major trading partners and competitor economies. For example:

- The Australian Manufacturers' Export Council noted:

> Our competitors in export markets have taxation regimes which are much more sympathetic to the needs of exporters-tax holidays, accelerated depreciation and rebates on indirect taxes, are typically available in our competitors' economies (Sub. 44, p.2).

- The Association of Australian Aerospace Industries thought that the overall cost of manufacturing in Australia was too high, the cost being boosted by direct and indirect taxes and by ineffective depreciation allowances (Sub. 48, p.5).

- and Edgell-Birds Eye supported:

> ... accelerated depreciation rates and investment allowances to offset the high cost of capital including high interest and finance charges (Sub. 8, Part 3, p.3).

Other participants thought that the Commission's Draft Report focused too much on depreciation issues. For example MTIA thought:

> Both wholesale sales tax and State payroll taxes fall heavily on manufacturers and are payable irrespective of whether companies are making a profit. They are also unnecessarily inflationary, since they increase the cost of business inputs. NITIA strongly supported the Government's recent legislation to expand wholesale tax exemptions for production-related inputs (Sub. 43, p.2).

The BCA considered that 'indirect taxation, tax rates, loss provisions, taxation of foreign source income, infrastructure taxation and tax administration' (Sub. 53, p.8) were key areas of taxation worthy of attention, in addition to concerns over depreciation rates.

The Bureau of Industry Economics commented that:

> The focus on Australia's depreciation arrangements seems to exclude consideration of the taxation of inventories. ... [and] Australia's imputation system of company taxation could have a significant impact on the effectiveness of policy measures such as accelerated depreciation that are intended to improve the incentive to undertake investment. Imputation allows Australian resident shareholders to claim a credit against personal taxation on income from the corporate sector for Australian tax paid by companies. To the extent that Australian tax paid by companies on their income was reduced, due for example to accelerated depreciation provisions, Australian resident shareholders would be liable for taxation on extra income distributed by companies (Sub. 31, pp. 1-2).

The Taxation Institute considered that major tax disincentives to business in Australia include legislation by press release (where the actual legislation differs materially from the original announcement); retrospective tax legislation; and uncertainty arising from the general complexity of tax law (and resulting lack of common standards). Also of concern to the Institute are compliance costs inherent in Australian legislation which can be adversely 'contrasted with Singapore and Hong Kong, for example, whose tax laws are readily understandable by business which means less time spent in dealing with tax issues and thus less costs' (Sub. 39, p.8).

Others were concerned that Australian tax law (perhaps inadvertently) operates to discourage exporters. For example, Ernst & Young pointed to a number of 'anomalies' which the accounting firm said actively discouraged exporting.

> [One] anomaly is that if an Australian company sells the building, land and plant used by a foreign branch any gain on those sales may well not be taxable in Australia; if an Australian company, however, sells the shares in a foreign subsidiary which owns buildings, land and plant, the gain on those shares will probably be taxable in Australia (Birchall 1991).

Indeed, several participants commented on the tax treatment of income earned overseas by Australian companies. For example, the Taxation Institute was concerned about the fact that 'tax losses incurred by Australian business in overseas markets where the tax rate is not comparable to Australia cannot, under present rules, be off-set against other income earned by that business' (Sub. 39, p.7); while the Australian Manufacturers' Export Council noted that Australian representatives located offshore were 'at a significant disadvantage compared with expatriates from other countries' (Sub. 44, p.2).

There was also concern about incentives which were not strictly tax-based ones. For example, the Australian Shipbuilders' Association noted:

> With respect to ship repair, a major impediment to Australian commercial ships refitting in Australian yards is that owners received duty/excise free fuel concessions for ships travelling internationally, eg. to Singapore, but pay full rates within Australia. For example, a 3000 tonne offshore supply vessel working on the North West Shelf has a concession on fuel costs of approximately $120 000 when going to Singapore to dock which is not available when going to the Perth area (Sub. 30, p.14).

In a similar vein, the Western Australian Department of State Development observed:

> Small businessmen remark that there is too long a delay between incurring the expenses and claiming them off assessable income. Tax deductions and tax holidays are of limited benefit to firms not yet earning profits. From the standpoint of government policy, and the desirability of carefully targeting assistance to genuine, deserving firms who are likely to achieve the goals sought by government, tax incentives may not be the measure of first choice. ... Tax holidays were of little use to firms when often no profit was earned during the early years. Furthermore, tax holidays eventually come to an end. Executives stated that a business had to be viable on its own merits, with or without financial incentives (Sub. 23, pp. 31 - 2).

while Asia Link Consulting thought that 'no business should rely on the proceeds of a favourable shift in the tax treatment of its endeavours in reaching a decision concerning the long term application of its resources' (Sub. 32, p.4).

6.4 Economic effects

On the firm

Firms usually consider the tax incentives that governments offer (and the tax regime more generally) as a package when investing. Tax incentives can affect both cash flow and the rate of return on an investment, and therefore have the potential to affect investment decisions significantly. The rate of return is, however, affected by many other influences -- such as how the firm funds its investments, the type of asset it invests in, and any grants it receives.

Some tax regimes influence the firm's cash flow and expected rate of return more than others. The allocative effects of alternative tax incentives depend on where they impact on income flows. For instance, accelerated depreciation allowances encourage adoption of more capital-intensive methods of production than would otherwise be the case (and so may reduce the demand for labour), as well as favouring capital-intensive activities generally.

Both low corporate tax rates and significant tax concessions will increase the rate of return on capital. Hong Kong levies a low corporate tax rate by international standards, as well as offering relatively high depreciation rates for plant and equipment purchases. In these circumstances, as one senior Hong Kong official noted during the Commission's visit, 'Who needs special incentives?' Combinations of a high corporate tax rate and tax holidays or accelerated depreciation may have the same effect as a lower corporate tax rate with no actual or implied tax incentives.

The Commission understands from its visits that:

- Singapore's low marginal tax rates have been a more important incentive than its specific export
  measures, which had worthwhile signalling value but, probably, low quantitative significance;

- Japanese firms see tax incentives as a third-order factor in their foreign investment decisions -- ranking along with infrastructure and legal and accounting systems, and below wage rates and access to suitable ports, power and water infrastructure; and

- Tax holidays, combined with a duty drawback system, are thought to have been important in stimulating Thai exports. Nevertheless, tax incentives are becoming less important as the policy emphasis shifts to reducing import barriers.

Tax incentives may significantly influence location decisions in industries characterised by highly 'footloose' capital -- such as the manufacture of garments, footwear and some computer components. Tax incentives may have little bearing in other cases, for example if competitiveness relies on achieving high production levels from relatively few locations, or where access to protected local markets is important.

The overall impression from available evidence is that, while tax incentives have little influence on corporate decisions regarding the initial step of undertaking direct foreign investment in a particular region, they can have a significant impact on the location of the investment within that region.

For example, a recent US survey by of 52 major multinational corporations (Group of Thirty 1987, p.70) found that:

> 'Tax advantages' and 'inducements offered by the host country' were regarded [by respondents] as unimportant influences on investment decisions, though some companies stressed that specific incentives could, on occasion, tip the balance of a decision in favour of investment in a particular country if all other conditions were satisfactory- which was, however, rare.

Two studies of OECD member countries (OECD 1983, 1989) found investment incentives to have a limited impact on the locational decisions of firms. Market prospects and cost considerations were reported as the primary influences on corporate decisions to serve particular markets (like North America or South East Asia) through investment in the region, rather than through export from another region. The 1989 study noted that:

> Foreign investors often see the question of location initially in terms of world regions and the choice between world regions (if there is one) is thus determined by factors perceived as having greater significance than the differential provision of investment incentives (p.45).

However, the same study found that investment incentives are likely to have a significant impact on the choice of country within the global region relevant to the market the investment is intended to service. For example:

> If ... a multinational corporation is considering investment in the European Community to serve that market, differences in the provision of incentives between different countries in the Community may strongly influence the actual country location chosen, along, obviously, with other factors such as the political and investment climate, availability of labour of the required characteristics, communications networks, etc (OECD 1989, p.45).

The study also noted differences between industries. For example, the locational decisions of some industries (such as 'footloose' industries and automobiles) were more likely to be influenced from the outset by investment incentives.

The evidence on the effects of investment incentives in influencing the regional location of investment is nevertheless patchy. For example, a study of 71 foreign firms located in Singapore ranked investment incentives second to political stability in determining the location of investment (Kng *et al* 1988). On the other hand, a similar study for Malaysia found incentives to be less important in determining location for large foreign firms than factors such as political stability, economic stability and availability of labour (Federation of Malaysian Manufacturers 1990).

Similarly, evidence provided to this inquiry suggests that, to some extent, tax incentives can influence the location decisions of firms. For example, BHP (Sub. 20) provided the following examples of government inducements to set up new plants:

- Malaysia offering taxation concessions to Australian Manganese Company Ltd for the EMD plant and to other mineral processing plants located there.
- Singapore granting a tax holiday to Ishihara Sangyo Kaisha Ltd of Japan for the establishment of a chloride titanium dioxide pigment plant. This was a deciding factor in the decision to build a plant in Singapore despite the fact that the raw material is sourced from Western Australia.
- Sierra Leone granting a tax holiday to Sierra Rutile Limited for the establishment of a rutile mine (p.6).

When it visited the Japan Centre for International Finance, the Commission learned of a July 1991 survey of ten major Japanese manufacturers which have established plants in South East Asia. The survey found that the main determinants of investment were political stability, infrastructure and wage levels. Export enhancing measures were said to be relatively insignificant considerations.

Some industries are likely to be particularly sensitive to effective tax lives for depreciation purposes; for example where an industry is characterised by rapid technological change (so that equipment needs to be replaced frequently in order to maintain international competitiveness). Recent amendments to depreciation arrangements in Australia (eg moves for taxpayers to be able to nominate effective tax lives of assets and accelerated depreciation rates for assets with long effective lives) are an attempt to recognise this.

As to tax holidays, the most profitable firms gain the most. When a company is unprofitable, to be attractive, such holidays will have to be combined with loss-carry forward provisions. Mintz (1990) found that the inclusion of such provisions was essential to the attractiveness of tax holidays to potential investors. He argued that even if a firm is fully exempt during a tax holiday, 'its investment decisions may be significantly affected by tax liabilities that will occur after the holiday'. If a firm must write-off its depreciable assets during the holiday, but its capital goods generate high income afterwards, without depreciation deductions, 'the firm may face relatively high effective tax rates' (Mintz 1990, p.95).

In the mid-1970s, Balassa (1976) concluded that tax holidays were only effective in attracting firms for the duration of the exempt period. Thereafter, a large proportion of the firms surveyed in his study moved to other locations. Later, Warr (1988) contended that much of the capital attracted to export processing zones is footloose. He found that multinational corporations using these zones exhibited high international mobility, and were generally involved in light, labour-intensive manufacturing processes. He suggested that this led to many such firms leaving when their tax holidays expired. However, in its visits to Asia economies, the Commission was told that most

companies remained after tax holidays ended. This suggests that offering generous exemptions may merely serve to deprive host governments of valuable tax revenues. In its 1992 budget, the Malaysian Government reduced tax holiday incentives available to pioneer status firms from an income abatement of 100 per cent to 70 per cent. Generally, industrialised countries (including Australia) do not offer tax holidays.

On the economy

Tax incentives and concessions can have significant effects on resource allocation if they distort relative prices. A *neutral* tax system is one which has minimal impact on economic decision making. An important precondition for achieving the desirable goal of tax neutrality is therefore that equivalent economic activities are taxed at the same rate. Otherwise, resources may be diverted from their most productive uses. For example, disparities in the taxation between, say, steel and aluminium production may lead to the over-expansion of one at the expense of the other, even though the underlying economic conditions may not justify such an outcome. Of course, the problems that arise from departures from tax neutrality are less serious the lower are tax rates. Thus the tax base should be as wide as possible, so that the absolute size of the average tax impost can be as low as practicable. An OECD comment accords with the Commission's view on the use of tax means to influence trade and industry policy:

> Fiscal concessions are a blunt instrument, difficult to target or focus. As such, the approach taken in the reforms of fiscal systems has been to simplify their structure, reduce tax rates and broaden tax bases as well as to abolish specific fiscal incentives and provide a greater role for the market (OECD 1989, p.52).

Although tax concessions for ' exports are not particularly transparent, and they only matter when the firm is profitable, in terms of their economic effect on production decisions, they can be viewed as analogous to export subsidies. They run counter to tax neutrality by favouring particular economic activities - in this case exports.

In addition, the loss of government revenue associated with new tax concessions (sometimes called tax expenditures) must be made up elsewhere in the economy to achieve *revenue* neutrality (unless offsetting cuts can be made elsewhere in government expenditure).

While it is easy to describe the direct *financial* incidence of a tax incentive, the wider *economic* effects are often harder to determine. Subsequent effects occur when it is possible for firms to pass on, or shift, the tax burden. For example, an important effect of tax incentives is that firms may realise the benefit of a concession through expanded production. On the other hand, companies may maintain production and choose to distribute the increased profits made available by the concessions. These could take the form of lower output prices, or shareholders could benefit through higher dividends and/or higher share prices. But high corporate profits may still be caught by the personal income tax net, depending on dividend imputation and capital gains arrangements. Then again, governments may recoup, through other taxes, the increased corporate returns due to those tax incentives.

Where dividend imputation arrangements apply, corporate and personal taxes are partial substitutes. Under dividend imputation, some or all of company tax on distributed income is treated as a prepayment of personal income tax on the dividends. Imputation credits may be denied on dividends paid to non-residents. Many economies do not allow any imputation credit to foreign direct investors, and also apply withholding tax to dividends remitted overseas.

Commodity flows and consumption choices are affected when international tax levels and arrangements vary. While some of the effects can be mitigated or eliminated through a country's own efforts -- such as through VAT exemptions -- others require international tax co-ordination. The main international measure is the use of tax treaties. Both measures reduce double taxation.

As the OECD (1991d) has recently noted:

> The increased openness of national economies has, in practice, made it more difficult to separate out domestic and international tax issues. When changes to national tax systems are made attention has increasingly to be paid to the international tax implications of any proposed modifications. This, in turn, may mean that traditional criteria used to evaluate tax reforms have to be reconsidered. Policies which may have been appropriate in economies where exchange controls and other limitations on international transactions were prevalent may be neither feasible nor desirable once these non-tax barriers are removed (p.14).

This increasing 'globalisation' of markets has led to concerns in a number of submissions. For example, The Taxation Institute of Australia, the BCA, AEEMA, Mr J.M. Legge, the Australian Manufacturers' Export Council, BHP and Goodman Fielder Wattie argued that tax measures have been insufficiently addressed by Australian authorities, particularly from the perspective of exporters (or potential exporters). The Taxation Institute of Australia thought Australia should consider the actions of our neighbours in the Asia-Pacific region, and that 'any system of incentives should aim at avoiding tax distortions and inconsistencies' (Sub. 39, p.4).

It is difficult to separate the effects of specific tax concessions from the effects of the overall tax regime. It is also difficult to compare effects of specific tax concessions on economies with disparate tax and other arrangements. In particular, the Commission has been unable to accurately determine the budgetary cost of many programs, due to limited information. Nor has it been able to locate comparative studies on the effect of tax incentives on exports in particular economies.

The Commission has been unable to locate any studies of the effects on the Australian economy of tax incentives applied by other countries. In principle, though, there would be two direct effects. First, the pattern of international investment would tend to be distorted away from Australia

(because of the investment incentives), although it is arguable that these effects are not large since there are many more significant influences on corporate investment decisions -- such as wage rates, access to efficient infrastructure, the size of the domestic market and political stability. Second, Australia's trade in goods and services may be adversely affected both by increased imports of subsidised products, and by increased competition in third markets.

6.5 Concluding comments

A key component of the policy climate to improve competitiveness is the tax system. A number of economies (eg Hong Kong, Korea, Singapore and Taiwan) offer low corporate tax rates and/or favour investment in high-technology plant and processes through mixes of fast rates of depreciation, investment allowances and special deductions for introducing new technology.

Comparisons of tax regimes among economies are tricky. It is difficult to ensure that like is compared with like. For example, it is still true that Australia is a high-wage economy compared with most other East Asian economies. However, in some cases the gap is closing fast. Several economies are rapidly moving out of low-wage-cost manufacturing and, possibly within five to ten years, investment decisions will be based increasingly on comparisons of the tax regime on industry in Australia compared with the tax regimes in other economies in the region.

There is an increasingly unwarranted tendency to compare the tax and investment regime in Australia with an OECD 'norm' when assessing international compatibility, and making international comparisons generally. This is often inappropriate. For example, in the case of high-technology manufacturing, the leading-edge competition is often in the Asia-Pacific region. In the case of minerals extraction and processing (leaving aside Canada, New Zealand and the United States), OECD countries do not share the resource-based character of the Australian economy. More frequently, investment decisions in this sector are based on international comparisons of other resource-based economies. On the other hand, all projects compete for capital on the basis of expected rates of return. So, it may simply make sense to compare tax regimes in capital-importing countries.

Australia offers greater social support and better (taxpayer-funded) infrastructure than many other countries in the region. This means that our economy has higher taxes than those other countries. If Australia's tax regime is to be competitive with those of economies which have less call on their tax dollar, Australia must achieve greater productivity to offset the extra costs in our economy. The alternative is to reduce government expenditure.

Some taxes are imposed on Australian exporters that are not matched internationally, especially because of the prevalence of value-added taxes. The Australian tax system should not reduce export competitiveness more than is absolutely necessary. This means ensuring that taxes on inputs used in exports are minimised.

The tax burden on industry should be as low as possible to enhance international competitiveness. To the extent that there is scope to lower taxes (including for exporters), the Commission believes that taxes should be lowered across-the-board, rather than for particular sectors. One issue that is perhaps worth examining in more detail is how the Australian tax system treats (income from) exports as compared with production for domestic consumption. Several participants maintained that present tax law (including the way the rules are administered) in effect discriminates against exports, perhaps unintentionally.

7 EXPORT PROCESSING ZONES

Free Trade Zones (FTZs) fall into two categories. First, there is the free port or entrepôt, in which trade-related storage and distribution activities take place, but no manufacturing. The zone is a defined area, usually fenced, in or near a seaport or airport. No customs duty is collected as the zone is considered outside the host country's jurisdiction for tariff purposes. Goods -- are stored in the zone enabling exporters to delay payment of import duties, or in some other way avoid or reduce indirect taxation. Such FTZs have existed for over 2500 years going back to ancient China, Greece and Rome.

This chapter discusses a second category of FTZ -- the Export Processing Zone (EPZ) -- focusing on export-oriented manufacturing and the provision of associated services. These zones tend to be located in developing economies, where they are used to stimulate exports of manufactured goods. Production in EPZs often exhibits the following characteristics:

- activities are almost entirely undertaken by foreign multinational corporations (MNCs);
- management, technology, capital goods, and intermediate inputs are largely imported; production is destined almost entirely for export; and
- there is zone-specific legislation (usually offering inducements in the areas of investment, tax and labour).

Typically, new production facilities are set up by foreign investors requiring workers for labour-intensive production and assembly activities. A good example is integrated circuits: although the design and production of silicon wafers is highly capital- and technology-intensive, the assembly of components using chips tends to be labour intensive and thus suited to assembly-line production methods.

Production in EPZs is usually concentrated in a few labour-intensive industries (see Table 7.1). In the mid-1980s, about 30 per cent of all the firms established in these zones throughout the world were engaged in manufacturing electronic components or goods, generating about 55 -- 60 per cent of total employment. Garment and textile production ranked second in importance. Growth has also occurred in industries which service and sell components to traditional EPZ firms. In Malaysia, for example, plastics firms provide casings to the electronics industry.

Table 7.1: **Activities in selected Asian EM**

EPZ	*Major products*
Korea, Rep. of (both zones)	Electronics, electrical, precision machinery, textiles, garments - footwear.
Malaysia (all zones)	Electronics, electrical, textiles, garments.
Philippines (Bataan)	Electronics, textiles, garments, footwear, metal and wood products, transport equipment.
Singapore (Jurong)	Printed circuit boards, computer software, fabricated aluminium and steel products, plastics.

Sources: Healy and Lültkenhorst 1989; JTC 1990; Price Waterhouse 1989a; Warr 1987

7.1 Rationale for establishing EPZs

The imposition of tariffs and other trade restrictions undermine the competitiveness of exports because of their adverse effects on industry costs. In many developing economies, EPZs have been seen as a way of countering this bias against exports - by establishing free trade conditions (at least on a limited basis) in economies which are not prepared to implement across-the-board reductions in protection. The other main reason for establishing EPZs is that efficient and effective infrastructure can be provided on what is a small scale, in situations where necessary resources are not available to provide such services on an economy-wide basis.

Governments often have somewhat different expectations of the benefits they wish to derive from establishing EM. However, in general terms, they aim to:

- encourage export-oriented industrial development, especially in areas of activity new to their country;
- attract foreign capital and advanced technical know-how (with the latter hopefully progressively transferred to the domestic economy);
- provide new employment opportunities;
- upgrade managerial and technical skills; and
- increase the demand for domestic raw materials and other necessary inputs to the production process (eg semi-manufactures).

In attempting to attract MNCs to their EPZs, governments are mindful of the expertise and access to foreign markets which they can bring.

In the last decade the economics of East Asia have become more concerned to promote 'high-technology' enterprises rather than just export industries. This has led to the establishment of 'science parks' and an extension of the scope of EPZs to include services, greater access to local markets, and greater entrepôt facilities. This trend is discussed in Section 7.4.

7.2 Rationale for investing in EPZs

In promoting their EPZs, governments can generally point to a range of favourable characteristics -- such as political stability and a 'pro-business' climate, a flexible workforce, and proximity to markets. EPZs generally offer a package of incentives to attract foreign direct investment, typically including:

- tax concessions;
- duty-free import and export of goods, with streamlined customs administration;
- regulations favouring the inflow of capital and enabling the repatriation of profits;
- low wage rates;
- perhaps restrictions on the formation of unions, collective bargaining etc; and
- subsidised utilities (eg electricity and water), infrastructure services (eg transport and communications), and factory space (often in the form of pre-built facilities).

Incentives and regulations differ in detail from country to country. In some cases, joint ventures between foreign and domestic firms are allowed, indeed often encouraged. In other cases, outputs may also be sold in the domestic market (usually attracting customs duty). Tax incentives differ and some governments offer incentives to domestic firms outside the zone similar to those that apply within it. For example, during its visit to Thailand, the Commission was told that, in Thailand's EPZs, incentives depended on the nature of the product. No distinction was made between production for the export market and for the domestic market, and the emphasis was on employment creation and use the of local raw materials.

Almost all EPZs offer tax concessions, exempting investors from part or all of:

- corporate income taxes (see Table 7.2);
- import and export duties (generally completely exempt), property tax, and city and regional taxes; and
- income tax for foreign personnel employed in the zone.

When the Commission visited Malaysia it was told by the Malaysian Institute for Economic Research (MIER) that companies were not attracted by tax incentives *per se,* but by cheap labour, political stability, mastery of English and good-quality infrastructure -- and only lastly incentives.

While tax incentives are more important for some firms than for others, the Malaysian Government now considers that they are not as necessary as previously thought. Changes to investment and tax incentives introduced in the 1992 Malaysian budget reflect this change in attitude.

Table 7.2: **Tax incentives offered in selected EM**

Country	*Zone-specific tax incentives*
China	Special 15 per cent income tax rate, reduced to 10 per cent if more than 70 per cent of output is exported. Tax holiday from this tax for first 2 years and 50 per cent reduction for next 3 years. 50 per cent reduction in withholding tax (20 to 10 per cent). Customs duty exemption.
India	Exemptions from customs duty, excise duty and sales tax. Unlimited income tax exemption for 100 per cent export-oriented firms, 5 year tax holiday for others.
Indonesia	VAT (value-added tax) and customs duty exemptions.
Korea, Republic of	Accelerated depreciation for plant and equipment, tax credits (3 - 10 per cent) for defined investments (eg in R&D). Exemptions for capital gains tax, customs duty, and VAT. Tax reserves for technology development [a], export loss; overseas market development, and price fluctuations.
Malaysia	All incentives available to 'pioneer' companies (see Volume 2). Sales tax and customs duty exemption.
Philippines	All incentives available to Board of Investment-registered enterprises (eg income tax holiday for 4 - 6 years, accelerated depreciation, customs duty, local tax and land tax exemptions).
Singapore	Customs duty exemptions.

a Tax reserves lower taxable income. They range from 1 - 5 per cent of annual sales and must be used within a limited period (usually 3 years).

Sources: Price Waterhouse 1987, 1988bc, 1989a, 19% abe

The labour-intensive and low-skilled nature of many EPZ jobs results in labour productivity levels not very much different from workers using similar capital equipment in developed economies. The Commission observed during its visits the current movement of labour-intensive industries such as footwear from increasingly 'high-cost' labour economies such as Korea and Taiwan to economies like Indonesia with its plentiful and still relatively low-cost labour supply.

Transport, communication and other infrastructure within EM is usually superior to that available in the wider economy. Factories may also be provided at lower rentals than general commercial rates. Utility services are also often subsidised -- for example, electricity tariffs are frequently below those applying elsewhere in the economy.

7.3 The performance of EPZs

Employment

EPZs in Malaysia and Taiwan have been among the more successful in terms of employment creation, but few economies have had zones providing directly more than 1 per cent of total employment.

In many cases the majority of workers in EPZs are young women. Although changing, in the past it has been common practice to hire women on 'apprenticeship' contracts at lower rates of pay than permanent workers. In some zones, such 'apprentices' consistently make up around 30 per cent of the workforce. For example, in 1981, employment in Korea's Masan Zone was 77 per cent female; 55 per cent apprentices; and about 83 per cent of the workforce was either unskilled or semi-skilled (OECD 1984). Promotion and off-the-job training opportunities for EPZ workers have been minimal.

Generation of foreign exchange and investment

Some EPZ strategies have succeeded in attracting foreign investment, the result of which has been an apparently large contribution to the balance of payments (eg Malaysia). In most cases, however, the high import content of many zone exports -- usually 60 per cent or more -- results in low net foreign exchange earnings attibutable to EPZs. Moreover, imported goods used in the initial infrastructure development may be significant, further reducing net foreign exchange earnings.

The contribution of EPZs to manufactured exports varies widely among countries. Usually the contribution is relatively low (less than 5 per cent), while some zones have accounted for some 20 per cent of such exports (eg Malaysia and Sri Lanka -- see Table 7.3).

From its visit to the Republic of Korea, the Commission understands that Korea's two EPZs account for only a negligible share of exports, and there are no plans to expand them.

Backward linkages

Backward linkages into the domestic economy - that is, purchases of locally produced goods and services - have often been limited because of the high propensity of MNCs to import their inputs.

The Commission was told during its visit to Malaysia that two main goals of its EPZs were to support the transfer of technology (of which there has been not much to date), and to encourage the emergence of indigenous industrial suppliers. The latter were a failure because most inputs to EPZ production were imported. The Commission understands that there have been few linkages between MNCs and local industry and limited spinoffs in terms of local expertise.

A number of reasons explain this lack of backward linkages: concessions on import duties, affiliations with foreign corporations (intra-firm trade), and the typically underdeveloped character of domestic manufacturing in hose economies. In many Asian EPZs, foreign firms import significantly more of their inputs than domestic firms, a pattern consistent with the enclave nature of zones. This has been particularly true of Malaysia and Korea (Healy and Lütkenhorst 1989; Warr 1988).

Table 7.3: **Exports from EPZs in selected economies: 1990**

Economy	*Value of exports*	*Share of total exports*
	($Am)	*(%)*
India [a]	456	3
Korea, Republic of	1 920	2
Malaysia	6 400	17
Philippines	767	8
Sri Lanka [b]	384	20
Taiwan [b]	4 992	6

a Data for 1988
b Data for 1989
Sources: IMF 1991; Industry Commission estimates

Government hopes of technology and skill transfers from EPZs into the wider economy have generally not been realised. One reason is that many zone firms employ mature technology that is readily available elsewhere - in clothing manufacture for example. When production is concentrated in standardised processes, the opportunities for valuable technological transfer to occur are often limited.

There may be though a valuable 'demonstration effect' between an EPZ and the domestic economy. This can happen on several levels: discipline in production, respect for deadlines, striving for quality, and a general spirit of enterprise and innovation. Although poorly documented, the transfer of managerial skills may be more important than the development of workers' skills. For example, a number of Taiwanese technical and managerial staff from EPZ electronic factories have gone on to establish their own companies.

A four-country comparison of EPWs[1]

Even though governments usually have quite good data on the financial costs and returns of their EPZs, there has been very little critical analysis on the net returns of adopting an EPZ strategy. Warr analysed Indonesia's Jakarta zone, Korea's Masan Free Export zone, Malaysia's Penang zone, and the Philippines' Bataan zone (see Tables 7.4 and 7.5).

Table 7.4: **Aggregate performance of four Asian EPZs**
($A million, 1990 prices)

Country	*Finns*	*Employment*	*Exports*	*Total taxes Paid*	*Local/ total raw materials*
	(No.)	*(No.)*	*($Am)*	*($Am)*	*(%)*
Indonesia					
1977	4	773	5	0.06	na
1982	18	7 742	97	10.7	41
Malaysia					
1972	10	na	17	na	5
1982	50	36 298	1 072	2.0	4
Philippines					
1972	1	na	5	na	30
1982	52	19 410	574	5.0	6
Korea, Republic of					
1972	70	72	268	0	6
1982	83	26 123	1 129	4.1	34

na Not available
Source: Warr 1988, pp. 39 - 42

According to Warr's analysis, in Korea, Malaysia and the Philippines, the major economic gains from establishing EPZs were in terms of employment and foreign exchange earnings. The development of local raw materials and tax revenue were of much smaller importance.

Warr found that the small Jakarta zone was less representative of most EPZs as it was established for experimental purposes. Due to the dominance of clothing manufacture there, a high proportion of raw materials was sourced locally. This explained why net gains from this

[1] This section is based on Warr 1988.

source were higher than for employment. An unusual feature of this zone was the composition of the 'tax and other revenue' category. According to Warr, 'most of this revenue is from "unofficial" taxes which represents the outcome of rent seeking behaviour by government officials.' When these revenues were excluded from the analysis, net present value (NPV) fell from $A38 million to negative (ie minus) $A28 million.

Table 73: **Welfare impact of EPZs, composition of net present value**
($A million, 1990 prices)

	Indonesia	*Korea, Rep. of*	*Malaysia*	*Philippines*
Employment	10	71	163	212
Foreign exchange earnings	0	120	138	255
Local raw materials	13	30	27	11
Local capital equipment	0	0	15	0
Taxes and other revenue	58	34	15	40
Electricity use	-3	-24	-79	-14
Administrative costs	-33	-32	-6	-83
Infrastructure costs/subsidies	8	-128	-65	-704
Domestic borrowing	0	0	0	-521
Net Present Value (NPV)[a]	38	75	211	-901
Internal Rate of Return(%)	26	15	28	-3

Note: Costs appear as negative items. Calculations based on a real discount rate of 7.5 per cent and zone life of 25 years.
a NPV represents the return on an investment when the discounted value of the costs of an investment are deducted from the discounted value of its returns.
Source: Warr 1988, p.44

Table 7.5 implies that large subsidies are often involved in EPZ operations. Subsidised infrastructure was offered as part of overall packages in all four EPZs. The costs of providing these subsidies may have exceeded the benefits from the EPZs. Features of the Philippines' Bataan zone were its enormous infrastructure costs, and the cost of granting subsidised access to the domestic capital market. Each of these items was estimated to have outweighed all other benefits derived from the zone. The heavy cost of Malaysia's subsidised electricity in itself outweighed the benefits from local raw material and capital equipment use, and all tax revenues.

Warr (1988, pp. 31-2) concluded that:

> The Malaysian and Korean examples show that, viewed as public investments, EPZs can yield acceptable social rates of return ... [However] benefits from EPZs are limited. They are definitely not 'engines of development'.

7.4 Growth triangles

A recent development in the East Asian region is the creation of so-called Growth Triangles designed to expand manufactured exports. Triangles combine the capital and expertise of the more developed areas of Asia with the land and labour supplies of less developed areas.

The best example of this is the relationship Hong Kong has with Guangdong, the (low-wage) Chinese province immediately to its north. Less than a decade ago, companies from Hone, Kong employed virtually no workers in Guangdong; today 2-3 million people are employed in some 16 000 factories. Hong Kong accounts for over 80 per cent of the area's foreign investment and trade. As much as 16 per cent, or over $A1 billion, of Hong Kong's currency circulates around the Guangdong delta. Chinese firms now invest substantially more in Hong Kong than Japanese companies, the second largest investors (Macrea 1992).

Similarly, the tightening of the labour market in Singapore has stimulated the search for additional low-cost labour. The idea is emerging of a greater Singapore economy, where the city-state becomes the focus of a sphere of economic influence via EPZs in nearby economies. The Government is encouraging companies to locate their headquarters in Singapore, but to produce elsewhere, particularly if they rely on low-cost labour.

One such Triangle links the southern Malaysian State of Johor with Singapore and Indonesia's neighbouring Riau Islands. The first manufactured products have appeared from factories set up on one of these islands, Batam, located 20 km south-east of Singapore.

Singapore's Jurong Environmental Engineering (JEE) has entered a similar joint-venture to develop an industrial estate in Thailand's Ayutthaya Province, 65 km north of Bangkok. Malaysia is looking at a similar scheme linking Penang to northern Sumatra and southern Thailand.

7.5 Science parks

The transfer of technology and skills to the domestic economy has usually been one of the main motivations for establishing EPZs, but success in this area has been limited. According to Warr (1988, p.19):

> Zone administrators generally agree that significant transfers of technology and skills from EPZ firms to the domestic economy have seldom occurred.

Some governments -- particularly in Hong Kong, Taiwan and Singapore -- have now taken the EPZ concept a step further and made technology transfer the main focus of a new type of zone, commonly known as a Science Park.

Taiwan's Hsinchu Science-based Industrial Park

The Hsinchu Park was established in 1980 on the site of an EPZ. The Government has invested about $A800 million in the Park, mainly for land acquisition and development. The Park's overall aims were (and continue to be) to create a synergy of human capital (and other factors) for small-to medium sized enterprises (SMEs) in high-technology industries and to help reverse Taiwan's 'brain-drain' to the US (especially to Silicon Valley).

A feature of the Park is the provision of 'one-stop-shopping' for all government interactions such as customs, registration, and trading documentation. This is funded by a 0.25 per cent levy on company sales, which also pays for maintaining the physical infrastructure of the Park. As well as providing infrastructure, Park authorities administer R&D grants, usually at the rate of 25 per cent of eligible expenditure up to $NT2 million (about $A100 000).

Companies have to carry out production as well as devote a substantial share of their resources to R&D to be allowed to locate in the Park. The Park's present occupants spend about 15 per cent of profits on R&D, compared with approximately 1 per cent in the rest of Taiwan's electronics industry. The Park now accounts for 93 per cent of Taiwan's integrated circuit production and 40 per cent of its personal computer output.

Acer, which makes personal computers and other IT (information technology) devices in the Park, told the Commission that Hsinchu was chosen partly because of the incentives provided by the Government, but more importantly for the efficiencies and intellectual benefits of co-locating with so many dynamic and innovative companies in similar fields.

The Singapore Science Park

The Jurong Town Corporation (JTC) manages 29 industrial estates throughout Singapore which together accommodate 4400 companies employing over 280 000 people**,** or about 76 per cent of total manufacturing employment. As part of JTC's corporatisation plan, in 1990 it became owner of the subsidiary company Technology Parks Pty Ltd, which now owns and manages the Singapore Science Park.

The Science Park was first developed in the early 1980s as the location for R&D oriented companies in Singapore. It is located next to the National University of Singapore to encourage a synergistic relationship. At the end of 1990, some 51 multinational and local companies had located in the Park, involving such disparate activities as chemical technology, medical and biomedical services, biotechnology, computer software and information technology applications.

Location in the Science Park is encouraged by tax incentives in the form of low corporate taxes, zero tariffs on manufactured inputs, and infrastructure incentives through the subsidised provision

of well-serviced estates. In other words, most of the incentives offered by EPZs are available, but a focus on R&D and high-technology industries aims to give the host economy the technology transfer that other EPZs have failed to provide.

7.6 Concluding comments

The development of EPZs marked the convergence of two significant trends. First, the adoption by many economies of an export-oriented development policy followed the widely acknowledged failure of import-substitution strategies. Second, there was a move by enterprises in industrial economies towards the adaption of cost-minimising strategies in an effort to maintain or increase competitiveness.

EPZs have been created mainly in developing economies with high import barriers. Thus, they have been used as a tariff compensation measure, as a way of providing localised infrastructure and services (where the level of industrialisation and budgetary limitations made their economy-wide provision impossible), and as a way of attracting much-needed foreign direct investment (primarily in manufacturing).

One effect of EPZs, therefore, can be to retard the implementation of trade liberalisation initiatives and domestic restructuring generally. At a more mature stage of development, economy-wide trade liberalisation -- tantamount to turning the whole country into an EPZ -- is usually seen as more desirable. The winding down of protection throughout East Asia is both clear evidence of this and is encouraging from the point of view of Australian policy on protection.

The success of EPZs has varied considerably. Some zones (eg in Malaysia, the Republic of Korea and Taiwan) have appeared to succeed, mostly because of the host government's general economic policies, rather than as a direct result of the operations of the zones themselves. More generally, however, employment creation, foreign exchange earnings and skill transfer have not realised initial expectations. In some cases, EPZs have been a net drain on the economy (see Warr's evidence on the Philippines).

Most of the beneficial features of EPZs can be, and often are, applied outside EPZs with similar effectiveness. Bonded warehouses show that the construction of expensive special zones is not necessary to give firms import duty and tax advantages. However, widespread deficiencies in infrastructure' that have typically encouraged the initial development of WZs means that the use of bonded warehouses will only be viable for economies that have overcome these problems.

The most significant trend in EPZs that the Commission observed during its Asian visits is the movement away from zones focused purely on low-technology labour-intensive exports towards zones focused primarily on R&D and high-technology transfer. The other main trend is towards internationalisation via the Growth Triangles concept.

The Commission did not receive any submissions that discussed EPZs or their relevance for Australia. That is perhaps not surprising, as they would seem to have limited application here. The provision of good-quality infrastructure on a small scale (one of the main reasons for zones in developing countries) is not relevant to Australian circumstances and tariff reductions will eventually make duty exemptions largely redundant.

8 EXPORT MARKETING ASSISTANCE

Exporting can be a risky business, and also a costly one -- particularly for firms selling overseas for the first time. Factors contributing to heightened risk compared with domestic sales can include having to become familiar with new legal systems and differences in language and culture. Factors adding to costs include start-up expenses (in the case of first-time exporters) and having to gather and regularly update all sorts of market intelligence (such as consumer preferences, competitive conditions, market saturation and so on). To be successful, firms contemplating exporting -- as well as established exporters -- need to identify and carefully research potential export markets, so that their entry (or continuing presence) can be planned in an informed way.

Most governments recognise the added risks and costs associated with exporting and try to help domestic firms secure sales on overseas markets by providing information, advice and related services (eg by organising trade fairs). The basic idea is that it makes sense for some information services to be organised and funded by a single trade-promotion body and the resulting services made available to potential and existing exporters either free or at marginal cost.

Such help can take a number of forms, ranging from simple trade inquiry services to the undertaking of detailed market research on potential overseas markets for a particular product or service. Other examples of export marketing assistance include: running training courses on how to go about marketing products and services in various countries; explicit taxation incentives (eg double deductions for start-up expenses associated with entry to new export markets); as well as government recognition of exporting excellence via a system of regular awards.

8.1 Rationale for government involvement in the provision of information and risk sharing

Gathering information about export prospects in various markets can be costly and the risks associated with entering foreign markets can be high -- especially for small-and medium-sized firms (SMEs). However, once assembled, such potentially valuable intelligence can be made available to other prospective exporters at negligible cost. This means that SMEs in particular may not even contemplate exporting because of the daunting costs and high risks involved. However, a body specially set up to assist exporters in marketing their goods and services may be able to provide good information and advice at a fraction of the cost. From the community's point of view, there may be a tendency for individual exporters to under-invest in promotional and marketing activities which, in turn, may impact unfavourably on the overall level of export activity. The possibility of under-investment has formed a central pillar of the argument for some form of government involvement in export marketing.

Of course, if there are gains to be made by exporters banding together, why does government have to be involved at all -- and why should taxpayers have to contribute even if government is involved in some capacity? Nevertheless, it is more usual for government to be involved in some way. This ranges across the full spectrum: from merely token support for what are essentially private-sector initiatives; through setting up agencies which charge for services rendered on a cost-recovery basis; to running and paying for trade-promotion bodies out of the public purse. The trend seems to be towards placing greater emphasis on cost recovery.

In general, the larger and/or more experienced a firm becomes at exporting, the less likely it is that success will depend on continuing government-provided assistance. This proposition led the Hughes Report (1989) to suggest that it may be most efficient to provide support to firms for a limited period while they are getting over the hurdles of entering a new market.

8.2 Types of export marketing assistance

Among the economies studied in this report, national governments tend to play the major institutional role in export promotion. Typically, government organisations provide basic information free, while charging for more specialised services in order to recover at least some of their costs.

By contrast, Germany, Japan and Taiwan rely more heavily on private sector organisations when it comes to promoting exports. In Germany, industry associations and domestic and overseas chambers of commerce are largely responsible for initiatives in this area. Often these are non-profit organisations which the government subsidises, if necessary. Japanese firms tend to rely on trading companies to promote exports, but have the back-up support of JETRO (a government body):

> In Japan, a majority of users, mostly small/medium Firms, reportedly think that the Government's services (JETRO) are well worth the modest costs. The more experienced exporters, however, apparently rarely approach the Government promotion agencies, mainly because their experience, expertise and commercial intelligence exceed the Government's. ... The private trading companies are thought to be the key to Japan's export success, while the Government's role is to expand the number of export firms at the periphery of Japanese international trade (Port Authority of New York 1988, pp. 21 - 2).

In Taiwan, CETRA is a private organisation but it is financed by a compulsory charge on exports.

Further information on assistance with export marketing available in specific economies can be found in Volume 2 -- Country Studies.

Export awareness

It seems to matter a great deal whether an economy has an export 'culture' or not (ie the extent to which firms, and indeed the community at large, are aware of the potential benefits of exporting and the degree to which they are motivated to sell on foreign markets when it is in their interest to do so). Australia is a case in point. Our farmers and miners have it, our manufacturers do not seem to -- arguably largely because the long history of protection of manufacturing in this country has encouraged them to look to domestic markets for most of their sales (ie they exhibit an 'inward' rather than an 'outward' orientation).

Export awareness programs aim to stimulate interest in selling domestically produced goods and services to foreigners. Such programs typically involve national (or sometimes local) media campaigns, seminars and export 'awards'-- the receipt of which is often accorded elevated status by having them presented by community leaders. An example is Korea, which has used export awards extensively to instil an export culture into its society.

Export counselling and education

Export counselling and education services provide formal training in effective strategies for participating in international trade. Such services usually involve running courses/seminars and making available publications that detail export practices and procedures peculiar to individual economies, as well as providing a guide to where further information and assistance can be obtained. The aim is to help managers develop successful strategies for selling in foreign markets. Students of these courses can typically obtain diplomas or post-graduate awards in export management. For example, Taiwan's China External Trade Development Council offers a variety of trade education courses (including postgraduate training programs) at little or no cost.

General information services

A basic function of many trade promotion agencies is to collect, collate and disseminate information which will help firms assess possible export markets and identify, evaluate and contact potential customers. Overseas posts, outside contractors or in-country consultants gather this information, which is often accessible electronically from a central database. Such 'on-line' intelligence will typically contain information on key trade and economic statistics, country and marketing data at the level of individual industries, trade opportunities, company background reports, and trade contacts. All the governments of the economies studied in this report provide general information services. Usually the information is provided free -- although several agencies charge when responding to company-specific queries.

Trade missions

Participating in overseas missions allows exporters to explore potential foreign demand for their products and services first hand, as well as to expand existing export activities. First timers can also benefit from the advice and assistance of experienced members of such groups.

Inward mission schemes provide help and financial support to bring groups of buyers, decision makers and opinion formers to visit local firms and product-related events in the home country. Such schemes allow firms to demonstrate their products to a specific and targeted group of potential overseas customers -- hopefully generating favourable publicity for their products in foreign markets.

Most governments provide administrative and logistic support for inward and outward missions. Typical services include briefing participants, organising the visits program, publicising the mission, and hosting receptions. However, financial support for this type of activity varies markedly between countries. Often, governments limit assistance to promoting foreign-buyer attendance at domestic trade fairs, and setting up appointments with local suppliers. Other governments are more generous - for example the Canadian Government pays all costs, while the Italian, Japanese and UK Governments make a partial contribution. Both inward and outward missions can be very costly. In 1990 - 9 1, for example, the UK Government supported 53 inward missions at an average cost of £15 000 each ($A37 350), as well as 135 outward missions at an average cost of £8 500 each ($A21 165) (BOTB 1991, p.53).

Product exhibition support (including trade fairs)

Trade displays and exhibitions are a valuable promotional tool, with trade fairs having been widely accepted for centuries as key meeting places for prospective buyers and sellers from all over the world. With the large gatherings trade fairs can attract, they 'provide excellent opportunities for exporters to test possible markets, attract business partners and make sales' (BOTB 1991, p.52). For example, during 1990, the Hong Kong Trade Development Council held 14 trade fairs -- which attracted over one million visitors (an average of 78 000 visitors per fair).

Most governments support a variety of exhibitions and fairs. The main differences between their programs lie in the number and kinds of events sponsored, the amenities offered and the extent of cost-sharing between the government and exhibitors. Most governments make some contribution towards the cost of fairs. For example, France, Canada, Singapore, Sweden and the United Kingdom shoulder up to 50 per cent of costs. Others allow generous tax deductions -- for example Singapore offers to pay 50 per cent of the costs of participating in a trade fair or allows such costs as a double deduction for tax purposes.

The Australian Book Publishers Association noted in its submission that, compared with Australia, the British Overseas Trade Board (BOTB) is very generous in providing subsidies to British publishers to enable their participation at a broad range of book fairs, including 'participation in African, Middle Eastern and Asian book fairs where significant sales are made' (Sub. 17, p.5). The Association also claimed that 'the costs of individual participation [in trade fairs] are prohibitive in the case of SMEs' (p.4).

Product design and adaptation

Many governments provide information on product standards which exporters must satisfy in order to be allowed to sell in foreign markets. Often, the information is offered in conjunction with financial or technical assistance to help firms make necessary adaptations to their products to suit individual markets. For example, the Canadian Government offers subsidies to adapt defence equipment to different markets. The Hong Kong Government provides a standards and calibration service when compliance becomes an important prerequisite for access to important markets (eg in the case of electrical appliances). The Government believes that this service 'cannot be provided by the private sector alone, both because of the high cost, and because the services must be recognised internationally as demonstrably reliable' (Barma 1991a, p.7). To help improve the image of local goods, the Hong Kong Quality Assurance Agency (HKQAA) certifies companies able to achieve internationally-recognised quality standards. The Government believes 'HKQAA's certificates will become well known, both in Hong Kong and overseas, as a seal of quality' (Barma 1991a, p.8).

In a more general way, the Singapore Trade Development Board (TDB) provides assistance to improve the design of manufactured products:

> After five years of design promotion by TDB, more manufacturers realise that design: differentiates their products; gives them a competitive edge in world markets; and determines their success or failure (TDB 1990, p.51).

Export management assistance

Governments sometimes subsidise the costs of hiring management consultants conversant with the peculiarities of foreign markets. Such consultants typically provide advice on selecting promising markets, developing export strategies, and can even set up overseas operations and conduct business for an initial period. Smaller firms generally need such assistance because they cannot afford full-time export managers. In Germany, for example, the Government reimburses up to 75 per cent of such consultancy fees. As another example, the Hong Kong Productivity Council provides industrial and management consultancies and technical support services, while recouping part of its costs via a small service fee.

Project-specific assistance

Project-specific assistance includes efforts to find suitable bidders for -- and to assist them to win -- foreign contracts (eg to build a dam or a road). Government assistance ranges from making representations on behalf of a prospective contractor to providing financial assistance to make the bid more attractive (Chapter 5).

The Singapore Government meets up to half the costs of local bids for overseas projects. In Britain, BOTB's Projects and Export Policy Division provides information and advice on potential project business, as well as financial support and government-to-government help in some cases.

8.3 Economic effects

It is difficult to gauge the effect of export marketing assistance on export sales or volumes. Most studies, are based on survey data and use measures based on attitudes and helpfulness to assess effectiveness. Gronhaug and Lorentzen found that 'assistance may be an intervening variable in a firm's export learning curve', but they were unable to isolate any definite impact of such assistance (Seringhaus 1986).

One of the problems associated with the provision of export marketing assistance is that firms may come to rely on it. Some exporters tend to continue using government provided services well after they have acquired substantial experience in exporting.

Both Seringhaus and Rosson (1990) and Hibbert (1990) have observed that, in developed countries, governments generally attempt to:

- cover the full spectrum of export market involvement;
- differentiate services and programs over different export phases according to perceived need; and
- recognise the relatively greater need for external assistance among SMEs.

Based on their research, Seringhaus and Rosson *(ibid)* suggested that government contribution to marketing should be confined to stimulating the exporting process, while the main commitment of marketing resources should remain with private sector companies.

Keesing (1988) studied the trade promotion organisations of Hong Kong, Korea, Singapore and Taiwan, and found some effects he specifically related to developing economies:

- Although many developing economies tend to offer a full range of marketing assistance -- including trade information and inquiry services, trade promotion, market development (including advice and strategically selected assistance to firms and export industries), and assistance to firms in key areas (such as product design and packaging) - elements which appeared to be most useful were trade

- information and inquiry services, and trade promotion;

- Trade promotion organisations can be kept small and inexpensive. However, some scale economies almost certainly exist, particularly in trade information and trade promotion activities, so that this rule may not apply everywhere; and

- The activities of the best of these organisations appear well designed to overcome the information barriers encountered in trying to expand exports rapidly. Thus it is probable that they have been able to achieve accelerated export growth at moderate cost.

In its visits to East Asia, the Commission gathered some views on the effects of government-sponsored marketing assistance in some of the economies under review. There was praise for Hong Kong's Trade Development Council, but criticism of some other government-run bodies. Taiwan's privately run organisation (CETRA) was well regarded. Others thought that the most important role of government was to encourage long-term business arrangements which were seen as a critical factor associated with doing business in some economies.

In Korea, the Commission was told that the role of the Korean Trade Promotion Corporation (KOTRA) had changed (and diminished) as the economy had developed. Many thought that motivating industry to export was best done by both government and industry -- and private trading companies could do the job of marketing exports better and more cheaply than KOTRA.

This brief review suggests that it is very difficult to evaluate to what extent government-provided export marketing assistance leads to increased exports. It seems clear that the quality of government-provided export marketing assistance varies greatly from economy to economy, which obviously affects the effectiveness of this type of assistance.

Private trade-promotion bodies also compete with (and complement) government-provided services. The role for government may be diminishing partly because improvements in technology mean that the costs of collecting and disseminating information are falling. Therefore, to avoid a possible over-servicing problem emerging, governments should regularly review the need for their ongoing involvement in export marketing assistance. It may make most sense for governments to largely limit their services to helping new exporters or companies with limited experience in particular markets.

Additionally, there is a case for governments charging for most of the services they provide to discourage unnecessary use (or over-use of their services), as well as to reduce the burden on taxpayers. In Hong Kong, for example the Government:

> ... has taken the view that, within limits, it is worth spending public money on development support where government intervention is necessary to achieve 'critical mass' in a certain area, and ... hope that once a service has developed to the stage where it can operate in a more commercial way, then it should be encouraged to do so (Barma 1991b, p.8).

Impact on Australia

The Commission has not found any studies which analyse the effect of foreign governments' export marketing activities on Australia, nor does it have the resources to undertake such analyses itself. However, effective international export marketing schemes could be expected to increase the competition Australian firms face in the international marketplace.

In its submission, the Australian Book Publishers Association Ltd gave the following example:

> Canadian publishers are often found to be competing directly with Australian publishers for United States and United Kingdom contracts. However, Canadian publishers, by virtue of their government funding for export, can often have the edge over their Australian competitors. ... Although Australian book publishers get some assistance from the Export Market Development Grants Scheme, it is not as extensive as that provided in other countries. ... no similar assistance is available to smaller publishing companies in Australia, putting them at a severe disadvantage vis-a-vis their Canadian competitors (Sub. 17, pp. 5-6).

In addition to increasing competition in third markets, the export marketing efforts of foreign governments may also adversely affect Australian firms selling domestically.

However, government spending on export promotion world wide is relatively small compared with other forms of assistance. It is therefore likely that this particular type of export enhancement measure on the part of others has a relatively small overall impact on the Australian economy.

8.4 Developing an export culture

In all eight Asia-Pacific economies which the Commission visited during this inquiry there is an export culture which is well embedded into the communities. There is high public appreciation of the importance of being internationally competitive and operating in international markets. There is also awareness of the need to be prepared to adjust quickly to changing circumstances.

Sadly, except among our farmers and miners, a well-developed export culture has been lacking in Australia. How can we foster a stronger export culture in Australia?

There are fundamental elements -- such as benchmarking, workplace reform, improvements in quality, and better infrastructure -- which have to be tackled if Australia is to achieve international competitiveness. Benchmarking (knowing what a business has to shoot for to be internationally competitive) has a key role to play, as Australian Federal and State Governments

acknowledge. Assistance programs for exporters need to pay due regard to international benchmarks of competitiveness. Further, business and employee organisations should collect benchmark information and disseminate it to their members.

There have also been a number of programs such as the 'Export Now' campaign which have sought to instil an export culture in Australia. Their effect has been slight, possibly because of the considerable ground that has to be made up in the case of 'non-traditional' exports. Currently there is a range of activities sponsored by federal and state agencies which each contribute to developing aspects of an export culture. These include Austrade's annual Export Awards and its International Business Week, State Export Awards like the Governor's Export Awards in Victoria, and best practice and quality programs to encourage adoption of international standards in enterprises, including the workplace.

Unlike overseas award schemes -- or even local sporting honours -- these programs have yet to give our successful exporters the same status their counterparts enjoy overseas.

The Commission's Draft Report concluded that the Federal Government should introduce a broad campaign to stimulate general public awareness of the importance of competing in international markets and of creating products which are internationally competitive. Comments and suggestions were invited about the most effective means by which this could be achieved.

Seven responses addressed this matter.

Strongest support for the Commission's view came from the Australian Manufacturing Council (AMC). The Council outlined its proposal for a Community Education Program (with the theme 'Australia Can Make It') with the aims of:

- increasing awareness at all levels of the community of the importance of manufacturing to Australia's future prosperity;

- creating a widespread sense of urgency about the importance of increasing the productivity and quality of our manufacturing industry to international standards of performance; and

- identifying in the public mind the directions of the change that is needed (Sub. 38).

While the AMC noted it had received much support for its proposal from companies, industry associations, unions and State Governments, it also noted a degree of reluctance in terms of funding with only three organisations (as at January 1992) committed to financial support -- with the majority, including the Federal Government, still considering the proposal.

The Business Council of Australia (BCA) also supported the Commission's proposal and outlined its own efforts in generating greater public awareness of the importance of international competitiveness through participation in the National Business Summits, the National Industry Education Forum, and the establishment of international benchmarks for industries in the non-traded sector (such as rail and electricity). It also noted the efforts of other organisations including:

- the development of a national core curriculum on exporting by the Technical and Further Education (TAFE) system and the Australian Institute of Exports; and
- the forthcoming National Trade Conference on Export Education and Training, jointly organised by the Department of Foreign Affairs and Trade, the University of Sydney and the Australian Institute of Exports.

However, the BCA cautioned that a campaign to stimulate awareness:

> ... should not distract the Government and other stakeholders from pressing ahead more urgently with the task of economic reforms ... and that ... a public awareness campaign to change perceptions is unlikely to succeed unless the necessary policy/institutional changes have occurred (Sub. 53, p.2).

This view was supported by several submissions, for example, the Australian Chamber of Manufactures noted bluntly that: 'No amount of public relations campaigns and hype will substitute for setting the right investment climate' (Sub. 36, p.9).

Austrade (Sub. 42) noted programs and resources, additional to those mentioned in the Draft Report, which have been allocated to the general promotion of an export culture in Australia. These include the Asia-Pacific Fellowship Program aimed at enhancing exporters' skills in doing business with Asia, the Austrade-sponsored TV series on international competitiveness, as well as its involvement in the development of specific education products, including resource materials, seminars and publications. Austrade also noted its liaison role between the exporting community and the education sector.

Furthermore, Austrade noted that it was currently developing an *Export Education and Training Strategy* which, although focused primarily on enhancing the international competitiveness of Australian companies, includes a community export education element. The key elements of the proposed strategy are:

- qualitative market research to determine the education and training needs of exporters for the next ten years; thoroughly auditing the scope and quality of programs currently in the marketplace;
- publication and marketing of the strategy including a Directory of Export Education and Training Programs; establishing an 'accreditation system' for Export Education and Training Programs;
- catalysing curriculum and program development by both private and public education and training institutions to fill identified gaps;

- support and marketing for quality programs currently available and to be developed; and
- community export education programs including the implementation of an integrated State/National Export Awards structure (Sub. 42, p.2).

A number of submissions emphasised that it was at the *industry* level that an attitudinal change towards exports was required, because there was a poor understanding of the needs of international markets. For example, the Australian Manufacturers' Export Council argued for industry to make a long-term commitment to market development and to maintain consistently high quality standards. Goodman Fielder Wattie Ltd (Sub. 50) noted that:

> Industry at large does not yet accept that most of our customers live in the Asian and Pacific regions. Accordingly, we have to accelerate efforts to learn about these countries, cultures and languages if we are to trade effectively (p.17).

Other suggestions about how general awareness of the advantages of exporting could be improved included:

- a scheme to cover the costs of advertising in national and local media by successful exporters (Sub. 32, p.2);
- encouragement of companies to include their export performance statistics in annual reports (Sub. 44, p.2); and
- a program of international benchmarking within high profile government business enterprises to highlight the necessity for improved competitiveness (Sub. 36, p.9).

8.5 Concluding comments

Governments provide export marketing assistance in recognition of the high risks and costs which firms would otherwise have to bear, particularly in the early stages of exporting. However it is very difficult to evaluate to what extent government-provided export marketing assistance leads to increased exports.

Although there are examples where governments appear to have been successful, the existence of private sector marketing organisations in a number of economies studied, and their reputed achievements, suggests that government involvement can and should be kept to a minimum. This applies to both the type of assistance and the period for which it is available. It also means that governments should not necessarily offer export marketing assistance at the expense of general taxpayers, a point most governments now recognise. The greater the benefit to the individual exporter, rather than the community as a whole, the stronger is the case for the government to charge for services rendered.

The Commission noted that since the Draft Report was prepared, the Government has announced (February 1992 'One Nation' Statement) that increased funding will be made available for Austrade, the Export Access Program and tourist promotion.

In the Asia-Pacific economies visited by the Commission during the inquiry, there is strong community awareness of the need for local industries to be internationally competitive. There is undoubtedly a growing appreciation of this in Australia also. The Commission is aware of the efforts that have already been made to stimulate increased awareness of the advantages of exporting, as well as international benchmarking and the adoption of best practice policies. But there is a major benefit to be secured from efforts to intensify in the community an appreciation of the need to be globally competitive and to operate in international markets. It will take continuing efforts to change attitudes in Australia and instil a well-developed export culture throughout the Australian community.

Several proposals on how to do this were put to the Commission in response to its Draft Report. The Commission has not attempted to assess the likely effectiveness of such initiatives.

9 TRADE-RELATED INVESTMENT MEASURES

In their efforts to enhance the level of exports associated with foreign direct investment in their economies, governments may use an array of incentives and disincentives to control or influence investment decisions. These are commonly referred to as trade-related investment measures or TRIMs.

TRIMs are distortionary in that they alter trade flows - for example, by artificially inducing firms to export more than they would otherwise. Unlike other investment measures which inadvertently affect trade, TRIMs are deliberately designed to target trade flows. While TRIMs generally apply to foreign companies, they may also affect domestic firms. However, this chapter, and most of the literature on this subject focuses on the impact of TRIMs on foreign investment.

Although TRIMs have been the subject of recent GATT multilateral trade negotiations, and numerous supporting documents and academic papers have been published on the subject, no standard definition has yet emerged. GATTs *Punta del Este* Declaration adopted a broad approach, defining TRIMs as 'any incentives or disincentives to investment that have trade-restrictive and trade-distorting effects' (GATT 1986). In the current context, this broad interpretation is applied to consideration of investment measures which mainly affect exports -- that is, export-related investment measures.

These measures are of interest for several reasons. First, by increasing the level of host-country exports they can, in certain circumstances, have effects similar to export subsidies. Second, there is evidence to suggest they are widely used to enhance exports. Third, there is widespread and increasing concern about their distorting effect on the level and pattern of international trade and investment flows, and the resulting inefficiencies in the international allocation of resources. And they appear to side-step some of the GATTs prohibitions on subsidising exports.

While no international discipline presently applies to TRIMs, this matter is under discussion in the GATI"s Uruguay Round. However, as noted by Maskus and Eby (199o):

> ... the contracting parties of the GATT set themselves a highly complicated task. Because there is little international consensus even over how to broadly define TRIMs and what their effects on trade and welfare may be, reaching a comprehensive agreement among very many countries that effectively disciplines the use of TRIMs seems to be an elusive goal (p.523).

This chapter considers the main types of export-related investment measures, looks at their incidence in selected economies, and examines their effects on host economies and on Australia.

9.1 Types of export-related investment measures

There are two basic types of export-related investment measures: *incentives* to entice investors to increase exports; and *requirements* which oblige investors to export in order to qualify for benefits offered by the government or to avoid being denied access to the local market.

Available incentives are usually restrictive in that each firm's access to them is subject to certain conditions. For example, the length of tax holidays and the amount of tax credit often depend, among other things, on the market orientation of the venture, and the local content of the output. The higher the degree of export orientation and the greater the proportion of local content, the more generous the incentives tend to be.

A wide variety of incentives are used by the host countries to entice corporations to export (Table 9.1). Many of these do not directly lower investment costs but subsidise outputs or inputs to the production process. However, these incentives are generally short-term in nature and hence are viewed by firms as lowering their investment costs -- rather than lowering costs or raising revenue from their ongoing production activities. This is reinforced by a perception that such incentives can be subject to change over the life of an investment.

Export-related investment requirements also come in a number of forms. Host governments may require a foreign corporation to export a proportion of its output as a condition of, say, access to the domestic market. Export requirements can be imposed in different ways. For example, while some measures are clearly export enhancing (such as requirements setting minimum export targets), other measures may be less direct (such as a requirement to produce goods for which there is inadequate local demand, thus forcing the corporation to seek export markets).

The main types of export requirements may be characterised as follows.

Export performance requirements

Export performance requirements include obligations to export a fixed proportion of production, a minimum quantity or value of goods, or some multiple of an investment's import requirement (Box 9.1).

Box 9. 1: **A typical export performance requirement**

Under Singapore's Export of Services Incentive Scheme, a firm earning 20 per cent of its total revenue from exports qualifies for a five-year exemption from tax on 90 per cent of export-related earnings.

Table 9.1: **Types of investment incentives** [a]

Measures affecting	*Type of measure*
Revenues	Tariff reductions Export subsidies Quotas (quantitative restrictions) Government purchasing preferences Exclusive licensing
Cost of fixed assets	Cash grants Tax credits Subsidised leasing Tariff exemption on imported plant and machinery Sales tax exemption on domestic plant and machinery Subsidised land and buildings
Cost of debt	Subsidised loans Loan guarantees Elimination of exchange risk on foreign loans Priority access to credit
Cost of equity	Subsidised equity purchases by government Exemption from registration taxes Dividend taxation waivers Debt-equity swap programs
Variable input costs	Subsidised inputs Wage subsidies Training grants
Tax Labilities	Tax holidays and concessions Accelerated depreciation Inflation adjustments in tax accounting Tax sparing agreements Liberal loss-carry forward provisions

a Measures with a positive effect on after-tax return on equity.
Source: Guisinger 1987, pp. 218 - 9

Export performance requirements distort trade to the extent that host-country exports are increased by these requirements rather than in response to market conditions, and to the extent that host country exports displace exports which would otherwise have been supplied by other countries.

In order to obtain the benefits from meeting minimum export targets (or to avoid penalties from not doing so), firms may find it profitable to sell products on the international market for less than they cost to make. Such behaviour may be difficult to respond to using countervailing duties, since no obvious export subsidy is involved.

Remittance and other exchange restrictions

Foreign exchange restrictions can limit a foreign corporation's ability to enter into international transactions, for example to finance imports. Host governments have used such restrictions to encourage exports. For example, an investor's access to foreign exchange may depend on a project's contribution to exports. Remittance restrictions which limit a firm's ability to repatriate profits are also used to influence investment decisions (Box 9.2).

Box 9.2: **An example of foreign exchange restrictions**

A machine tool manufacturer wishes to expand the activities of its offshore subsidiary and needs to import various components. The company is informed by the host-country government that, because of the country's current account deficit, half of the firm's annual foreign exchange needs have to be covered by export sales. The company is also told that profits may be remitted at a maximum annual rate of 15 per cent of foreign equity capital,. and investment capital may be remitted over not less than three years, beginning two years after the initial investment.

Where foreign companies are not permitted to remit profits and dividends freely, funds which could be used more profitably elsewhere may be locked up in investments in the host country. Where access to foreign exchange is tied to export performance, firms may be prepared to export products at below cost in order to gain the foreign exchange required to remit profits or purchase imported products.

Manufacturing or product mandate requirements

Manufacturing requirements oblige foreign corporations to produce a component or product that it may not have otherwise intended to make in the host country. As part of such a requirement, the company may be prohibited from importing like or similar products (Box 9.3).

Box 9.3: **An example of a manufacturing requirement**

A foreign company wishes to establish a petrochemicals subsidiary. As a condition of entry, the company must agree to produce chemical fertilizer in the host country for sale on the local market. However, because it cannot obtain adequate economies of scale from local market sales for fertilizers, it must export.

Apart from the trade-restricting effects of measures that *reserve* markets, manufacturing requirements can distort investment and trade flows by inducing investors to export, when they would not have otherwise done so. Product mandates similarly distort trade.

Technology transfer and licensing requirements

Foreign companies may be required to manufacture products locally which require the use of more advanced technologies than the firm would otherwise transfer to the host country. In addition, some countries have technology-transfer agreements to ensure that the technology is transferred to the host country at acceptable cost and with acceptable conditions about the freedom of local firms to exploit it (Box 9.4). However, one study of the international transfer of technology suggested that these controls had not advantaged local industries. Another finding was that many countries, such as Korea and Japan, were relaxing controls in this area (BIE 1988).

Box 9.4: **A typical technology-transfer requirement**

A foreign manufacturer of information technology products is interested in producing a line of minicomputers for local sale and export. The government requires the company, as a condition for entry, to manufacture locally the high-speed circuits to be incorporated into the final product (rather than just importing the circuits). This will require the company to transfer the necessary technology to undertake this task. In addition, the firm is required to develop compatible software applications, and to conduct at least a specified amount of R&D in the host country during the life of the investment.

Such requirements can distort trade flows when they involve the transfer of technology to host countries at an artificially low price (in effect an input subsidy), thereby increasing the competitiveness of the host country's exports.

Local equity requirements

These requirements usually specify that a proportion of equity in a proposed venture be controlled or owned by local investors. Alternatively, they may place a ceiling on foreign equity. The share of equity 'reserved' for local investors may increase over the life of the investment, and there may be restrictions on how foreign equity participation is justified. For example, the foreign investor may or may not be allowed to justify its equity position by contributing technology. Such equity requirements may be softened in return for commitments by the foreign company to increase exports.

Box 9.5: **An example of a local equity requirement**

The Malaysian Government imposes local equity requirements on foreign corporations, which are eased where the company exports. For example, no local equity conditions are imposed on companies exporting at least 80 per cent of their output. Companies exporting between 50 and 80 per cent of production can have 100 per cent foreign ownership if they invest more than $M50 million ($A24m) or implement projects to produce goods with at least 50 per cent value added.

Trade balancing requirements

Some countries consider a firm's export performance relative to its import performance. This may reflect a motivation, on the part of the host country, to eliminate some of the balance-of-payments costs associated with foreign investment (Box 9.6).

Box 9.6: **A trade balancing requirement**

Under Australia's 'Partnerships for Development Program', foreign-companies with information technology sales to Australian governments exceeding $A40 million are required, within a seven year period of joining the program, to achieve:

- exports equal to 50 per cent of their annual imports;
- expenditure on R&D equal to 5 per cent of turnover; and
- an average of 70 per cent local value-added across all exports.

Trade balancing requirements can have restrictive effects on both imports and exports. The most immediate effect is the ceiling on imports into the host country which is determined by the company's export performance.

Incentives and requirements in combination

Typically, governments use a combination of incentives and requirements in an attempt to stimulate exports. A World Bank study found that, in all cases where foreign investment was subject to performance requirements, such investment also enjoyed substantial incentives (Guisinger and Associates 1986). Guisinger (1986b, p.169) noted that:

> ... it would be difficult to envisage these investments ever having been made if the requirements were present but the incentives absent. Governments use these incentive-generated rents to promote balance-of-payments equilibrium and import substitution.

This 'carrot and stick' approach of governments to foreign investment reflects the fact that performance requirements generally impose substantial costs on foreign investors which need to be compensated in some way if investment projects are to remain attractive. For many governments, investment incentives and performance requirements are viewed as policy instruments by which foreign direct investment and the associated technology inflow can be meshed with national development priorities.

Performance requirements are, in effect, controls placed on a company to maximise the benefits flowing to the host country from investment, or are designed to minimise the associated host-country costs of such investment (such as current account debits resulting from the remittance of profits). For the foreign company, such controls act as a disincentive, because of the reduced return to equity from the firm being forced to market what can be high-cost exports at the margin.

The international market for investment is increasingly competitive, and host governments must expect to have to provide more-than-compensating inducements to attract foreign investment if they wish to insist on performance requirements. Indeed, Moran and Pearson (1988) described performance requirements and investment incentives as 'chips' used by host-countries in their bargaining strategy with foreign firms.

Governments not only often use a combination of incentives and disincentives, they commonly employ more than one type of policy instrument. One study of the policies employed in ten developed and developing economies revealed that national inventories of these types of measures ranged from 12 to 35 different instruments, with the average country relying on 22 measures (Guisinger 1986b). The policy outcomes in this situation can be of bewildering complexity. McCullock (1990, p.547) suggests this approach may be deliberate:

> Since an equivalent net incentive could be provided much more simply, some investigators have concluded that the non-transparency achieved through multiple and apparently contradictory policy instruments might in fact serve the interests of the host government and perhaps even the foreign firm. The availability of multiple incentives and disincentives could enhance the ability of the host to act as a discriminating monopolist, ie to extract a larger share of the profits associated with a particular project. On the other hand, an investing firm would be better able to conceal from potential competitors -- and perhaps from a suspicious public -- the extent of preferential treatment bestowed on its activity.

9.2 Use of export-related investment measures

There have been several studies of the use of performance requirements and investment incentives. One comprehensive study (of 23 641 foreign affiliates of US companies surveyed in 1977) found that, while about a quarter of the firms benefited from some type of investment incentive, only 2 per cent were subject to a minimum export requirement, suggesting a low use of export-related investment measures (US Department of Commerce 1981).

While more recent studies have indicated a higher incidence of trade-related requirements, their coverage has not been as extensive. For example, a World Bank study found that, of 74 investment projects, 38 were subject to an export requirement (Guisinger 1986a). Similarly, a study of 682 projects supported by the US Overseas Private Investment Corporation (OPIC) found that 40 per cent were subject to trade-related performance requirements (Moran and Pearson 1987).

It is difficult to establish the extent to which export requirements are used because some countries administer these measures implicitly through discretionary incentives. For example, foreign investment promotion agencies may either grant or withhold incentives from foreign investors, depending on their willingness to meet performance requirements that might not necessarily be announced publicly. Singapore's Economic Development Board, Thailand's Board of Investment, and the Malaysian Industrial Development Authority are examples of such agencies visited by the Commission during this inquiry.

This problem is reflected in the studies. For example, a 1987 study of OECD member countries, reported no instances of explicit export-related investment measures (OECD 1987). This finding was qualified in a later study which took into account the possible use of *implicit* measures. It noted (OECD 1989, p.23) that:

> ... a number of countries also have measures with possible disincentive effects related to the award of discretionary incentives. In some cases, a given award or the amount of the award may be conditional on the agreement of a particular performance requirement. In other cases, aspects such as imports, exports, marketing arrangements and technology transfer may enter into a general assessment of applications for incentives awards. While little information on the latter practice is available it is likely that, to varying extents, many Member countries examine such features in assessing applications for awards.

TRIMS, however, appear to be more typical of developing countries than developed countries (Table 9.2).

Table 9.2: **Developing economies using export-related investment measures**

Middle East and Asia	*Central and South America*	*Africa*
Bangladesh	Columbia	Egypt
China	Ecuador	Ghana
India	Mexico	Tunisia
Malaysia	Paraguay	Zimbabwe
Korea, Republic of	Uruguay	
Sri Lanka	Venezuela	
Taiwan		

Source: Office of the US Trade Representative 1985, cited in OECD 1989, pp. 67-9

The 1980s saw a marked proliferation of TRIMS. Two main factors were behind this. First, the intense competition for foreign investment within regions experiencing rapid economic growth (such as South-East Asia) resulted in governments being ready to at least match the incentives on offer elsewhere. Second, the worsening debt problems of some developing countries resulted in increased restrictions on foreign firms.

In recent years, however, some countries have moved away from the use of TRIMs and applied stricter eligibility criteria. To illustrate, Canada removed its export requirements following the replacement of its Foreign Investment Review Agency by Investment Canada, Portugal and Spain have removed export requirements tied to the award of investment incentives, and Korea has relaxed its system of investment authorisation, while Taiwan has reduced the scope of its export requirements (OECD 1989a).

On the other hand, the OECD (1989) noted that Brazil and Mexico have maintained or increased their use of TRIMs in recent years.

9.3 Economic effects

The Commission is unaware of any published studies of the wider economic effects of TRIMs. Moran and Pearson (1988) attribute the lack of analysis to the severe conceptual problems and data limitations which plague this field. For example, it is virtually impossible to unravel the trade or investment effects of investment incentives from those attributable to export requirements. Also, there are conceptual problems in interpreting the efficiency outcomes of removing one set of distortions (say, those resulting from export requirements), while leaving other distortions in place.

There is limited evidence available on the effect of TRIMs on the export and investment behaviour of firms subject to these measures. However, it appears that while TRIMs can bring about an acceleration in the export development plans of foreign corporations, they are relatively insignificant in inducing an overall increase in the level of host-country exports. Guisinger and Associates (1986), for example, studying the effect of TRIM requirements across industry sectors, found that exports were increased only in the case of motor vehicles and concluded that the principal impact of the TRIM requirements was to accelerate firms' plans to enter export markets.

Similarly, a survey of member firms of OPIC found that in 83 per cent of cases TRIM requirements did not significantly alter the investor's purchasing or sales patterns. Typically, survey respondents indicated that it had been their intention from the start to export all or part of subsidiaries' production and that their increased export activity was not due to TRIMs. Because of the apparent redundancy of TRIM requirements, OPIC concluded that these requirements, as such, did not significantly affect the pattern of trade (Moran and Pearson 1987).

The effect of investment incentives on the locational decisions of foreign investors is discussed in Chapter 6.

9.4 Concluding comments

The extent to which TRIMs increase host-country exports in aggregate is unclear. Although governments compete for export-oriented foreign investment using TRIMs, the Commission does not consider this necessarily results in significant benefits to the host country for three reasons. First, export performance requirements may simply accelerate corporate decisions to expand exports, rather than induce any additional exports over the longer term. Second, investment incentives (which typically take the form of forgone tax revenues) are required to offset the foreign corporation's costs of having to meet the host government's export requirements. And last, there is a cancelling-out effect between governments which attempt to match each other's incentives.

The trend in recent years has been away from using TRIMs towards a more liberalised attitude to direct foreign investment. There are several reasons for this. Including TRIMs in the Uruguay Round of GAIT negotiations has highlighted not only their distortionary effect, but also the objections raised by the governments of major investing nations. Also, a slowdown in direct foreign investment in the late

1980s may have weakened the bargaining position of host governments, and led to questioning of TRIMs' effectiveness in assisting national development. Many governments have cut back on incentives due to budgetary constraints, while others (like Malaysia) are now questioning the need for incentives to attract export-oriented foreign investment.

APPENDICES

A Conduct of the inquiry

B Australia’s export enhancement measures

C GATT provisions

D International agreements on export finance

Appendix A: CONDUCT OF THE INQUIRY

Following receipt of the terms of reference on 8 April 1991, the Commission advertised the inquiry in the press and sent circulars to industry and government organisations, domestic producers, importers, users and others likely to have an interest in participating.

A second circular was despatched on 13 May calling for submissions and announcing the broad timetable for the inquiry. Participants and other interested parties were sent an issues paper. Further circulars were despatched in August giving participants the opportunity to obtain and comment on submissions.

The Draft Report was released in December 1991 and distributed to all participants and interested parties. Draft report hearings were held in Melbourne and Canberra in February 1992.

A1 Visits

The Commission conducted several visits both in Australia and overseas, as follows.

Table AI: **Inquiry Visits**

Australia

Aerospace Technologies of Australia Pty Ltd
Arthur Andersen & Co
Australia & New Zealand Banking Group Ltd
Austrade
Australian Bureau of Agricultural and Resource Economics
Australian Chamber of Manufactures (Melb. & Syd.)
Australian Manufacturing Council Secretariat
Australian Mining Industry Council
Australian Paper Manufacturers
Australian Wool Corporation

Bergsten, C.F., Institute for International Economics

BHP Steel
BHP Steel Sheet & Coil Products
Bureau of Industry Economics
Confederation of Australian Industry
CRA
CSR Ltd

Department of Foreign Affairs and Trade
Department of Industry, Technology and Commerce
Ernst & Young
Fraser, Hrones & Co Pty Ltd
Goodman Fielder Wattie Australia Ltd
Hughes, Professor H., National Centre for Development Studies
IBM Australia Ltd
Leighton Holdings Construction Group
Metal Trades Industry Association
National Farmers' Federation

New Zealand Ministry of Commerce

Nucleus Ltd
Price Waterhouse
Price Waterhouse Urwick
Telecom Australia International
Thai Board of Investment (seminar)
Westpac Banking Corporation Ltd

Hong Kong

Australian business representatives
Hong Kong Export Credit Insurance Corporation
Hong Kong Government Industry Department
Hong Kong Government Trade Department
Hong Kong Productivity Council
Hong Kong Trade Development Council

Indonesia

Centre for Strategic and International Studies
Department of Industry, Agency for Industrial Research and Development
Department of Trade, Trade Research and Development Agency
Indonesian Chamber of Commerce and Industry
Investment Coordinating Board (BKPM)
Mangkusuwondo, Dr S., University of Indonesia
Ministry of Finance, Agency for Export Facilities and Financial Data Processing
World Bank

Japan

Economic Planning Agency
Export-Import Bank of Japan, Policy Co-ordination and Planning Department
Industrial Bank of Japan, Research Department
Japan Center for International Finance
Ministry of International Trade and Industry
Overseas Economic Cooperation Fund
Professor Yoko Sazanami, Keio University

Republic of Korea

Bank of Korea, Research Department
Economic Planning Board
Han Seung-Soo, Member of the National Assembly
Korea Development Institute
Korea Foreign Trade Association
Korea Institute for Industrial Economics and Trade
Korea Trade Promotion Corporation
Ministry of Trade and Industry, International Trade Bureau
Sakong II

Malaysia

Australian business representatives
Bank Negara
Federation of Malaysian Manufacturers
Institute of Strategic & International Studies
Malaysian Export Trade Centre
Malaysian Industrial Development Authority
Malaysian Institute for Economic Research
Ministry of International Trade and Industry

Singapore

Australian business representatives
Batamindo Industrial Management Pty Ltd
Economic Development Board
Export Credit Insurance Corporation of Singapore
Jurong Town Corporation
National University of Singapore, Faculty of Business Administration
National University of Singapore, Institute of Policy Studies
Singapore Institute of Standards and Industrial Research
Singapore International Chamber of Commerce
Singapore National Committee for Pacific Economic Cooperation
Singapore Trade Development Board

Taiwan

Acer Incorporated
Australian business representatives
China External Trade Development Council
Chung-Hua Institution for Economic Research
Council for Economic Planning and Development
Hsinchu Science-based Industrial Park
Ministry of Economic Affairs, Industrial Development Bureau

Thailand

Australian-Thai Chamber of Commerce
Chulalongkorn University, Faculty of Economics
Ministry of Commerce, Department of Business Economics
Ministry of Commerce, Department of Foreign Trade
Ministry of Industry, Department of Industrial Promotion
Office of the National Economic and Social Development Board
Thai Board of Investment

United States of America

Export-Import Bank of the United States
Institute for International Economics
International Monetary Fund
Office of Management and Budget
Trade and Development Program
World Bank

A2 Participants

A total of 53 submissions were received, 30 before the Draft Report was released. Participants who made a submission to the inquiry are listed in Table A2.

Table A2: **Submissions**

Participant	*Submission Number(s)*
Aerospace Technologies of Australia Ply Ltd	14
Altona Petrochemical Company Ltd	21
American Home Assurance Company	33
Arthur Webster Pty Ltd	1
Asia Link Consulting	32
Association of Australian Aerospace Industries	48
Austrade*	42
Australian Book Publishers Association Limited	17,24
Australian Chamber of Manufactures	36
Australian Dairy Farmers' Federation	25
Australian Dairy Industry Council Inc	19,51
Australian Electrical and Electronic Manufacturers' Association Limited	6,27,41
Australian Manufacturers' Export Council	44
Australian Manufacturing Council	38
Australian Shipbuilders' Association Ltd	30
AWA Limited	37
BHP Co Ltd	20,47
Bunge (Australia) Pty Ltd	7
Bunnings Limited	2
Bureau of Industry Economics	31
Business Council of Australia	53
Canned Fruits Industry Council of Australia	5,10
Chemical Confederation of Australia	22
CSR Limited	3
Edgell-Birds Eye	8
Ego Pharmaceuticals Pty Ltd	4
Export & Commercial Research Services Pty Ltd	9
Export Finance and Insurance Corporation	28,34
Goodman Fielder Wattie Limited	50
Kodak (Australasia) Ply Ltd	29
KPMG Peat Marwick	16
Legge,John M.	45
Metal Trades Industry Association of Australia	43
New South Wales Treasury	11
Rattigan, G.A. and Carmichael, W.B.	46
Ricegrowers' Co-operative Limited	15,18
Scottish Pacific Business Finance Pty Ltd	49
The Federated Tanners' Association of Australia*	13
The Institute of Engineers, Australia	40
The Taxation Institute of Australia	39
Trade Indemnity Australia Ltd	52
United Dairyfarmers of Victoria	12
West Australian Department of State Development	23
Wilson Transformer Company Pty Ltd	26,35

* Contains confidential material

Appendix B: AUSTRALIA'S EXPORT ENHANCEMENT MEASURES

Export support is provided by both the Federal and State Governments. Direct assistance is provided through generally available measures to support export marketing, product development, and export finance and insurance. Selective export assistance is provided through several industry plans and programs. And finally, exporters benefit from some generally available but non-export-specific assistance programs. Table B1 summarises Australia's export enhancement measures.

In 1990-91, over $700 million in direct budgetary assistance was provided by the Federal Government to support exports and about $44 million was provided by various State Governments. However, the total value of Australia's export support is difficult to assess for several reasons. First, the support provided under some programs (for example the import credit schemes is implicit and defies quantification. Second, much of the assistance provided under the various industry plans and programs (for example the Civil Offsets Program) is administered using complex arrangements, making it virtually impossible to disentangle the export component. And last, it is not possible to identify the export assistance component associated with the generally available, but non-export specific schemes (such as support for research and development (R&D).

B1 Export subsidies

Agricultural Industry Export Underwriting Schemes

The Federal Government underwrites average export returns for:

- *apples and pears -- this* scheme terminated in 1990-91 with a final payment of $4 million;
- *certain dairy products* at 85 per cent of the long-term trend level. The underwriting provision for dairy products was triggered in 1990-91, resulting in payments of $22 million in 1991-92. The Government expects underwriting to be triggered again in the 1991-92 season;
- *wheat* - $6 million in underwriting liability payments (a carry-over from previous years) will be made to the Australian Wheat Board (AWB) in 1991-92. The Government currently guarantees the borrowing of the AWB up to 85 per cent of the estimated value of its total net sales of wheat (the AW13 markets other grains as well, but these sales are not underwritten). This will be phased down to 80 per cent by 1993-94 and thereafter will cease.

Table B1: **Summary of Australia's export enhancement measures ($ million)**

Measure	*1990-91*	*1991-92*
Export Subsidies		
Agricultural Industry Export Underwriting Schemes		
Apple and Pear	4.0	Nil
Dairy	Nil	223
Wheat [a]	Nil	6.0
Metal Working Machines and Robots (MMR) Bounty [b]	4.0	3-5
Passenger Motor Vehicle Export Facilitation Scheme	na	na
Photographic Colour Film Production Bounty	na	na
Shipbuilding Bounty [b]	18.0	16.0
Textile, Clothing & Footwear (TCF) Import Credits Scheme	na	na
Export Marketing		
Australian Tourist Commission	61.5	63.4
Australian Trade Commission (Austrade)		
Export marketing and trade promotion	99.9	124.4
Special purpose grants		
Engineering Industries Internationalisation	1.8	3.9
TCF Program	1.0	Nil
Product development and export awareness programs		
operating ex rises	6.0	5.4
Asia Pacific Fellowship Program	Nil	4.1
Export Market Development Grants Scheme (EMDGS)		
operating expenses	5.9	3.5
payments	162.0	134,0
Innovative Agricultural Marketing Program (IAMP) [c]	4.1	8.4
International Trade Enhancement Scheme (ITES) [d]	4.5	41.7
Project Marketing Loans Facility [e]	Nil	0.8
Dairy Industry Market Support	141.0	119.2
Export Access Program	na	1.0
National Industry Extension Service (NIES)	0.5	0.7
State Government export and trade promotion	44.0	na
Wool promotion	22.9	30.0
Export Finance Assistance		
Export credit insurance EFIC interest subsidy	7.9	14.7
Development Import Finance Facility (DIFF) [f]	83.8	103.0
National Interest Business (NIB)	234.0	264.0
Compensation to the grains industry	Nil	35.1
Trade-Related Investment Measures		
Customer Premises Telecommunications Equipment	na	na
Australian Civil Offsets Program	na	na
Partnerships for Development and Fixed Term Agreements	na	na
Pharmaceuticals factor 1 scheme"	13.0	30.0
Research and Development (R&D)	na	na

na not available
a Residual payments in respect of 1986 - 87 wheat pool.
b Commission estimates.
c 1991 - 92 estimate includes a carryover of $3.4 million.
d 1991-92 estimate includes a carryover of $19.8 million.
e Funded from Austrade's operating budget.
f 1991-92 estimate includes $10 million announced in November 1991.
Source: DFAT 1991a; DITAC 1991; DPIE 1991; McKinsey and Co 1990; PM&C 1991; Sub. 42

Metal Working Machines and Robots (MMR) Bounty

A 24 per cent production bounty is payable for the manufacture of MMR products for either export (except to New Zealand) or domestic sale. The bounty is paid as a proportion of in-house value added. In 1990-91, bounty payments amounted to $15 million, of which the Commission estimates about a quarter ($4 million) related to export production. The bounty rate is to be phased down from its current rate to 5 per cent in mid-1996 to align with the revised general tariff structure.

Passenger Motor Vehicle Export Facilitation Scheme

Subsidised automotive exports are part of a package of assistance provided under the Passenger Motor Vehicle Plan's Export Facilitation Scheme. The scheme allows firms to import duty free components or vehicles in return for automotive exports. These duty free entitlements (export credits) are based upon Australian value added in eligible export activities and are in addition to the 15 per cent automatic allowance to vehicle producers. The scheme makes it profitable to export at a price which does not cover costs, provided that losses are more than offset by the benefits derived from the additional duty-free entitlements earned by exporting.

Photographic Colour Film Production Bounty

Since January 1990, the production of photographic film has been eligible for bounty assistance under the Photographic Industry Development Agreement (PIDA). Effectively, the bounty is available only to Kodak Australasia Pty Ltd. The Government's decision to pay a subsidy to Kodak was in response to its threat to move offshore.

The bounty payments have a ceiling of $36 million over the life of PIDA. The arrangement requires Kodak to maintain export commitments for five years. Payments of $12 million were made in 1990-91. According to DITAC (1991b), the bounty contributed to a 25 per cent increase in exports of photographic film and chemicals over 1989-90 levels.

The bounty's export requirement conditions have been referred to the GATT by the EC which has alleged that:

> ... the granting of this subsidy is expressly contingent upon Kodak maintaining and increasing its exports from Australia (notably to Asian Markets) at least over the next five years ... The granting of a straightforward export subsidy, even in the absence of explicit export requirements in the relevant legislation ... is contrary to Article 9 of the Agreement, in particular as exemplified by item (a) of the Illustrative List of Export Subsidies annexed to the Agreement (GATT 1990b).

Although the EC sought consultation and conciliation with the GATT Committee on Subsidies and Countervailing Measures in June 1990, there have been no further developments since that time.

Shipbuilding Bounty

A 15 per cent shipbuilding bounty is payable to vessels built for either export or domestic sale. The bounty is available to all eligible shipbuilding activity irrespective of an assisted vessel's end-use or destination, with one exception- no production bounty is paid on vessels used in trans-Tasman trade.

In 1990-91, shipbuilding bounty payments amounted to $37 million, of which the Commission estimates about half ($18 million) was export-related. The bounty is to be phased down from its current level to 5 per cent by 1993, reducing to zero by 1995.

Textiles, Clothing and Footwear (TCF) Import Credits Scheme

The TCF Import Credits Scheme was introduced on 1 July 1991 and is to operate until 30 June 2000. The scheme enables TCF manufacturers to accrue import credits from export sales -- so providing an incentive to increase their exports. The credits, which are freely transferable and can be used to offset tariff duties otherwise payable on TCF imports, will initially accrue at a rate of 30 per cent of the domestic value added in certain exports. The rate will phase down to 15 per cent over the life of the scheme. Exports to New Zealand are excluded and the credits will only accrue to companies exporting more than $100 000 a year.

B2 Export marketing

Australian Tourist Commission (ATC)

Tourism, with export earnings of $7.3 billion (or 10 per cent of total exports) in 1990-9 1, is Australia's largest single earner of foreign exchange.

In 1990-91, around $62 million was spent by the ATC on promoting Australia as an international tourist venue. Funding of these activities was boosted in February 1992 with the allocation of a further $5 million for 1991 - 92 and $ 10 million for 1992-93.

Australian Trade Commission (Austrade)

Austrade, a Commonwealth statutory authority, is the main instrument for the delivery of Australia's export assistance. It has a staff of around 1000 employed in 62 posts in 55 countries.

Austrade's activities include the provision of:

- *export marketing and trade promotion* services such as export counselling, export planning assistance, development of export strategies for specific industries, and in-market support. It also delivers export market programs (for example, the Engineering Industries Internationalisation Program and TCF Program) on behalf of other agencies;

- *product development and export awareness programs* such as sponsorship of the Australian Export Awards and International Business Week, and the development of export education and training programs; and,

- *financial support programs* including the Asia-Pacific Fellowship Program, Export Market Development Grants Scheme, Innovative Agricultural Marketing Program, International Trade Enhancement Scheme, and the Project Marketing Loans Facility.

Austrade's 1991-92 gross operating expenditure is estimated at $140 million of which about 10 per cent is expected to be recovered through user charges (Sub. 42). In February 1992, the Government announced Austrade's funding would be increased by $5 million each year for the next three years to enable it to open new offices in the Asia-Pacific region.

Asia - Pacific Fellowship Program

This program supports Australian organisations in developing skills for business success in Asia. Fellowships are available to employees of Australian organisations to develop some familiarity with the business practices, language, and culture of Asian economies. The program will cost $10 million over the next three years.

Dairy Industry Market Support

In 1990-91, $141 million was spent on export market support for dairy products. This was funded through a levy on all milk supplied by farmers. The levy (collected by the Department of Primary Industry and Energy) is transferred to a market support fund (administered by the Australian Dairy Corporation) from which payments are made to manufacturers involved in exporting dairy products. In effect, the levy raises domestic prices above export parity prices.

Engineering Industries Internationalisation Program

This is a discretionary scheme to assist firms in the Australian metal-based engineering sector to capture more international business opportunities. Financial support is provided on a 50:50 basis to a maximum

of $25 000 for the identification of international business opportunities; the development of international business plans or project-oriented strategic market plans; and a maximum of $200 000 for marketing activities associated with plan implementation.

In 1990-91, $1.8 million was spent on the program and this is expected to increase to $3.9 million in 1991-92. The program is run jointly by the Department of Industry Technology and Commerce (DITAC) and Austrade.

Export Access Program

This program, introduced in October 1991, assists small-and medium-sized enterprises to develop the expertise and resources to maintain a sustained export development program. The key elements of the program are:

- identifying opportunities and preparing for the overseas market;
- individually tailored business appointments in the target market; an
- post market visit evaluation.

Assistance is available to firms with an annual turnover of less than $20 million, or with less than 200 employees in manufacturing, or less than 50 employees in the case of service industries. In February 1992, the Government announced that funding for the program is to be increased from $4 million to $12 million over three years. The number of participating firms is expected to increase from 250 to 700.

The program is delivered by the Australian Chamber of Manufactures in association with the Confederation of Australian Industry, the Metal Trades Industry Association and the Council of Small Business Organisations of Australia.

Export Market Development Grants (EMDG) Scheme

The EMDG scheme aims to encourage Australian exporters to establish and develop overseas markets for goods, specified services, industrial property rights and know-how which are substantially of Australian origin. It provides taxable cash grants towards the cost of export promotion and development. In 1990-91, some 3000 EMDG claims to the value of $162 million were paid.

The assistance is available to exporters who have incurred $30 000 in eligible expenditure and have eligible export revenue of less than $25 million in the year of the claim. The scheme also provides a special facility for joint ventures and consortia.

Innovative Agricultural Marketing Program (IAMP)

LAMP provides financial assistance to producers, manufacturers, and marketers in Australian agricultural, forestry and fishing industries who have innovative projects with sound commercial potential. In 1990-91, $4.1 million was spent under the program.

Austrade funds up to 50 per cent of the project budget to a maximum of $250 000 in any financial year for up to 3 years.

International Trade Enhancement Scheme (ITES)

ITES enhances the international business prospects for individual firms, joint ventures, consortia, and industry associations developing proposals which may generate substantial foreign exchange earnings for Australia.

The scheme finances market entry and expansion activities as well as activities facilitating new investment. Austrade funds up to 50 per cent of the project expenditure up to a maximum of $2.25 million. Funds are provided as a concessional loan, repayable with interest, or as an advance involving a success fee in the form of a percentage of the revenue generated from the project.

In 1990-91, $4.5 million was spent on the scheme and this is expected to increase to $41.7 million in 1991-92.

National Industry Extension Service (NIES)

NIES is a joint Commonwealth-State program which aims to improve the effectiveness and efficiency of small-land medium-sized enterprises in the traded goods and services sectors, thereby increasing their competitiveness in international markets. NIES provides a free diagnostic service for client companies and subsidises external consultancies, usually on a dollar-for-dollar basis. Its export-oriented services include:

- assisting firms in strategic market planning through the World Competitive Services (WCS) strategic planning model. In 1990 - 91 this involved expenditure of $120 000; and
- the Preparing an Export Plan (PEP) program. Expenditure on PEP totalled $450 000 in 1990 - 9 1.

In 1991-92, $500 000 will be provided by NIES to assist small innovative firms to establish in international markets through the development of strategic networks and joint ventures, while the WCS model is being expanded at a cost of $225 000.

Project Marketing Loans Facility (PMLF)

Introduced in 1990-91, the PMLF provides interest-free loans to exporters who are pursuing international projects or similar opportunities with significant Australian export content. The up-front loans are repayable in full with a success fee only if the project is won. If the project is lost, 50 per cent of the loan is forgiven.

The PMLF is funded from Austrade's operating budget and around $863 000 has been allocated for 1991-92.

State Government Marketing Assistance

Export marketing activities undertaken by State Governments cost $44 million in 1990-91. Of this, Victoria spent around $14 million, NSW $13 million, South Australia and Queensland $6 million each and Western Australia $5 million (McKinsey and Company 1990).

Wool Industry Export Promotion

The Federal Government contributed $23 million to the Australian Wool Corporation's wool export market promotion efforts in 1990-91 and a further $30 million has been allocated for 1991-92.

B3 Export finance assistance

The Export Finance and Insurance Corporation (EFIC) provides export credit insurance, investment insurance and export finance guarantees and facilities to Australian firms. With some exceptions, the Corporation generally operates on a self-funding basis. EFIC is a member of the Berne Union and its export credit facilities are administered in accordance with the OECD Arrangement (described in Appendix D).

In 1990-91, $326 million was provided through various export finance and insurance schemes-payments are expected to increase to $407 million in 1991-92. The figures are unusually high, reflecting Government compensation payments to Australian exporters following the UN-imposed trade sanctions against Iraq.

EFIC's Export Credit Insurance and Export Finance

Export credit insurance is EFIC's primary form of support to Australian exporters. Exports of meat, wool,

metalliferousores, aluminium and coal account for around 70 per cent of exports insured. In 1990-91, total exports insured through EFIC amounted to $4.1 billion. EFIC insures about 13 per cent of Australia's total exports. The value of the interest subsidy arising from EFIC's concessional export credit and finance activities was $7.9 million in 1990-91 and this is expected to increase to $14.7 million in 1991-92.

In 1990-91, EFIC provided 21 export finance loans totalling $299 million for export contracts worth $337 million. These loans involve the foreign purchase of Australian capital goods and services. EFIC also provided protection for financial institutions which provide performance bonds, although this facility was not extensively used during 1990-91. EFIC itself did, however, issue bonds totalling $4.1 million and insured Australian suppliers of goods and services against the 'unfair' calling of bonds totalling $24.3 million.

In November 1991, Parliament legislated to extend its backing of EFIC's insurance guarantee and lending operations with the provision of a further $200 million in capital to supplement the existing reserves of some $160 million. Also, the EFIC Performance Bond Facility was set up to cover bonding requirements (where performance and other bonding requirements are demanded by overseas buyers) for firms with a proven record of performance but which are unable to meet the requirements of private bonders. In February 1992, funding for the facility was boosted from $50 million to $150 million. The Federal Government will be liable for up to $100 million under the National Interest provisions of the Export *Finance Insurance Corporation Act 1991,* and EFIC will provide up to $50 million in bonding support on its commercial account.

Development Import Finance Facility (DIFF)

Through the DIFF, EFIC provides support to developing countries, enabling them to obtain better credit terms for essential imports, and to selected Australian firms, enabling them to increase the penetration of Australian exports.

In 1990-91, EFIC used $ 84 million in DIFF grants to extend mixed credits to Australian exporters (on terms consistent with the OECD Arrangement). For example, a $238 million EFIC finance package enabled the Transfield Group to supply pre-fabricated bridges to Indonesia.

In November 1991, the Government increased DIFF's 1991-92 funding from $93 million to $103 million to alleviate the growing backlog of projects seeking assistance. In February 1992, the Government announced that DIFF funding will be boosted to $120 million in 1992-93.

National Interest Business (NIB)

The Government may direct EFIC to underwrite transactions in the *national interest,* which EFIC would otherwise have considered unsuitable for commercial underwriting.

During 1990-91, international instability in some of Australia's export markets for wool, wheat and mutton led to a high level of NIB activity. For example:

- in November 1990, the Government topped up its NIB account with a $400 million, 240 day rollover credit facility for Australia's second largest wool customer, the Soviet Union. This enabled new trade to commence and contracted produce (wool, wheat and mutton) to be exported. As at November 1991, $340 million of the credit had been used, mainly for purchases of wool and mutton.

- the imposition of UN sanctions against Iraq and the Gulf War stopped Iraq's payment to the Australian Wheat Board (AWB) for credit sales of wheat and rice. These transactions were insured under the national interest provisions of the Austrade Act. Hence, the AWB is eligible to claim 70-80 per cent of these defaulted payments.

In 1990-91, $242 million was paid out in respect of NIB and this is expected to increase to $279 million in 1991-92.

Compensation to the Grains Industry

For 1991-92, the Federal Government has allocated $35.1 million to be paid to grains exporters as compensation for lost sales as a result of the UN sanctions on Iraq. This payment provides for losses not covered under NIB.

B4 Trade-related investment measures

Customer-Premises Telecommunications Equipment (CPTE)

Access to the Australian market for customer-premises equipment is governed by a set of industry development arrangements (IDAs) intended to encourage greater local production and exports, and to move the industry to a position where it can compete internationally. The IDA was introduced in 1989 and will apply until 1993.

The scheme covers private automatic branch exchanges, small business systems, and cellular mobile telephones. The IDA restricts access to the Australian telecommunications network (managed by Austel) to firms which achieve a threshold level of 'points' for exports, local content, and R&D. The number of points needed to retain endorsement progressively increases over the life of the arrangements.

Austel's 1991 third-quarter report shows that 31 firms, with a turnover of $267 million, have had equipment connected to the network. Exports were reported at $32 million, 5 per cent more than over the same period in the previous year.

> ... create an environment which would encourage a significant increase in research and development performance by the industry, together with increased investment, production and export performance, and strengthen export opportunities (Button and Blewett 1987).

The workings of the Factor f scheme are quite complex. However, in simple terms, agreements are made between the Pharmaceutical Benefits Pricing Authority (PBPA) and pharmaceutical companies whereby a company that can meet the scheme's eligibility criteria, and can increase its level of activity in Australia, receives cash payments from the Government. These payments are limited to not more than 25 per cent of the additional exports, R&D and import substitution that companies are able to achieve over the life of the scheme.

In 1990-91, the nine companies in the scheme received a total of $17 million in Factor f payments, of which the Commission estimates about $13 million to be export-related. The PBPA expects these companies to receive much greater payments in the latter years of the scheme, because of the lead times involved in increasing R&D and export capacity. Indeed, Factor f payments to these firms until the present scheme's 1993 expiry date are estimated to be around $170 million, of which about 75 per cent is expected to be accounted for by payments for increased pharmaceutical exports.

In March 1992, the Government foreshadowed a substantial increase in assistance to the pharmaceutical industry. The Factor f scheme is to be extended for a further six years with annual Factor f payments forecast to increase to $150 million in 1998-99.

B5 Research and development

Australia's R&D assistance is not targeted towards any particular industry sector or activity (such as exporting). For this reason, it is not possible to identify the export assistance component in R&D assistance.

Direct Federal Government support for R&D involved expenditure of around $2.4 billion in 1990-91. Industry-related R&D assistance is provided through special purpose grants ($309 million in 1990-91) such as the Grants for Industry Research and Development scheme, through various government research organisations ($421 million in 1990-91) such as the Commonwealth Scientific and Industrial Research Organisation (CSIRO) and through taxation concessions.

Until 1993, domestic R&D is to be promoted through a 150 per cent tax deduction on eligible expenditures. Thereafter, a 125 per cent rate of deduction will apply. The forgone revenue to government of the concession was $232 million in 1990-91 and this is expected to increase to $250 million in 1991-92.

In addition to direct support, indirect R&D support is provided through several of the schemes discussed above, for example the Partnerships for Development Program, the Australian Civil Offsets Program, the 'Factor f' Pharmaceutical Scheme, the Small and Medium Enterprise Development Scheme and the Customer Premises Telecommunications Equipment Scheme.

B6 Recent reviews of programs

Many of the above - mentioned export enhancement measures have been the subject of recent review or will be subject to review in the near future. The following is a partial list:

Program	**Review Body and Year Of Review**
Export Underwriting:	
Wheat	IAC 1988a
Apples and Pears	IAC 1990
Certain Dairy Products	IC 1991e,
Shipbuilding Bounty	IAC 1988b
Australian Tourist Commission	IAC 1989
MMR Bounty	BIE 1990
PMV Export Facilitation	IC 1991b
Pharmaceuticals ‘Factor f’	BIE 1991
Austrade	McKinsey and Company 1990
Austrade (including ITES, EMDGS, IAMP & DIFF).	Hughes Report 1989
EMDGS	BIE 1988b
State Government Marketing	McKinsey and Company 1990
Wool Industry Export Promotion	Wool Review Committee 1991
EFIC	McKinsey and Company 1990
Customer Premise Equipment (CPTE)	Allen 1991
Civil Offsets Program	XPA 1989,1990

Current and Future Reviews

DIFF	National Institute of Economic and Industry Research 1991-92
GIRD	IC 1992 - 93
NIES	IC 1993
Long Term Agreements (Partnership and Fixed Term)	IC 1993

Appendix C: GATT PROVISIONS

This appendix reproduces those Articles of the General Agreement on Tariffs and Trade (GAIT) that are most directly relevant to export enhancement measures -- the GATT Subsidies Code, the Illustrative List of export subsidies annexed to that Code and a letter relating to Australia's acceptance of the Code. There is also some information about the current Uruguay Round of negotiations.

The GATT is an international treaty which sets out, for governments which accede to the agreement (ie signatories), rules governing trade.

The key obligations of the agreement are:

- to use only approved instruments of protection, primarily tariffs;
- to use trade instruments in a non-discriminatory way, extending any opening of a market to all GATT trading partners (formally this is known as the principal of 'most-favoured-nation'); and
- to support open markets and market forces by committing themselves to a long-term process of non-reversible reductions in protection.

The principal sections of the GATT dealing with export subsidies, shown on pages C147-150, are:

- Article VI Anti-dumping and Countervailing Duties; and
- Article XVI, Subsidies.

A countervailing duty may be levied by an importing country to offset an exporting country's subsidy. An *anti-dumping duty* may be imposed by an importing country when the exporter is supplying the product at a price below its normal value or below the price of a similar product sold in the exporting country.

Article VI of the GATT requires that the levying of countervailing and anti-dumping duties be subject to a material injury test. Because it has the right to maintain laws which were in place before it acceded to the GATT, the United States does not have to apply this test, except in the case of goods entering duty free. The United States will, however, apply the injury test to other countries if they subscribe to the Subsidies Code.

In an effort to tighten up disciplines on the use of subsidies, a Subsidies Code was negotiated during the Tokyo Round of trade negotiations. The provisions of the GATT and the Subsidies Code do not outlaw

export subsidies on primary products or export credit. They also generally permit developing countries to use export subsidies. The provisions do not try to eliminate all subsidies, but rather to establish an international discipline for subsidy practices which distort trade.

Australia and New Zealand did not accede to the Code at first. Also, despite the more flexible conditions available to them, few Developing Countries joined the Code. Australian accession followed a bilateral agreement with the United States. Australia abolished two export enhancement measures and the United States agreed to apply the injury test to Australia.

The text of the understanding between the United States and Australia is contained on pages C176-179. This text (and other letters relating to Brazil, India, Korea, New Zealand, Pakistan, Spain, Taiwan and Uruguay) is reproduced in Hufbauer and Erb (1984, pp. 161-88).

The United States has applied similar pressure to New Zealand and to a range of developing countries. In most cases, the accession of these countries to the Code followed bilateral agreements with the United States. Nevertheless, many developing countries (including some ASEAN members) have elected to stay outside the Code. Current Code membership (12 EC member states plus 24 other countries) contrasts with the present number of contracting parties to the General Agreement (104). The text of the Code is on pages C150-175. Code signatories (the EC counting as one) are as follows:

Australia*	Hong Kong	Philippines*
Austria	India	Sweden
Brazil	Indonesia*	Switzerland
Canada	Israel*	Turkey
Chile	Japan	United States
Colombia	Korea	Uruguay
EC	New Zealand	Yugoslavia
Egypt	Norway	
Finland	Pakistan	

Those countries marked with an asterix adopted the Code with some reservations.

In contrast to the general experience under other GAIT Codes, the dispute-settlement procedures of the Subsidies Code have been unsuccessful. To date no 'findings' on disputes over subsidies under the procedures of the- Subsidies Code have been adopted. At the same time, the success or failure of

dispute-settlement processes does not represent an accurate representation of the degree of observance of obligations. On the whole, most issues are resolved bilaterally. The ban in the Code on export subsidies for manufactures is generally effective. Most disputes under the Code involve agriculture.

The GATT contracting parties agree to convene major conferences every few years for the sole purpose of negotiating to reduce tariffs and other barriers to open markets. These are known as 'Rounds' of trade negotiations. The purpose of the rounds now includes the drafting of new rules which reduce trade barriers and open trade, but are not negotiated in the way specific reductions to tariffs are negotiated. The first Round, known as the Kennedy Round, was held in Geneva (1964-67) and contracting parties are now negotiating in the eighth session, the Uruguay Round.

Recent developments in the Uruguay Round of GATT

Preparation for the Uruguay Round of Multilateral Trade Negotiations began in September 1986 at *Punta del Este.* The Ministerial meeting agreed to schedule the round to cover negotiations on some 15 topics.

The main issues of the Round are agriculture, trade in services, intellectual property, and trade-related investment measures (TRIMs). Some of the negotiations have aimed to bring agricultural policies in line with GATT rules and start the process of reform to open up the world's agricultural markets. Another group is discussing ways to set out common international trade rules for services. A negotiating group on intellectual property rights is looking for an agreement on international measures to provide better trading opportunities for products with significant intellectual property content.

A Draft Final Act containing the results of the negotiations was tabled in Geneva on 20 December 1991 by the GATT Director-General Arthur Dunkel.

This package contains measures to overcome long-standing problems in world trade, especially the corruption of world agricultural markets. It offers rules for trade in services to bring stability to the fastest growing sector of world trade; and it is designed to improve the scope and effectiveness of current GATT rules and disciplines. Negotiations on concluding the Uruguay Round, including the negotiations on schedules of commitments on market access, agriculture and services, have not yet been finalised.

The package includes a new agreement on subsidies and countervailing measures. There are three specifically defined categories of subsidies: prohibited (red), actionable (amber) and non-actionable, non-countervailable (green).

The proposed *prohibited* category of subsidies would continue to include export subsidies. The core of this prohibition continues to be an illustrative list of export subsidies which is largely the same as that in the current Subsidies Code. The prohibited category has, however, also been extended to subsidies contingent on the use of domestic over imported goods.

The obligation proposed under the *actionable* category of subsidies is that no country should cause adverse effects to the interests of other signatories. Disciplines on non-prohibited subsidies where they are damaging the trade interests of other GATT members have been strengthened by introducing a provision that a subsidy program will be deemed to be causing serious prejudice to the interests of another signatory if certain conditions are satisfied, including, in particular, if the total *ad valorem* subsidisation of a product exceeds 5 per cent.

The *non-actionable, non-countervailable* category of subsidies would cover generally available measures that is, measures not specific to certain enterprise), most subsidies for research and subsidies to disadvantage regions. Provision are included for prior notification and review of ‘green’ program, as well as a residual right to challenge any such program if it is causing serious and long lasting trade effects.

Special and differential provisions would be provided for developing countries. In particular for developing countries other than least-developed countries, export subsidies are to be phased out within eight years. If a developing country wishes to apply export subsidies beyond this period, it will have to be determined by the Committee on Subsidies and Countervailling Measures (which comprise all members of the agreement) whether this is justified. However, developing countries would not be permitted to increase the level of, or introduce, new export subsidies.

C1 Selected Articles from the General Agreement on Tariffs and Trade (GATT)

Article V1: Anti-dumping and Countervailing Duties

1. The contracting parties recognise that dumping, by which products of one country are introduced into the commerce of another country at less than the normal value of the products, is to be condemned if it causes or threatens material injury to an established industry in the territory of a contracting party or materially retards the establishment of a domestic industry. For the purposes of this Article, a product is to be considered as being introduced into the commerce of an importing country at less than its normal value, if the price of the product exported from one country to another

(a) is less than the comparable price, in the ordinary course of trade, for the like product when destined for consumption in the exporting country, or,

(b) in the absence of such domestic price, is less than either

(i) the highest comparable price for the like product for export to any third country in the ordinary course of trade, or

(ii) the cost of production of the product in the country of origin plus a reasonable addition for selling cost and profit.

Due allowance shall be made in each case for differences in conditions and terms of sale, for differences in taxation, and for other differences affecting price comparability.

2. In order to offset or prevent dumping, a contracting party may levy on any dumped product an anti-dumping duty not greater in amount than the margin of dumping in respect of such product. For the purposes of this Article, the margin of dumping is the price difference determined in accordance with the provisions of paragraph 1.

3. No countervailing duty shall be levied on any product of the territory of any contracting party imported into the territory of another contracting party in excess of an amount equal to the estimated bounty or subsidy determined to have been granted, directly or indirectly, on the manufacture, production or export of such product in the country of origin or exportation, including any special subsidy to the transportation of a particular product. The term 'countervailing duty' shall be understood to mean a special duty levied for the purpose of offsetting any bounty or subsidy bestowed, directly or indirectly, upon the manufacture, production or export of any merchandise.

4. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to anti-dumping or countervailing duty by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund such duties or taxes.

5. No product of the territory of any contracting party imported into the territory of any other contracting party shall be subject to both anti-dumping and countervailing duties to compensate for the same situation of dumping or export subsidisation.

6. (a) No contracting party shall levy any anti-dumping or countervailing duty on the importation of any product of the territory of another contracting party unless it determines that the effect of the dumping or subsidisation, as the case may be, is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry.

(b) The Contracting Parties may waive the requirement of sub-paragraph (a) of this paragraph so as to permit a contracting party to levy an anti-dumping or countervailing duty on the importation of any product for the purpose of offsetting dumping or subsidisation which causes or threatens material injury to an industry in the territory of another contracting party exporting the product concerned to the territory of the importing contracting party. The Contracting Parties shall waive the requirements of sub-paragraph (a) of this paragraph, so as to permit the levying of a countervailing duty, in cases in which they find that a subsidy is causing or threatening material injury to an industry in the territory of another contracting party exporting the product concerned to the territory of the importing contracting party.

(c) In exceptional circumstances, however, where delay might cause damage which would be difficult to repair, a contracting party may levy a countervailing duty for the purpose referred to in sub-paragraph (b) of this paragraph without the prior approval of the Contracting Parties; provided that such action shall be reported immediately to the Contracting Parties and that the countervailing duty shall be withdrawn promptly if the Contracting Parties disapprove.

7. A system for the stabilisation of the domestic price or of the return to domestic producers of a primary commodity, independently of the movements of export prices, which results at times in the sale of the commodity for export at a price lower than the comparable price charged for the like commodity to buyers in the domestic market, shall be presumed not to result in material injury within the meaning of paragraph 6 if it is determined by consultation among the contracting parties substantially interested in the commodity concerned that:

(a) the system has also resulted in the sale of the commodity for export at a price higher than the comparable commodity price charged for the like commodity to buyers in the domestic market, and

(b) the system is so operated, either because of the effective regulation of production, or otherwise, as not to stimulate exports unduly or otherwise seriously prejudice the interests of other contracting parties.

Article XVI: Subsidies

Section A - Subsidies in General

1. If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase exports of any product from, or to reduce imports of any product into, its territory, it shall notify the Contracting Parties in writing of the extent and nature of the subsidisation, of the estimated effect of the subsidisation on the quantity of the affected product or products imported into or exported from its territory and of the circumstances making the subsidisation necessary. In any case in which it is determined that serious prejudice to the interest of any other contracting party is caused or threatened by any such subsidisation, the contracting party granting the subsidy shall, upon request, discuss with the other contracting party or parties concerned, or with the Contracting Parties, the possibility of limiting the subsidisation.

Section B - Additional Provisions on Export Subsidies

2. The contracting parties recognise that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this Agreement.

3. Accordingly, contracting parties should seek to avoid the use of subsidies on the export of primary products. If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in the product.

4. Further, as from 1 January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than a primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31 December 1957

no contracting party shall extend the scope of any such subsidisation beyond that existing on 1 January 1955 by the introduction of new, or the extension of existing, subsidies.

5. The Contracting Parties shall review the operation of the provisions of this Article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this Agreement and avoiding subsidisation seriously prejudicial to the trade or interests of contracting parties.

C2 Agreement On Interpretation and Application of Articles VI, XVI and XXIII of The General Agreement on Tariffs and Trade (The Tokyo Subsidy Code)

The signatories[1] to this Agreement,

Noting that Ministers on 12-14 September 1973 agreed that the Multilateral Trade Negotiations should, *inter alia,* reduce or eliminate the trade restricting or distorting effects of non-tariff measures, and bring such measures under more effective international discipline,

Recognising that subsidies are used by governments to promote important objectives of national policy,

Recognising also that subsidies may have harmful effects on trade and production,

Recognising that the emphasis of this Agreement should be on the effects of subsidies and that these effects are to be assessed in giving due account to the internal economic situation of the signatories concerned as well as to the state of international economic and monetary relations,

Desiring to ensure that the use of subsidies does not adversely affect or prejudice the interest of any signatory to this Agreement, and that countervailing measures do not unjustifiably impede international trade, and that relief is made available to producers adversely affected by the use of subsidies within an agreed international framework of rights and obligations,

Taking into account the particular trade, development and financial needs of developing countries,

Desiring to apply fully and to interpret the Provisions of Articles V1, XVI and XXIII of the General Agreement on Tariffs and Trade[2] (hereinafter referred to as 'General Agreement' or 'GATT) only with respect to subsidies and countervailing measures and to elaborate rules for their application in order to provide greater uniformity and certainty in their implementation.

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[1] The term ‘signatories’ is hereinafter used to mean Parties to this Agreement.

[2] Whenever in this Agreement there is reference to ‘the terms of this Agreement’ or the ‘Articles’ or ‘provisions of this Agreement’ it shall be taken to mean, as the context requires, the Provisions of the General Agreement as interpreted and applied by this Agreement.

Desiring to provide for the speedy, effective and equitable resolution of disputes arising under this Agreement,

Have agreed as follows:

PART 1

Article 1: Application of Article V1 of the General Agreement[3]

Signatories shall take all necessary steps to ensure that the imposition of a countervailing duty[4] on any product of the territory of any signatory imported into the territory of another signatory is in accordance with the Provisions of Article VI of the General Agreement and the terms of this Agreement.

Article 2: Domestic procedures and related matters

1. Countervailing duties may only be imposed pursuant to investigations initiated[5] and conducted in accordance with the provisions of this Article. An investigation to determine the existence, degree and effect of any alleged subsidy shall normally be initiated upon a written request by or on behalf of the industry affected. The request shall include sufficient evidence of the existence of (a) a subsidy and, if possible, its amount, (b) injury within the meaning of Article V1 of the General Agreement as interpreted by this Agreement[6] and (c) a causal link between the subsidised imports and the alleged injury. If in special circumstances the authorities concerned decide to initiate an investigation without having received such a request, they shall proceed only if they have sufficient evidence on all points under (a) to (c) above.

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[3] The Provisions of both Part 1 and Part II of this Agreement may be invoked in parallel. However, with regard to the effects of a particular subsidy in the domestic market of the importing country, only one form of relief (either a countervailing duty or an authorised countermeasure) shall be available.

[4] The term 'countervailing duty' shall be understood to mean a special duty levied for the purpose of offsetting any bounty or subsidy bestowed directly or indirectly upon the manufacture, production or export of any merchandise, as provided for in Article V1:3 of the General Agreement.

[5] The term 'initiated' as used hereinafter means procedural action by which a signatory formally commences an investigation as provided in paragraph 3 of this Article.

[6] Under this Agreement the term 'injury' shall, unless otherwise specified, be taken to mean material injury to a domestic industry, threat of material injury to a domestic industry or material retardation of the establishment of such an industry and shall be interpreted in accordance with the provisions of Article 6.

2. Each signatory shall notify the Committee on Subsidies and Countervailing Measures[7] (a) which of its authorities are competent to initiate and conduct investigations referred to in this Article and (b) its domestic procedures governing the initiation and conduct of such investigations.

3. When the investigating authorities are satisfied that there is sufficient evidence to justify initiating an investigation, the signatory or signatories, the products of which are subject to such investigation and the exporters and importers known to the investigating authorities to have an interest therein and the complainants shall be notified and a public notice shall be given. In determining whether to initiate an investigation, the investigating authorities should take into account the position adopted by the affiliates of a complainant party[8] which are resident in the territory of another signatory.

4. Upon initiation of an investigation and thereafter, the evidence of both a subsidy and injury caused thereby should be considered simultaneously. In the event the evidence of both the existence of subsidy and injury shall be considered simultaneously (a) in the decision whether or not to initiate an investigation and (b) thereafter during the course of the investigation, starting on a date not later than the earliest date on which in accordance with the provision of this Agreement provisional measures may be applied.

5. The public notice referred to in paragraph 3 above shall describe the subsidy practice or practices to be investigated. Each signatory shall ensure that the investigating authorities afford all interested signatories and all interested parties[9] a reasonable opportunity, upon request, to see all relevant information that is not confidential (as indicated in paragraph 6 and 7 below) and that is used by the investigating authorities in the investigation, and to present in writing, and upon justification orally, their views to the investigating authorities.

6. Any information which is by nature confidential or which is provided on a confidential basis by parties to an investigation shall, upon cause shown, be treated as such by the investigating authorities. Such information shall not be disclosed without specific permission of the party submitting it.[10] Parties providing confidential information may be requested to furnish non-confidential summaries thereof. In the event such parties indicate that such information is not susceptible of summary, a statement of reasons why summarisation is not possible must be provided.

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[7] As established in Part V of this Agreement and hereinafter referred to as 'the Committee.'

[8] For the purposes of this Agreement 'party' means any natural or juridical person resident in the territory of any signatory.

[9] Any Interested signatory' or 'interested party' shall refer to a signatory or a party economically affected by the subsidy in question shall not be disclosed without specific permission of the party submitting it.

[10] Signatories are aware that in the territory of certain signatories disclosures pursuant to a narrowly-drawn

7. However, if the investigating authorities find that a request for confidentiality is not warranted and if the party requesting confidentiality is unwilling to disclose the information, such authorities may disregard such information unless it can otherwise be demonstrated to their satisfaction that the information is correct.[11]

8. The investigating authorities may carry out investigations in the territory of other signatories as required, provided they have notified in good time the signatory in question and unless the latter objects to the investigation. Further, the investigating authorities may carry out investigations on the premises of a firm and may examine the records of a firm if (a) the firm so agrees and (b) the signatory in question is notified and does not object.

9. In cases in which any interested party or signatory refuses access to, or otherwise does not provide, necessary information within a reasonable period or significantly impedes the investigation, preliminary and final findings[12], affirmative or negative, may be made on the basis of the facts available.

10. The procedures set out above are not intended to prevent the authorities of a signatory from proceeding expeditiously with regard to initiating an investigation, reaching preliminary or final findings, whether affirmative or negative, or from applying provisional or final measures, in accordance with relevant provisions of this Agreement.

11. In cases where products are not imported directly from the country of origin but are exported to the country of importation from an intermediate country, the provisions of this Agreement shall be fully applicable and the transaction or transactions shall, for the purposes of this Agreement, be regarded as having taken place between the country of origin and the country of importation.

12. An investigation shall be terminated when the investigating authorities are satisfied either that no subsidy exists or that the effect of the alleged subsidy on the industry is not such as to cause injury.

13. An investigation shall not hinder the procedures of customs clearance.

14. Investigations shall, except in special circumstances, be concluded within one year after their initiation.

15. Public notice shall be given of any preliminary or final finding whether affirmative or negative and of the revocation of a finding. In the case of an affirmative finding each such notice shall set forth

[11] Signatories agree that requests for confidentiality should not be arbitrarily rejected.

[12] Because of different terms used under different systems in various countries, the term 'finding' is hereinafter used to mean a formal decision or determination.

the findings and conclusions reached on all issues of fact and law considered material by the investigating authorities, and the reasons and basis therefor. In the case of a negative finding each notice shall set forth at least the basic conclusions and a summary of the reasons therefor. All notices of finding shall be forwarded to the signatory or signatories the products of which are subject to such finding and to the exporters known to have an interest therein.

16. Signatories shall report without delay to the Committee all preliminary or final actions taken with respect to countervailing duties. Such reports will be available in the GATT secretariat for inspection by government representatives. The Signatories shall also submit, on a semi-annual basis, reports on any countervailing duty actions taken within the preceding six months.

Article 3: Consultation

1. As soon as possible after a request for initiation of an investigation is accepted, and in any event before the initiation of any investigation, signatories the products of which may be subject to such investigation shall be afforded a reasonable opportunity for consultations with the aim of clarifying the situation as to the matters referred to in Article 2, paragraph 1 above and arriving at a mutually agreed solution.

2. Furthermore, throughout the period of investigation, signatories the products of which are the subject of the investigation shall be afforded a reasonable opportunity to continue consultations, with a view to clarifying the factual situation and to arriving at a mutually agreed solution.[13]

3. Without prejudice to the obligation to afford reasonable opportunity for consultation, these provisions regarding consultations are not intended to prevent the authorities of a signatory from proceeding expeditiously with regard to initiating the investigation, reaching preliminary or final findings, whether affirmative or negative, or from applying provisional or final measures, in accordance with the provisions of this Agreement.

4. The signatory which intends to initiate any investigation or is conducting such an investigation shall permit, upon request, the signatory or signatories the products of which are subject to such investigation access to non-confidential evidence including the non-confidential summary of confidential data being used for initiating or conducting the investigation.

[13] It is particularly important, in accordance with the provisions of this paragraph, that no affirmative finding whether preliminary or final be made without reasonable opportunity for consultations having been given. Such consultations may establish the basis for proceeding under the provisions of Part VI of this Agreement.

Article 4: imposition of countervailing duties

1. The decision whether or not to impose a countervailing duty in cases where all requirements for the imposition have been fulfilled and the decision whether the amount of the countervailing duty to be imposed shall be the full amount of the subsidy or less are decisions to be made by the authorities of the importing signatory. It is desirable that the imposition be permissive in the territory of all signatories and that the duty be less than the total amount of the subsidy if such lesser duty would be adequate to remove the injury to the domestic industry.

2. No countervailing duty shall be levied[14] on any imported product in excess of the amount of the subsidy found to exist, calculated in terms of subsidisation per unit of the subsidised and exported product.[15]

3. When a countervailing duty is imposed in respect of any product, such countervailing duty shall be levied, in the appropriate amounts, on a non-discriminatory basis on imports of such product from all sources found to be subsidised and to be causing injury, except as to imports from those sources which have renounced any subsidies in question or from which undertakings under the terms of this Agreement have been accepted.

4. If, after reasonable efforts have been made to complete consultations, a signatory makes a final determination of the existence and amount of the subsidy and that, through the effects of the subsidy, the subsidised imports are causing injury, it may impose a countervailing duty in accordance with the provisions of this section unless the subsidy is withdrawn.

5. (a) Proceedings may[16] be suspended or terminated without the imposition of provisional measures or countervailing duties, if undertakings are accepted under which:

   (i) the government of the exporting country agrees to eliminate or limit the subsidy or take other measures concerning its effects; or
   (ii) the exporter agrees to revise its prices so that the investigating authorities are satisfied that the injurious effect of the subsidy is eliminated. Price increases under undertakings shall not be higher than necessary to eliminate the amount of the subsidy. Price undertakings shall not be sought or accepted from exporters unless the importing signatory has first (1) initiated an investigation in accordance with the provisions of Article 2 of this Agreement and (2) obtained the consent of the exporting signatory.

[14] As used in this Agreement 'levy' shall mean the definitive or final legal assessment or collection of a duty or tax.

[15] An understanding among signatories should be developed setting out the criteria for the calculation of the amount of the subsidy.

[16] The word 'may' shall not be interpreted to allow the simultaneous continuation of proceedings with the implementation of price undertakings, except as provided in paragraph 5(b) of this Article.

Undertakings offered need not be accepted if the authorities of the importing signatory consider their acceptance impractical, for example if the number of actual or potential exporters is too great, or for other reasons.

(b) If the undertakings are accepted, the investigation of injury shall nevertheless be completed if the exporting signatory so desires or the importing signatory so decides. In such a case, if a determination of no injury or threat thereof is made, the undertaking shall automatically lapse, except in cases where a determination of no threat of injury is due in large part to the existence of an undertaking; in such cases the authorities concerned may require that an undertaking be maintained for a reasonable period consistent with the provisions of this Agreement.

(c) Price undertakings may be suggested by the authorities of the importing signatory, but no exporter shall be forced to enter into such an undertaking. The fact that governments or exporters do not offer such undertakings or do not accept an invitation to do so, shall in no way prejudice the consideration of the case. However, the authorities are free to determine that a threat of injury is more likely to be realised if the subsidised imports continue.

6. Authorities of an importing signatory may require any government or exporter from whom undertakings have been accepted to provide periodically information relevant to the fulfilment of such undertakings, and to permit verification of pertinent data. In case of violation of undertakings, the authorities of the importing signatory may take expeditious actions under this Agreement in conformity with its provisions which may constitute immediate application of provisional measures using the best information available. In such cases definitive duties may be levied in accordance with this Agreement on goods entered for consumption not more than ninety days before the application of such provisional measures, except that any such retroactive assessment shall not apply to imports entered before the violation of the undertaking.

7. Undertakings shall not remain in force any longer than countervailing duties could remain in force under this Agreement. The authorities of an importing signatory shall review the need for the continuation of any undertaking, where warranted, on their own initiative, or if interested exporters or importers of the product in question so request and submit positive information substantiating the need for such review.

8. Whenever a countervailing duty investigation is suspended or terminated pursuant to the provisions of paragraph 5 above and whenever an undertaking is terminated, this fact shall be officially notified and must be published. Such notices shall set forth at least the basic conclusions and a summary of the reasons therefor.

9. A countervailing duty shall remain in force only as long as, and to the extent necessary to counteract the subsidisation which is causing injury. The investigating authorities shall review the need for continued imposition of the duty, where warranted, on their own initiative or if any interested party so requests and submits positive information substantiating the need for review.

Article 5: Provisional measures and retroactivity

1. Provisional measures may be taken only after a preliminary affirmative finding has been made that a subsidy exists and that there is sufficient evidence of injury as provided for in Article 2, paragraph 1(a) to (c). Provisional measures shall not be applied unless the authorities concerned judge that they are necessary to prevent injury being caused during the period of investigation.

2. Provisional measures may take the form of provisional countervailing duties guaranteed by cash deposits or bonds equal to the amount of the provisionally calculated amount of subsidisation.

3. The imposition of provisional measures shall be limited to as short a period as possible, not exceeding four months.

4. The relevant provisions of Article 4 shall be followed in the imposition of provisional measures.

5. Where a final finding of injury (but not of a threat thereof or of a material retardation of the establishment of an industry) is made or in the case of a final finding of threat of injury where the effect of the subsidised imports would in the absence of the provisional measures, have led to a finding of injury, countervailing duties may be levied retroactively for the period for which provisional measures, if any, have been applied.

6. If the definitive countervailing duty is higher than the amount guaranteed by the cash deposit or bond, the difference shall not be collected. If the definitive duty is less than the amount guaranteed by the cash deposit or bond, the excess amount shall be reimbursed or the bond released in an expeditious manner.

7. Except as provided in paragraph 5 above, where a finding of threat of injury or material retardation is made (but no injury has yet occurred) a definitive countervailing duty may be imposed only from the date of the finding of threat of injury or material retardation and any cash deposit made during the period of the application of provisional measures shall be refunded and any bonds released in an expeditious manner.

8. Where a final finding is negative any cash deposit made during the period of the application of provisional measures shall be refunded and any bonds released in an expeditious manner.

9. In critical circumstances where for the subsidised product in question the authorities find that injury which is difficult to repair is caused by massive imports in a relatively short period of a product benefiting from export subsidies paid or bestowed inconsistently with the provisions of the General Agreement and of this Agreement and where it is deemed necessary, in order to preclude the recurrence of such injury, to assess countervailing duties retroactively on those imports, the definitive countervailing duties may be assessed on imports which were entered for consumption not more than ninety days prior to the date of application of provisional measures.

Article 6: Determination of injury

1. A determination of injury[17] for purposes of Article V1 of the General Agreement shall involve an objective examination of both (a) the volume of subsidised imports and their effect on prices in the domestic market for like products[18] and (b) the consequent impact of these imports on domestic producers of such products.

2. With regard to volume of subsidised imports the investigating authorities shall consider whether there has been a significant increase in subsidised imports, either in absolute terms or relative to production or consumption in the importing signatory. With regard to the effect of the subsidised imports on prices, the investigating authorities shall consider whether there has been a significant price undercutting by the subsidised imports as compared with the price of a like product of the importing signatory, or whether the effect of such imports is otherwise to depress prices to a significant degree or prevent price increases, which otherwise would have occurred, to a significant degree. No one or several of these factors can necessarily give decisive guidance.

3. The examination of the impact on the domestic industry concerned shall include an evaluation of all relevant economic factors and indices having a bearing on the state of the industry such as actual and potential decline in output, sales, market share, profits, productivity, return on investments, or utilisation of capacity; factors affecting domestic prices; actual and potential negative effects on cash flow, inventories, employment, wages, growth, ability to raise capital or investment and, in the case of agriculture, whether there has been an increased burden on Government support programmes. This list is not exhaustive, nor can one or several of these factors necessarily give decisive guidance.

[17] Determinations of injury under the criteria set forth in this Article shall be based on positive evidence. In determining threat of injury the investigating authorities, in examining the factors listed in this Article, may take into account the evidence on the nature of the subsidy in question and the trade effects likely to arise therefrom.

[18] Throughout this Agreement the term 'like product' ('product similaire') shall be interpreted to mean a product which is identical, i.e. alike in all respects to the product under consideration or in the absence of such a product, another product which although not alike in all respects, has characteristics closely resembling those of the product under consideration.

4. It must be demonstrated that the subsidised imports are, through the effects[19] of the subsidy, causing injury within the meaning of this Agreement. There may be other factors[20] which at the same time are injuring the domestic industry, and the injuries caused by other factors must not be attributed to the subsidised imports.

5. In determining injury, the term 'domestic industry' shall, except as provided in paragraph 7 below, be interpreted as referring to the domestic producers as a whole of the like products or to those of them whose collective output of the products constitutes a major proportion of the total domestic production of these products, except that when producers are related[21] to the exporters or importers or are themselves importers of the allegedly subsidised product the industry may be interpreted as referring to the rest of the producers .

6. The effect of the subsidised imports shall be assessed in relation to the domestic production of the like product when available data permit the separate identification of production in terms of such criteria as: the production process, the producers' realisation, profits. When the domestic production of the like product has no separate identity in these terms of effects of subsidised imports shall be assessed by the examination of the production of the narrowest group or range of products, which includes the like product, for which the necessary information can be provided.

7. In exceptional circumstances the territory of a signatory may, for the production in question, be divided into two or more competitive markets and the producers within each market may be regarded as a separate industry if (a) the producers within such market sell all or almost all of their production of the product in question in that market, and (b) the demand in that market is not to any substantial degree supplied by producers of the product in question located elsewhere in the territory. In such circumstances injury may be found to exist even where a major portion of the total domestic industry is not injured provided there is a concentration of subsidised imports into such an isolated market and provided further that the subsidised imports are causing injury to the producers of all or almost all of the production within such market.

8. When the industry has been interpreted as referring to the producers in a certain area, as defined in paragraph 7 above, countervailing duties shall be levied only on the products in question consigned

[19] As set forth in paragraphs 2 and 3 of this Article.

[20] Such factors can include *inter alia,* the volume and prices of non-subsidised imports of the product in question, contraction in demand or changes in the pattern of consumption, trade restrictive practices of and competition between the foreign and domestic producers, developments in technology and the export performance and productivity of the domestic industry.

[21] The Committee should develop a definition of the word 'related' as used in this paragraph.

for final consumption to that area. When the constitutional law of the importing signatory does not permit the levying of countervailing duties on such a basis, the importing signatory may levy the countervailing duties without limitation, only if (a) the exporters shall have been given an opportunity to cease exporting at subsidised prices to the area concerned or otherwise give assurances pursuant to Article 4, paragraph 5, of this Agreement, and adequate assurances in this regard have not been promptly given, and (b) such duties cannot be levied only on products of specific producers which supply the area in question.

9. Where two or more countries have reached under the provisions of Article XXIV:8(a) of the General Agreement such a level of integration that they have the characteristics of a single, unified market the industry in the entire area of integration shall be taken to the industry referred to in paragraphs 5 to 7 above.

Part II

Article 7. Notification of subsidies[22]

1. Having regard to the provision of Article XVI:1 of the General Agreement, any signatory may make a written request for information on the nature and extent of any subsidy granted or maintained by another signatory (including any form of income or price support) which operates directly or indirectly to increase exports of any product from or reduce imports of any product into its territory.

2. Signatories so requested shall provide such information as quickly as possible and in a comprehensive manner, and shall be ready, upon request, to provide additional information to the requesting signatory. Any signatory which considers that such information has not been provided may bring the matter to the attention of the Committee.

3. Any interested signatory which considers that any practice of another signatory having the effects of a subsidy has not been notified in accordance with the provisions of Article XVI:1 of the General Agreement may bring the matter to the attention of such other signatory. If the subsidy practice is not thereafter notified promptly, such signatory may itself bring the subsidy practice in question to the notice of the Committee.

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[22] In this Agreement, the term 'subsidies' shall be deemed to include subsidies granted by any government or any public body within the territory of signatory. However, it is recognised that for signatories with different federal systems of government, there are different divisions of powers. Such signatories accept nonetheless the international consequences that may arise under this Agreement as a result of the granting of subsidies within their territories.

Article 8: Subsidies - General provisions

1. Signatories recognise that subsidies are used by governments to promote important objectives of social and economic policy. Signatories also recognise that subsidies may cause adverse effects to the interests of other signatories.

2. Signatories agree not to use export subsidies in a manner inconsistent with the provisions of this Agreement.

3. Signatories further agree that they shall seek to avoid causing, through the use of any subsidy:

   (a) injury to the domestic industry of another signatory,[23]

   (b) nullification or impairment of the benefits accruing directly or indirectly to another signatory under the General Agreement,[24] or

   (c) serious prejudice to the interests of another signatory.[25]

4. The adverse effects to the interests of another signatory required to demonstrate nullification or impairment[26] or serious prejudice may arise through

   (a) the effects of the subsidised imports in the domestic market of the importing signatory,

   (b) the effects of the subsidy in displacing or impeding the imports of like products into the market of the subsidising country, or

   (c) the effects of the subsidised exports in displacing[27] the exports of like products of another signatory from a third country market.[28]

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[23] Injury to the domestic industry is used here in the same sense as it is used in Part 1 of this Agreement.

[24] Benefits accruing directly or indirectly under the General Agreement include the benefits of tariff concessions bound under Article H of the General Agreement.

[25] Serious prejudice to the interests of another signatory is used in this Agreement in the same sense as it is used in Article XVIA of the General Agreement and includes threat of serious prejudice.

[26] Signatories recognize that nullification or impairment of benefits may also arise through the failure of a signatory to carry out its obligations under the General Agreement or this Agreement. Where such failure concerning export subsidies is determined by the Committee to exist, adverse effects may, without prejudice to paragraph 9 of Article 18 below, be presumed to exist. The other signatory will be accorded a reasonable opportunity to rebut this presumption.

[27] The term 'displacing' shall be interpreted in a manner which takes into account the trade and development needs of developing countries and in this connection is not intended to fix traditional market shares.

[28] The problem of third country markets so far as certain primary products are concerned is dealt with exclusively under Article 10 below.

Article 9: Export subsidies on products other than certain primary products[29]

1 Signatories shall not grant export subsidies on products other than certain primary products.

2. The practices listed in points (a) to (1) in the Annex are illustrative of export subsidies.

Article 10: Export subsidies on certain primary products

1. In accordance with the provisions of Article XVI:3 of the General Agreement, signatories agree not to grant directly or indirectly any export subsidy on certain primary products in a manner which results in the signatory granting such subsidy having more than an equitable share of world export trade in such product, account being taken of the shares of the signatories in trade in the product concerned during a previous representative period, and any special factors which may have affected or may be affecting trade in such product.

2. For purposes of Article XVI:3 of the General Agreement and paragraph 1 above:

   (a) 'more than equitable share of world export trade' shall include any case in which the effect of an export subsidy granted by a signatory is to displace the exports of another signatory bearing in mind the developments on world markets;

   (b) with regard to new markets traditional patterns of supply of the product concerned to the world markets region or country, n which the new market is situated shall be taken into account in determining 'equitable share of world export trade';

   (c) 'a previous representative period' shall normally be the three most recent calendar years in which normal market conditions existed.

3. Signatories further agree not to grant export subsidies on exports of certain primary products to a particular market in a manner which results in prices materially below those of other suppliers to the same market.

Article 11: Subsidies other than export subsidies

1. Signatories recognise that subsidies other than export subsidies are widely used as important instruments for the promotion of social and economic policy objectives and do not intend to restrict the right of signatories to use such subsidies to achieve these and other important policy objectives which they consider desirable. Signatories note that among such objectives are:

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[29] For purposes of this Agreement 'certain primary products' means the products referred to in Note Ad Article XVI of the General Agreement, Section B, paragraph 2, with the deletion of the words 'or any mineral'.

(a) the elimination of industrial, economic and social disadvantages of specific regions,

(b) to facilitate the restructuring, under socially acceptable conditions, of certain sectors, especially where this has become necessary by reason of changes in trade and economic policies, including international agreements resulting in lower barriers to trade,

(c) generally to sustain employment and to encourage re-training and change in employment,

(d) to encourage research and development programmes, especially in the field of high-technology industries,

(e) the implementation of economic programmes and policies to promote the economic and social development of developing countries,

(f) redeployment of industry in order to avoid congestion and environmental problems.

2. Signatories recognise, however, that subsidies other than export subsidies, certain objectives and possible form of which are described, respectively, in paragraphs 1 and 3 of this Article, may cause or threaten to cause injury to a domestic industry of another signatory or serious prejudice to the interests of another signatory or may nullify or impair benefits accruing to another signatory under the General Agreement, in particular where such subsidies would adversely affect the conditions of normal competition. Signatories shall therefore seek to avoid causing such effects through the use of subsidies. In particular, signatories, when drawing up their policies and practices in this field, in addition to evaluating the essential internal objectives to be achieved, shall also weigh, as far as practicable, taking account of the nature of the particular case, possible adverse effects on trade. They shall also consider the conditions of world trade, production (e.g. price, capacity utilisation etc.) and supply in the product concerned.

3. Signatories recognise that the objectives mentioned in paragraph 1 above may be achieved, *inter alia,* by means of subsidies granted with the aim of giving an advantage to certain enterprises. Examples of possible forms of such subsidies are: government financing of commercial enterprises, including grants, loans or guarantees; government provision or government financed provision of utility, supply distribution and other operational or support services or facilities; government financing of research and development programmes; fiscal incentives; and government subscription to, or provision of, equity capital.

Signatories note that the above form of subsidies are normally granted either regionally or by sector. The enumeration of forms of subsidies set out above is illustrative and non-exhaustive, and reflects these currently granted by a number of signatories to this Agreement.

Signatories recognise, nevertheless, that the enumeration of forms of subsidies set out above should be reviewed periodically and that this should be done, through consultations, in conformity with the spirit of Article XVI:5 of the General Agreement.

4. Signatories recognise further that, without prejudice to their rights under this Agreement, nothing in paragraphs 1 -- 3 above and in particular the enumeration of forms of subsidies creates, in itself, any basis for action under the General Agreement, as interpreted by this Agreement.

Article 12: Consultations

1. Whenever a signatory has reason to believe that an export subsidy is being granted or maintained by another signatory in a manner inconsistent with the provisions of this Agreement, such signatory may request consultations on with such other signatory.

2. A request for consultations under paragraph 1 above shall include a statement of available evidence with regard to the existence and nature of the subsidy in question.

3. Whenever a signatory has reason to believe that any subsidy is being granted or maintained by another signatory and that such subsidy either causes injury to its domestic industry, nullification or impairment of benefits accruing to it under the General Agreement, or serious prejudice to its interests, such signatory may request consultations with such other signatory.

4. A request for consultations under paragraph 3 above shall include a statement of available evidence with regard to (a) the existence and nature of the subsidy in question and (b) the injury caused to the domestic industry or, in the case of nullification or impairment, or serious prejudice, the adverse effects caused to the interests of the signatory requesting consultations.

5. Upon request for consultations under paragraph 1 or paragraph 3 above, the signatory believed to be granting or maintaining the subsidy practice in question shall enter into such consultations as quickly as possible. The purpose of the consultations shall be to clarify the facts of the situation and to arrive at a mutually acceptable solution.

Article 13: Conciliation, dispute settlement and authorised countermeasures

1. If, in the case of consultations under paragraph 1 of Article 12, a mutually acceptable solution has not been reached within thirty days[30] of the request for consultations, any signatory party to such consultations may refer the matter to the Committee for conciliation in accordance with the provisions of Part VI.

[30] Any time periods mentioned in this Article and in Article 18 may be extended by mutual agreement.

2. If, in the case of consultations under paragraph 3 of Article 12, a mutually acceptable solution has not been reached within sixty days of the request for consultations, any signatory party to such consultations may refer the matter to the Committee for conciliation in accordance with the provisions of Part VI.

3. If any dispute arising under this Agreement is not resolved as a result of consultations or conciliations, the Committee shall, upon request, review the matter in accordance with the dispute settlement procedures of Part VI.

4. If, as a result of its review, the Committee concludes that an export subsidy is being granted in a manner inconsistent with the provisions of this Agreement or that a subsidy is being granted or maintained in such a manner as to cause injury, nullification or impairment, or serious prejudice, it shall make such recommendations[31] to the parties as may be appropriate to resolve the issue and, in the event the recommendations are not followed, it may authorise such countermeasures as may be appropriate, taking into account the degree and nature of the adverse effects found to exist, in accordance with the relevant provisions of Part VI.

Part III

Article 14: Developing Countries

1. Signatories recognise that subsidies are an integral part of economic development programmes of developing countries.

2. Accordingly, this Agreement shall not prevent developing country signatories from adopting measures and policies to assist their industries, including those in the export sector. In particular the commitment of Article 9 shall not apply to developing country signatories, subject to the provisions of paragraphs 5 through 8 below.

3. Developing country signatories agree that export subsidies on their industrial products shall not be used in a manner which causes serious prejudice to the trade or production of another signatory.

4. There shall be no presumption that export subsidies granted by developing country signatories result in adverse effects, as defined in this Agreement, to the trade or production of another signatory. Such adverse effects shall be demonstrated by positive evidence, through an economic examination of the impact on trade or production of another signatory.

[31] In making such recommendations, the Committee shall take into account the trade, development and financial needs of developing country signatories.

5. A developing country signatory should endeavour to enter into a commitment[32] to reduce or eliminate export subsidies when the use of such export subsidies is inconsistent with its competitive and development needs.

6. When a developing country has entered into a commitment to reduce or eliminate export subsidies, as provided in paragraph 5 above, countermeasures pursuant to the provisions of Parts 11 and V1 of this Agreement against any export subsidies of such developing country shall not be authorised for other signatories of this Agreement, provided that the export subsidies in question are in accordance with the terms of the commitment referred to in paragraph 5 above.

7. With respect to any subsidy, other than an export subsidy, granted by a developing country signatory, action may not be authorised or taken under Parts 11 and V1 of this Agreement, unless nullification or impairment of tariff concessions or other obligations under the General Agreement is found to exist as a result of such subsidy, in such a way as to displace or impede imports of like products into the market of the subsidising country, or unless injury to domestic industry in the importing market of a signatory occurs in terms of Article V1 of the General Agreement, as interpreted and applied by this Agreement. Signatories recognise that in developing countries, governments may play a large role in promoting economic growth and development. Intervention by such governments in their economy, for example through the practices enumerated in paragraphs 3 of Article 11, shall not, per se, be considered subsidies.

8. The Committee shall, upon request by an interested signatory, undertake a review of a specific export subsidy practice of a developing country signatory to examine the extent to which the practice is in conformity with the objectives of this Agreement. If a developing country has entered into a commitment pursuant to paragraph 5 of this Article, it shall not be subject to such review for the period of that commitment.

9. The Committee shall, upon request by an interested signatory, also undertake similar reviews of measures maintained or taken by developed country signatories under the provisions of this Agreement which affect interests of a developing country signatory.

10. Signatories recognise that the obligations of this Agreement with respect to export subsidies for certain primary products apply to all signatories.

[32] It is understood that after this Agreement has entered into force, any such proposed commitment shall be notified to the Committee in good time.

Article 15: Special Situations

1. In cases of alleged injury caused by imports from a country described in NOTES AND SUPPLEMENTARY PROVISIONS to the General Agreement (Annex I, Article VI, paragraph 1, point 2) the importing signatory may base its procedures and measures either

   (a) on this Agreement, or, alternatively

   (b) on the Agreement on Implementation of Article V1 of the General Agreement on Tariffs And Trade.

2. It is understood that in both cases (a) and (b) above the calculation of the margin of dumping or of the amount of the estimated subsidy can be made by comparison of the export price with

   (a) the price at which a like product of a country other than the importing signatory or those mentioned above is sold, or

   (b) the constructed value[33] of a like product in a country other than the importing signatory or those mentioned above.

3. If neither prices nor constructed value as established under (a) or (b) of paragraph 2 above provide an adequate basis for determination of dumping or subsidisation then the price in the importing signatory, if necessary duly adjusted to reflect reasonable profits, may be used.

4. All calculations under the provisions of paragraph 2 and 3 above shall be based on prices or costs ruling at the same level of trade, normally at the ex factory level, and in respect of operations made as nearly as possible at the same time. Due allowance shall be made in each case, on its merits, for the difference in conditions and terms of sale or in taxation and for the other differences affecting price comparability, so that the method of comparison applied is appropriate and not unreasonable.

Part V

Article 16: Committee on Subsidies and Countervailing Measures

1. There shall be established under this Agreement a Committee on Subsidies and Countervailing Measures composed of representatives from each of the signatories to this Agreement. The Committee shall elect its own Chairman and shall meet not less than twice a year and otherwise as envisaged by relevant provisions of this Agreement at the request of any signatory. The Committee

[33] Constructed value means cost of production plus a reasonable amount for administration, selling and any other costs and for profits.

shall carry out responsibilities as assigned to it under this Agreement or by the signatories and it shall afford signatories the opportunity of consulting on any matters relating to the operation of the Agreement or the furtherance of its objectives. The GAIT secretariat shall act as the secretariat to the Committee.

2. The Committee may set up subsidiary bodies as appropriate.

3. In carrying out their functions, the Committee and any subsidiary bodies may consult with and seek information from any source they deem appropriate. However, before the Committee or a subsidiary body seeks such information from a source within the jurisdiction of a signatory, it shall inform the signatory involved.

Part VI

Article 17: Conciliation

1. In cases where matters are referred to the Committee for conciliation failing a mutually agreed solution in consultations under any provision of this Agreement, the Committee shall immediately review the facts involved and, through its good offices, shall encourage the signatories involved to develop a mutually acceptable solution.[34]

2. Signatories shall make their best efforts to reach a mutually satisfactory solution throughout the period of conciliation.

3. Should the matter remain unresolved, notwithstanding efforts at conciliation made under paragraph 2 above, any signatory involved may, thirty days after the request for conciliation, request that a panel be established by the Committee in accordance with the provisions of Article 18 below.

Article 18: Dispute Settlement

1. The Committee shall establish a panel upon request pursuant to paragraph 3 of Article 17.[35] A panel so established shall review the facts of the matter and, in light of such facts, shall present to the Committee its findings concerning the rights and obligations of the signatories party to the dispute under the relevant provisions of the General Agreement as interpreted and applied by this Agreement.

[34] In this connexion, the Committee may draw signatories' attention to those cases in which, in its view, there is no reasonable basis supporting the allegations made.

[35] This does not preclude, however, the more rapid establishment of a panel when the Committee so decides, taking into account the urgency of the situation.

2. A panel should be established within thirty days of a request therefor[36] and a panel so established should deliver its findings to the Committee within sixty days after its establishment.

3. When a panel is to be established, the Chairman of the Committee, after securing the agreement of the signatories concerned, should propose the composition of the panel. Panels shall be composed of three or five members, preferably governmental, and the composition of panels should not give rise to delays in their establishment. It is understood that citizens of countries whose governments[37] are parties to the dispute would not be members of the panel concerned with that dispute.

4. In order to facilitate the constitution of panels, the Chairman of the Committee should maintain an informal indicative list of governmental and non-governmental persons qualified in the fields of trade relations, economic development, and other matters covered by General Agreement and this Agreement, who could be available for serving on panels. For this purpose, each signatory would be invited to indicate at the beginning of every year to the Chairman of the Committee the name of one or two persons who would be available for such work.

5. Panel members would serve in their individual capacities and not as government representatives, nor as representatives of any organisation. Governments would therefore not give them instructions with regard to matters before a panel. Panel members should be selected with a view to ensuring the independence of the members, a sufficiently diverse background and a wide spectrum of experience.

6. To encourage development of mutually satisfactory solutions between the parties to a dispute and with a view to obtaining their comments, each panel should first submit the descriptive part of its report to the parties concerned, and should subsequently submit to the parties to the dispute its conclusions, or an outline thereof, a reasonable period of time before they are circulated to the Committee.

7. If a mutually satisfactory solution is developed by the parties to a dispute before a panel, any signatory with an interest in the matter has a right to enquire about and be given appropriate information about that solution and a notice outlining the solution that has been reached shall be presented by the panel to the Committee.

8. In cases where the parties to a dispute have failed to come to a satisfactory solution, the panels shall submit a written report to the Committee which should set forth the findings of the panel as to the questions of fact and the application of the relevant provisions of the General Agreement as interpreted and applied by this Agreement and the reasons and bases therefor.

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[36] The parties to the dispute would respond within a short period of time, ie. seven working days, to nominations of panel members by the Chairman of the Committee and would not oppose nominations except for compelling reasons.

[37] The term ‘governments’ is understood to mean governments of all member countries in cases of customs unions.

9. The Committee shall consider the panel report as soon as possible and taking into account the findings contained therein, may make recommendations to the parties with a view to resolving the dispute. If the Committee's recommendations are not followed within a reasonable period, the Committee may authorise appropriate countermeasures (including withdrawal of GATT concessions or obligations) taking into account the nature and degree of the adverse effect found to exist. Committee recommendations should be presented to the parties within thirty days of the receipt of the panel report.

Part VII

Article 19: Final Provisions

1. No specific action against a subsidy of another signatory can be taken except in accordance with the provisions of the General Agreement, as interpreted by this Agreement.[38]

Acceptance and accession

2. (a) This Agreement shall be open for acceptance by signature or otherwise, by governments contracting parties to the GATT and by the European Economic Community.

   (b) This Agreement shall be open for acceptance, by signature or otherwise by governments having provisionally acceded to the GATT, on terms related to the effective application of rights and obligations under this Agreement, which take into account rights and obligations in the instruments providing for their provisional accession.

   (c) This Agreement shall be open to accession by any other government on terms, related to the effective application of rights and obligations under this Agreement, to be agreed between that government and the signatories, by the deposit with the Director-General to the Contracting Parties to the GATT of an instrument of accession which states the terms so agreed.

   (d) In regard to acceptance, the provisions of Article XXVI:5(a) and (b) of the General Agreement would be applicable.

[38] This paragraph is not intended to preclude action under other relevant provisions of the General Agreement, where appropriate.

Reservations

3. Reservations may not be entered in respect of any of the provisions of this Agreement without the consent of the other signatories.

Entry into force

4. This Agreement shall enter into force on 1 January 1980 for the governments[39] which have accepted or acceded to it by that date. For each other government it shall enter into force on the thirtieth day following the date of its acceptance or accession to this Agreement.

National legislation

5. (a) Each government accepting or acceding to this Agreement shall take all necessary steps, of a general or particular character, to ensure, not later than the date of entry into force of this Agreement for it, the conformity of its laws, regulations and administrative procedures with the provisions of this Agreement as they may apply to the signatory in question.

(b) Each signatory shall inform the Committee of any changes in its laws and regulations relevant to this Agreement and in the administration of such laws and regulations.

Review

6. The Committee shall review annually the implementation and operation of this Agreement taking into account the objectives thereof. The Committee shall annually inform the Contracting Parties to the GAIT of developments during the period covered by such reviews.[40]

Amendments

7. The signatories may amend this Agreement having regard, *inter alia,* to the experience gained in its implementation. Such an amendment, once the signatories have concurred in accordance with procedures established by the Committee, shall not come into force for any signatory until it has been accepted by such signatory.

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[39] The term 'governments' is deemed to include the competent authorities of the European Economic Community.

[40] At the first review, the Committee shall, in addition to its general review of the operation of the Agreement, offer all interested signatories an opportunity to raise questions and discuss issues concerning specific subsidy practices and the impact on trade, if any, of certain direct tax practices.

Withdrawal

8. Any signatory may withdraw from this Agreement. The withdrawal shall take effect upon the expiration of sixty days from the day on which written notice of withdrawal is received by the Director-General to the CONTRACTING PARTIES to the GATT. Any signatories may upon such notification request an immediate meeting of the Committee.

Non-application of this agreement between particular signatories

9. This Agreement shall not apply as between any two signatories if either of the signatories, at the time either accepts or accedes to this Agreement, does not consent to such application.

Annex

10. The Annex to this Agreement constitutes an integral part thereof.

Secretariat

11. This Agreement shall be serviced by the GATT Secretariat.

Deposit

12. This Agreement shall be deposited with the Director-General to the Contracting Parties to the GATT who shall promptly furnish to each signatory and each Contracting Party to the GATT a certified copy thereof and of each amendment thereto pursuant to paragraph 7, and a notification of each acceptance thereof or accession thereto pursuant to paragraph 2, and of each withdrawal therefrom pursuant to paragraph 8 of this Article.

Registration

13. This Agreement shall be registered in accordance with the provision of Article 102 of the Charter of the United Nations.

Done at Geneva this twelfth day of April nineteen hundred and seventy-nine in a single copy in the English, French and Spanish languages, each text being authentic.

Illustrative List of Export Subsidies

(a) The provision by governments of direct subsidies to a firm or an industry contingent upon export performance.

(b) Currency retention schemes or any similar practices which involve a bonus on exports.

(c) Internal transport and freight charges on export shipments, provided or mandated by governments, on terms more favourable than for domestic shipments.

(d) The delivery by governments or their agencies of imported or domestic products or services for use in the production of exported goods, on terms or conditions more favourable than for delivery of like or directly competitive products or services for use in the production of goods for domestic consumption, if (in the case of products) such terms or conditions are more favourable than those commercially available on world markets to their exporters.

(e) The full or partial exemption, remission, or deferral specifically related to exports, of direct taxes (Note 1) or social welfare charges paid or payable by industrial or commercial enterprises (Note 2).

(f) The allowance of special deductions directly related to exports or export performance, over and above those granted in respect to production for domestic consumption, in the calculation of the base on which direct taxes are charged.

(g) The exemption or remission in respect of the production and distribution of exported products, of indirect taxes (Note 1) in excess of those levied in respect of the production and distribution of like products when sold for domestic consumption.

(h) The exemption, remission or deferral of prior stage cumulative indirect taxes (Note 1) on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior stage cumulative indirect taxes are levied on goods that are physically incorporated (making normal allowance for waste) in the exported product (Note 3).

(i) The remission or drawback of import charges (Note 1) in excess of those levied on imported goods that are physically incorporated (making normal allowance for waste) in the exported product; provided, however, that in particular cases a firm may use a quantity of home market goods equal to, and having the same quality and characteristics as, the imported goods as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, normally not to exceed two years.

(j) The provision by governments (or special institutions controlled by governments) of export credit guarantees or insurance programmes, of insurance or guarantee programmes against increases in the costs of exported products (Note 4) or of exchange risk programmes, at premium rates, which are manifestly inadequate to cover the long-term operating costs and losses of the programmes (Note 5).

(k) The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters or financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.

Provided, however, that if a signatory is a party to an international undertaking on official export credits to which at least twelve original signatories (Note 6) to this Agreement are parties as of 1 January 1979 (or a successor undertaking which has been adopted by those original signatories), or if in practice a signatory applies the interest rates provisions of the relevant undertaking, an export credit practice which is in conformity with those provisions shall not be considered an export subsidy prohibited by this Agreement.

(1) Any other charge on the public account constituting an export subsidy in the sense of Article XVI of the General Agreement.

Notes

1 For the purpose of this Agreement:

The term 'direct taxes' shall mean taxes on wages, profits, interest, rents, royalties, and all other forms of income, and taxes on the ownership of real property;

The term 'import charges' shall mean tariffs, duties, and other fiscal charges not elsewhere enumerated in this note that are levied on imports;

The term 'indirect taxes' shall mean sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes and all taxes other than direct taxes and import charges;

'Prior stage' indirect taxes are those levied on goods or services used directly or indirectly in making the product:

'Cumulative' indirect taxes are multi-staged taxes levied where there is no mechanism for subsequent crediting of the tax if the goods or services subject to tax at one stage of production are used in a succeeding stage of production;

'Remission' of taxes includes the refund or rebate of taxes.

2 The signatories recognise that deferral need not amount to an export subsidy where, for example, appropriate interest charges are collected. The signatories further recognise that nothing in this text

prejudges the disposition by the Contracting Parties of the specific issues raised in GATT document L/4422. The signatories reaffirm the principle that prices for goods in transactions between exporting enterprises and foreign buyers under their or under the same control should for tax purposes be the prices which would be charged between independent enterprises acting at arm's length. Any signatory may draw the attention of another signatory to administrative or other practices which may contravene this principle and which result in a significant saving of direct taxes in export transactions. In such circumstances the signatories shall normally attempt to resolve their differences using the facilities of existing bilateral tax treaties or other specific international mechanisms, without prejudice to the rights and obligations of signatories under the General Agreement, including the right of consultation created in the preceding sentence.

Paragraph (e) is not intended to limit a signatory from taking measures to avoid the double taxation of foreign source income earned by its enterprises of the enterprises of another signatory.

Where measures incompatible with the provisions of paragraph (e) exist, and where major practical difficulties stand in the way of the signatory concerned bringing such measures promptly into conformity with the Agreement, the signatory concerned shall, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable period of time.

In this connexion the European Economic Community has declared that Ireland intends to withdraw by 1 January 1981 its system of preferential tax measures related to exports, provided for under the Corporation Tax Act of 1976, whilst continuing nevertheless to honour legally binding commitments entered into during the lifetime of this system.

3 Paragraph (h) does not apply to value-added tax systems and border-tax adjustment in lieu thereof; the problem of the excessive remission of value-added taxes is exclusively covered by paragraph (g).

4 The signatories agree that nothing in this paragraph shall prejudge or influence the deliberations of the panel established by the GATT Council on 6 June 1978 (C/M/126).

5 In evaluating the long-term adequacy of premium rates, costs and losses of insurance programmes, in principle only such contracts shall be taken into account that were concluded after the date of entry into force of this Agreement.

6 An original signatory to this Agreement shall mean any signatory which adheres ad referendum to the Agreement on or before 30 June 1979.

C3 Letter from Australia to the United States concerning the Subsidies Code

Embassy of Australia
Washington, DC
25 September 1981

The Honourable Williarn Brock,
United States Trade Representative,
Suite 209,
600 17th Street, NW,
Washington, DC 20506

Dear Ambassador Brock,

With reference to bilateral discussions between representatives of the Government of the United States of America and the Government of Australia regarding acceptance by the Government of Australia of the Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade done at Geneva on 12 April 1979 (called 'The Code') and regarding the basis on which each Government will apply provisionally to the other the rights and obligations of the Code when it enters into force between them, 1 wish to inform you that the following represents the understanding of my Government of the outcome of those discussions.

1. The Government of Australia will accept the Code by 29 September 1981 on which occasion it will lodge the statement at Annex A with the GATT Secretariat, for circulation to the parties to the Code and to other GATT Contracting Parties.

2. The rights and obligations of the Code will apply between our two Governments subject to the right of each Government to terminate the application of the Code to the other Government if its expectations, as set out below, are not realised. This right will not prejudice the right of withdrawal under Article 19.8 of the Code.

3. While recognising that the Government of the United States of America is not in a position to commit itself with respect to the following the Government of Australia has the expectation:

   (1) That the Government of the United States of America will not operate a Domestic International Sales Corporation System (DISC) in a manner inconsistent with the Code beyond a reasonable time, which in the view of the Government of Australia will be no later than 30 June 1983, and

   (II) That the DISC will not be modified to increase the value of benefits available that are not in conformity with the Code over those available under existing criteria.

4. In addition, the Government of Australia has the expectation:

(1) That the Government of the United States of America will not introduce any new export incentive schemes, the use of which is proscribed by the Code.

(I1) That the Government of the United States of America will recognise Australia as a 'country under the Agreement' in terms of the United States countervailing duty law and will accord Australian exports the benefit of a material injury test in any countervailing duty investigations affecting these exports, and

(111) That our two Governments will co-operate in the Code in the development of disciplines relating to agricultural export subsidies which are substantially equivalent to those adopted in respect of products other than certain primary products as defined in the Code.

5. Similarly, while recognising that the Government of Australia is not in a position to commit itself to the following, the Government of the United States of America has the expectation:

(1) That the Government of Australia will not operate an Export Expansion Grants (EEG) Scheme or an Export Market Development Grants (EMDG) Scheme in a manner inconsistent with the Code beyond a reasonable time which in the view of the Government of the United States of America will be no later than 30 June 1983, and

(11) That the EEG and EMDG schemes will not be modified to increase the value of benefits available that are not in conformity with the Code over those available under existing criteria. In this connection, the 'value of benefits' means the rate of assistance expressed *inter a1ia* as a maximum amount payable and/or as a percentage. In addition, neither scheme will be modified to permit new sectors or products that would not be eligible under existing legislation to qualify for benefits proscribed by the Code.

6. In addition, the Government of the United States of America has the expectation:

(I) That the Government of Australia will not introduce any new export incentive schemes, the use of which is proscribed by the Code, and

(11) That our two Governments will co-operate in the Code in the development of disciplines relating to agricultural export subsidies which are substantially equivalent to those adopted in respect of products other than certain primary

7. Our two Governments will consult prior to any proposed termination of the application of the Code to one another.

8. Each of our Governments will lodge with the Director-General of the GATT, as depositary of the Code, the relevant statement set out in Annex B.

9. 1 should be grateful to have your confirmation that the understanding of your Government conforms with the foregoing.

Yours sincerely,

Nicholas Parkinson

Annex A: Statement by the Government of Australia on Acceptance of the Agreement on the Interpretation and Application of Articles VI, W and XXIII of the GATT

It is a matter of regret to the Government of Australia that participants in the MTN were unable to develop more effective disciplines on the use of agricultural export subsidies. The Agreement on the Interpretation and Application of Articles VI, XVI and XXIII of the GATT is heavily imbalanced as between its provisions relating to agricultural and to industrial products.

Notwithstanding the disappointing result, the Government of Australia has decided to accept the Agreement on the expectation that within a reasonable time GATT Contracting Parties will develop disciplines relating to agricultural export subsidies which are substantially equivalent to those adopted in respect of export subsidies on products other than certain primary products (as defined in the Agreement).

In respect of Australian measures which may exist within the purview of the illustrative list at the time of acceptance by the Government of Australia of the Agreement and where major practical difficulties stand in the way of the Government of Australia bringing such measures promptly into conformity with the Agreement, the Government of Australia will, without prejudice to the rights of other signatories under the General Agreement or this Agreement, examine methods of bringing these measures into conformity within a reasonable time.

In any event the Government of Australia will be reviewing its position in relation to the Agreement in the light of experience.

Annex B

1. Formal Notification by the United States on the Subsidy Code

Until such time as the United States Government otherwise notifies the Director-General to the CONTRACTING PARTIES to the GATT, the United States will provisionally apply to Australia all rights and obligations of the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade.

II.. Formal Notification by Australia on the Subsidy Code

Until such time as the Government of Australia otherwise notifies the Director General to the CONTRACTING PARTIES to the GATT, Australia will provisionally apply to the United States all rights and obligations of the Agreement on the Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade.

* * *

Ambassador Brock responded on 25 September 1981 confirming that Ambassador Parkinson's letter conformed to the understanding of his Government.

Appendix D: INTERNATIONAL AGREEMENTS ON EXPORT FINANCE

D1 The Berne Union

Co-operation in the field of export finance goes back to 1934, when the International Union of Credit Insurers (the Berne Union) was set up as a voluntary association to co-ordinate the insurance and guarantee practices of export finance agencies. The founding members were the UK's Export Credit Guarantee Department (ECGD) and three private insurance companies in France, Italy, and Spain. There are currently over 40 members from 32 countries in the Berne Union[1].

The Berne Union is an independent legal entity constituted under Swiss law -- its purpose is to promote discipline in the area of export credit.

> The international acceptance of sound principles of export credit insurance and the establishment and maintenance of discipline in the terms of credit for international trade; and, the maintenance on sound principles of foreign investment insurance and the encouragement of a favourable investment climate, by co-operating in efforts to provide investment insurance for the benefit of investors and host countries (Berne Union 1991, p.2).

The Berne Union has developed guidelines in its attempt to exert some discipline in the field of credit and investment insurance. To achieve this it agreed that, as far as possible, its member institutions should base their activities on the principle of financial self-support. It also endeavours, through consultative procedures, to ensure a degree of co-ordination with respect to the duration of the credit guarantees and insurance granted by its members. This duration is limited to a maximum of five years. It has also developed several sector agreements that set maximum terms of payment for specific categories of goods.

Agencies' compliance to these principles, however, has been varied. According to Fitzgerald and Monson (1989, p.108), 'more than half the Berne Union members are still cumulatively unprofitable'.

[1] Countries represented in the Berne Union are Argentina, Australia, Austria, Belgium, Canada, Cyprus, Denmark, Finland, France, Germany, Hong Kong, India, Israel, Italy, Jamaica, Japan, Republic of Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, South Africa, Spain, Sri Lanka, Sweden, Switzerland, United Kingdom, United States, and Zimbabwe.

D2 The OECD Arrangement on Guidelines for Officially Supported Export Credits[2]

During the post war period, governments became more active in the export finance field. New agencies were established to provide official support and the activities of existing institutions were expanded. The risk of 'destructive' competition became more worrisome. Governments felt the need for intergovernmental rules to cover these activities. A further impetus came as export credit agencies became active in granting and guaranteeing longer-term loans (over five years) which are not covered by the Berne Union.

In January 1955, the Organisation for European Economic Co-operation (OEEC) Council adopted rules governing measures designed to aid exports. The rules committed member countries to abstain from artificial aid to exporters. Specifically listed among the prohibited measures was, charging of premiums:

> ... otherwise than in accordance with sound insurance principles (ie lower than is appropriate to the cost and extent of the risks covered) (Ray 1991, p.17).

This prohibition was modified in 1958 as follows:

> ... in respect of government export credit guarantees, the charging of premiums which are manifestly inadequate to cover the long-term operating costs and losses of the credit insurance institutions (cited in Ray 1991, p.17).

When the OEEC became the OECD in 1960, these obligations in relation to export credits were transferred to the GATT, along with other OEEC obligations on export subsidies. In the GATT, subsidised export credits (at interest rates below the rate at which an agency's funds were borrowed) were included in the category of direct export subsidies, which were banned under Article XVI(4). According to Moravcsik (1989), this ban on export credit subsidies was almost universally ignored in the early years.

In 1963, the OECD reconsidered the question of export credits. The OECD Trade Committee established the Group on Export Credits and Credit Guarantees (ECG). Between 1963 and 1975, ECG suggestions for international limitations on subsidies were blocked by the US Government. In 1973, fearing that the oil crisis would provoke a credit war, the US changed its attitude; quickly thereafter the major industrialised countries reached agreements pertaining to ground satellite stations, civilian airliners, and nuclear power plants. This culminated in 1976 when G7 countries reached a secret, non-binding set of guidelines referred to as the 'Consensus' stipulating minimum down-payments and interest rates, and maximum duration of credits (Moravcsik 1989).

[2] Unless otherwise indicated the source of the material in this section is OECD 1990.

Implementation of the Consensus was uneven until April 1978 when the OECD's ECG extended and formalised the Consensus into what became the 'Arrangement on Guidelines for Officially Supported Export Credits'. The Arrangement is not an act of the OECD Council and thus is not in a formal sense a legal instrument of the OECD. All members of the OECD (except Turkey) participate in the Arrangement.

The main purpose of the Arrangement is to provide an institutional framework for an orderly export credit market -- and thus prevent an export credit race in which exporting countries compete on the basis of who grants the most favourable financing terms, rather than on the basis of who provides the highest quality and the best service for the lowest price. The full text of the Arrangement is published in OECD (1990b).

The most important conditions of the Arrangement are as follows:

- At least 15 per cent of the contract is to be covered by cash payments from the purchaser;
- The maximum repayment term is 8.5 years. This may be extended to ten years for relatively poor, and for a limited number of intermediate, countries;
- Minimum rates of interest are set. Since October 1983, these minima, known as the 'matrix' (Table D1), have been subject to change every January and July, according to an automatic mechanism based on the SDR weighted average of five major currencies.

If the commercial interest rate of a participant's currency falls below these minima, any participant may lend in that currency at 'commercial interest reference rates' (CIRRs), which are subject to monthly adjustment to reflect market rates. Since 1988, matrix rates have been tied more closely to commercial interest rates, and matrix minima have not been available for Category 1 (Relatively Rich) countries. Thus, the appropriate CIRR is the minimum rate for financing support on credit to these countries.

Table D 1: **Arrangement matrix of interest rate minima: 1990**
(Per cent)

	I *Relatively rich countries*	*II* *Intermediate countries* [a]	*III* *Relatively poor countries*
Credit for 2 - 5 years	CIRR	9.15	8.30
Credit for 5 - 8.5 years	CIRR	9.65	8.30
Credit for 8.5 - 10 years	b	9.65	8.30

a Since July 1982, the Arrangement has classified as Category II countries those with a GDP per capita of over $U54000 according *to data* published in the 1981 World Bank Atlas.
b Subsidised credit with repayment over 8.5 years is not available to rich countries.
Source: OECD 1990

The Arrangement does not cover the conditions or terms of insurance and guarantees -- only the conditions or terms of the export credits that benefit from such insurance and guarantees. As such, it deals with actions and policies of official export credit and insurance agencies. It sets limits on the terms and conditions for export credits with a duration of two years or more. Within these limits, certain 'derogations' from the rules and some 'deviations' from normal practice are possible. These must be notified to all other participants in the Arrangement, who can then match the deviation or derogation.

However, in its submission to the Commission, EFIC (Sub. 28, pp. 2-3) stated:

> In both the Berne Union and the OECD there are systems of notification and information exchanges, designed to make derogations from agreed guidelines transparent. The effectiveness of such systems are dependent on members' readiness to abide by the rules. in practice, unless prompted to do so by a specific inquiry from another party to the agreement, many members tend not to volunteer information which might indicate a derogation. Also on occasion, respondents also may be somewhat selective about the information supplied about specific transactions. Clearly, the extent and impact of such actions, which are designed to give the derogating country's exporters a competitive edge, cannot be quantified.

D2.1 Sector understandings

Separate OECD agreements exist to cover exports of certain capital goods. Having been accepted by the OECD Council, sector understandings have a different status than does the Arrangement. Sector understandings provide for minimum cash payments, minimum rates of interest and maximum length of payments, at levels different from those set by the Arrangement. The agreements include the:

- Understanding on Export Credits for Ships (1971);
- Understanding on Export Credits for Ground Satellite Communications Stations (1974);
- Understanding on Export Credits for Nuclear Power Plants (1984); and
- Understanding on Export Credits for Civil Aircraft (1986).

The Arrangement does not apply to military equipment or agricultural commodities.

D2.2 Mixed credits and the arrangement

In addition to export credit activity, the Arrangement allows for tied or partially untied development aid financing (mixed credits). Conditions may be more favourable than is normal under the Arrangement if the overall concession level is at least 35 per cent and if the tied or partially untied mixed credit is duly notified to the other participants.

In a fiercely competitive environment, the late 1970s saw a greater use of mixed credits as a method of circumventing the Arrangement. The advantage of mixed credits is that they permit a more attractive package of financing terms than that allowed under the Arrangement (Hartland-Thunberg and Crawford 1982).

Two major problems, however, flow from the use of mixed credits. First, trade patterns are distorted because conditions of commercial competition are disrupted. Second, mixed credits divert scarce aid funds away from projects with a high development priority toward more commercially attractive transactions (see Volume 1, Chapter 5.5).

In view of the growing competition through the use of mixed credits, at their May 1984 meeting, OECD Ministers called on those responsible for export credit policy to take action to improve existing arrangements so as to strengthen transparency and discipline in the area of mixed credits. In 1985, the minimum permissible grant element in tied and partially untied aid financing (including mixed credits) was increased from 20 to 25 per cent.

After further negotiation, a compromise agreement known as the 'Wallen package' was developed in 1987. This agreement had three parts:

- the development of a formula for calculating the 'concessionality level' of aid credits that more closely reflect market rates of interest;
- an increase in the minimum permissible concessionality level of aid credits or of mixed credits, to 50 per cent for Category 111 countries in 1987 and to 35 per cent for Category 11 countries in 1988;
- the replacement of matrix minimum interest rates with the appropriate CIRRs for export credits to rich (Category 1) countries, and an increase of matrix rates by 0.3 percentage points for other (Category 11 and 111) countries.

When completely implemented in July 1988, the Wallen package had sharply increased the costs to Arrangement participants of extending mixed credits. It was thought that if costs were increased, aid agencies would be less willing to allow their scarce aid funds to be used to improve the competitiveness of their exporters in bidding for commercial projects of limited developmental worth. This would result in a fall in the share of 'hard' aid credits (those with a grant component of less than 50 per cent), which are most likely to be commercially motivated.

This has not happened. In fact, the use of 'hard' aid credits has increased, both absolutely and relatively. For example, in 1986 '100 per cent aid' grants accounted for nearly 50 per cent of the aid given by Arrangement participants, while 'hard' aid credits accounted for 35 per cent. By 1990, the proportion of grants had fallen to less than 20 per cent, while the share of 'hard' aid credits had climbed to nearly 70 per cent. In absolute terms the amount of 'hard' aid credits increased by 46 per cent over the period, while the amount of '100 per cent' grants fell by just over 70 per cent. Aid credits are now going more to the creditworthy, relatively well-off developing countries than to the poorest nations.

The 1990 meeting of OECD Ministers was told that there was as yet no evidence that the reforms of the Wallen package had significantly reduced trade distortions caused by mixed credits.

D2.3 The impact of the Arrangement on export credit subsidies

An important impact of the Arrangement has been that buyers have come to 'expect' credit with the most generous terms allowable under the Arrangement. It has had the effect of institutionalising credit subsidies.

An indication of how the OECD Arrangement limits are perceived as the norm, was observed by the Commission while visiting Japan. The Commission was told that: Japan's Eximbank complied with the OECD Arrangement and, therefore, it won export sales for commercial reasons and not because of better credit facilities. The clear implication here is that countries expect that all competitors will provide facilities which offer the maximum subsidy allowed under the Arrangement.

This development was also observed by Kemp (1989, p.3 l):

> ... one result of dealing with the problem in this way [through the Arrangement] has been to institutionalise certain levels of interest-rate and aid softening. ... it is now more difficult than ever to win an order without offering the best credit terms permitted by the Consensus. In other words, the limit has inevitably tended to become the norm.

D3 The GATT Subsidies Code

GATT rules for export credits are found in its Code on Subsidies and Countervailing Duties (Subsidies Code) which was negotiated during the Tokyo Round of multilateral trade negotiations and went into effect in 1979. The Code is reprinted in Appendix C.

The Code's direct reference to export finance subsidies is found in its Annex, which gives an 'illustrative list' of export subsidies that come under the ban of its no-subsidy rule. This list includes: failure to cover costs of export credit insurance or financing costs of obtaining credits; and providing export credits at less than the cost of funds. It shows its derivation from the 1958 OEEC and the 1960 GATT lists, except for the addition of a clear, albeit indirect, exception for the OECD Arrangement which was negotiated the year before. The GATT Subsidies Code requires all developed-country signatories to apply the provisions of the Arrangement; certain developing-country signatories have agreed to apply some of the provisions.

The GATT Subsidies Code, however, has serious weaknesses. Paragraph 0) permits subsidised export credit insurance as long as premiums are not 'manifestly inadequate' to cover operating costs and underwriting losses. This vague terminology permits the continuance of loss-making export insurance programs. In Paragraph (k), GATT effectively hands over to the OECD the task of regulating industrial countries' export credit subsidies.

On the question of whether existing financial subsidies should be considered illegal under the Subsidies Code, EFIC (Sub. 28, p.3) stated:

> A large proportion of international trade is transacted on the basis of commercially available credit, on terms usually ranging up to one year. The main avenue for official enhancement of this high volume of export trade is via the provision of supplier credit insurance, against the risk of non-payment for commercial and political reasons. The potential for a degree of export subsidy thus exists, whereby premiums charged may not be commensurate with the risks insured. Furthermore, insurance cover may be made available even though there exists a relatively high risk of claims eventuating.
>
> Circumstantial evidence would appear to support the contention that certain governments are using their export credit agencies to assist exporters in this manner. It is difficult to compare the performance of export credit agencies, given their varying functions, structures and the nature of their commitments. Nevertheless, a number of agencies in major industrial countries are conspicuous in terms of the size of their losses over a protracted period.

D4 Recent agreements

In October 1991, the OECD Export Credit Group agreed on new rules to further strengthen the Arrangement and increase disciplines in the area of mixed credits. The 'Helsinki' package is designed to extend and improve on the Wallen package of 1987. Agreements were reached in the following areas:

- notification and consultation procedures were strengthened;
- mixed credits were banned for developed countries -- those with a per capita income above 1990 $US2465 ($A3150) -- and a 'Commercial Viability' requirement was introduced for all but Least Developed Countries. This means that mixed credits cannot be made available for projects viable enough to be financed on market or Arrangement terms; and
- adjustments were made to the interest rate matrix used to limit export credit subsidies to Category 11 and 111 countries bringing them further into line with commercial interest rates.