

Canada-United States Trade Center Occasional Paper No. 8

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SUBSIDIES IN MANUFACTURING

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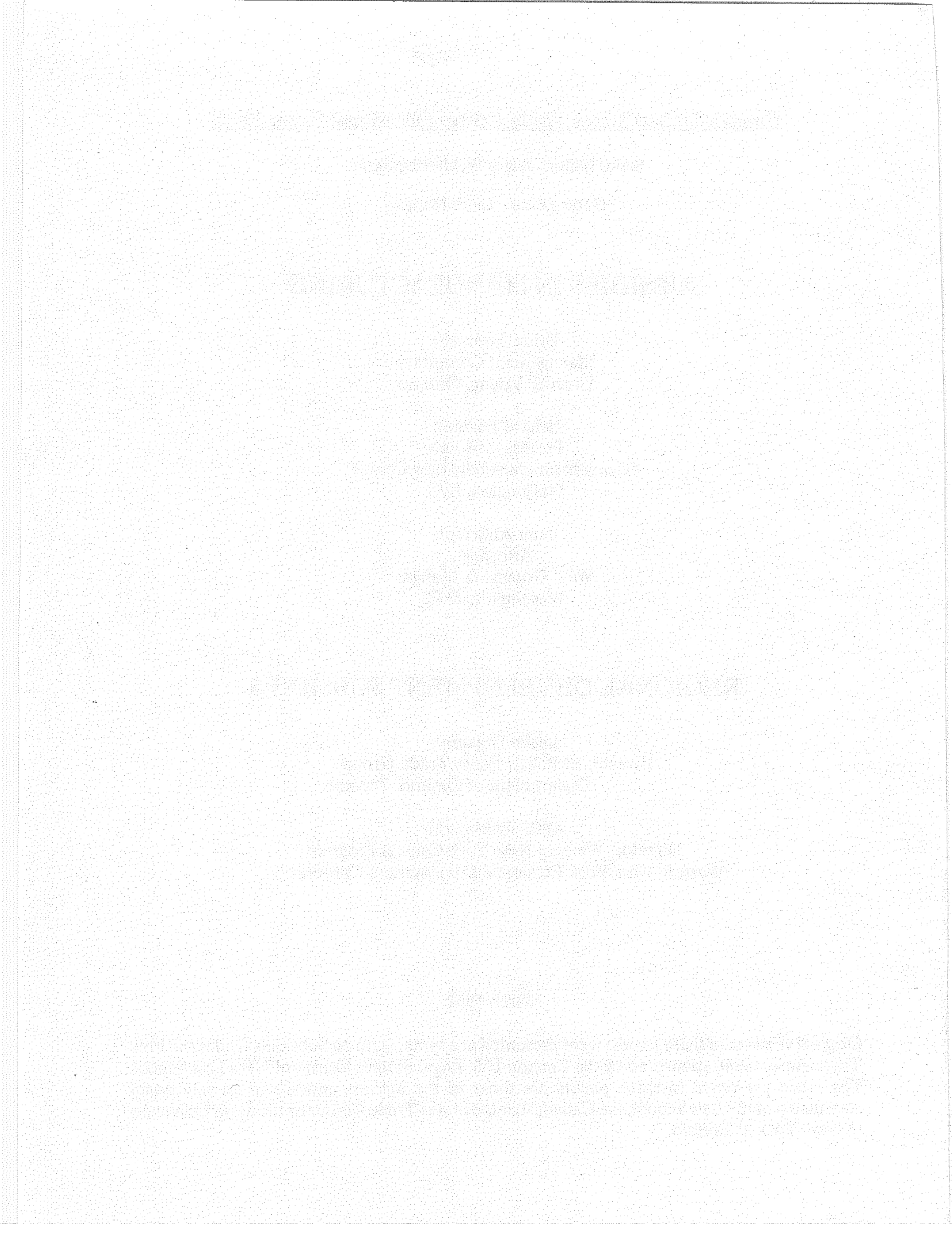


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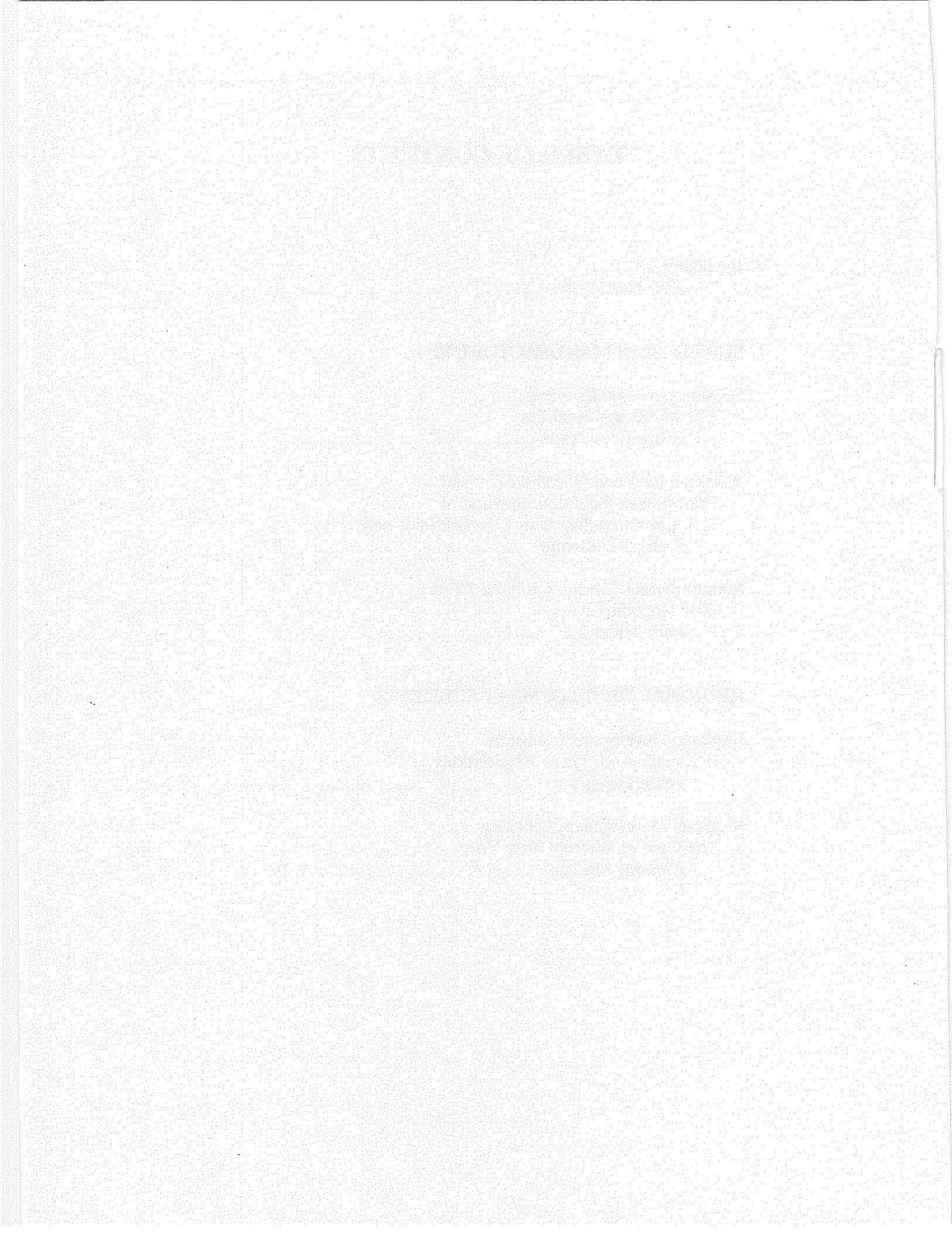
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INTRODUCTION

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The papers and notes that comprise this set of CUSTAC Occasional Papers (Numbers 6, 7, and 8) focus on the nature and effects of subsidies granted by US and Canadian governments to domestic producers. The papers originated as symposium presentations at the Canada-United States Legal Studies Centre, University at Buffalo Law School, in the spring of 1990. The purpose of the symposium, and of these papers, is to come to some understanding of the issues involved as the two countries attempt to decide what form of domestic subsidies are to be allowed in the two-year-old free trade area of Canada and the United States.

If anyone thought that the late-1988 signing of the Canada-United States Free Trade Agreement (FTA) settled the controversy about the rules and nature of the world's largest bilateral trade flow, the succeeding years have surely convinced him or her otherwise. Questions remain and grow: some questions, like the exact workings of the dispute-settlement process or the definition of allowable internal subsidies, were clearly and deliberately left for further discussion. Other questions, like the role that subsidy negotiation will play in proposed Canada-U.S.-Mexico trade talks, were not so obvious in 1988. Certain mutual goals, such as the removal of agricultural subsidies, were worded to recognize the salience of the Uruguay Round of GATT negotiations, which did not conclude in December 1990 as planned. The impact of the proposed trilateral discussions and the conclusion of the GATT round are still very unclear. Therefore, these Occasional Papers grapple with the first set of uncertainties - how should the intent of the FTA's Chapter 19, "to develop more effective rules and disciplines concerning the use of government subsidies"¹ be implemented?

The United States has been especially slow to recognize the magnitude of its own direct and indirect subsidies, and has been slow to measure domestic and foreign subsidies systematically.² The papers by Harry Baumes and John Ragosta develop methodologies for systematic measurement of subsidies in the agricultural and natural-resource sectors, respectively. The papers by Erna Van Duren and Jeffrey Thomas introduce the nature of subsidies in these two sectors, and analyze the political and legal influence that the GATT negotiations could have on the bilateral negotiation called for by the FTA's Chapter 19. Van Duren's and Baumes's papers appears in Occasional Paper 6, while Thomas's and Ragosta's papers comprise Paper 7.

Subsidies to manufacturing industries and to disadvantaged regions are the topic of the three papers and two abstracts collected in Occasional Paper 8. The federal and subnational governments in the two countries choose, sometimes implicitly, among many different interests that can be protected by subsidies: from mobile, large corporations to more region-specific

¹ Canada-United States Free Trade Agreement, Article 1907, Section 1(a).

² Morton, C.S. 1989. Subsidies Negotiations and the Politics of Trade. Canada-US Outlook 1 (1). Washington, DC: National Planning Association.

workers and small firms.³ Bruce Fountain notes the wide range of points at which a government can assist the private procurement, production, or sale of manufactures. This range of potential actions complicates the task of subsidy measurement and assessment. Richard Diamond abstracts from his article, published elsewhere, which searches for the basic principle underlying U.S. use of countervailing duties. He finds no consistency among the stated basis (reducing economic distortion), the more likely basis (allowing U.S. producers the same returns as if there were no foreign subsidy), and the actual practice (response to industry complaint). This inconsistency complicates the practice and predictability of countervail.

Also in Occasional Paper 8, Jean Anderson reviews some subsidy and countervailing-duty concept whose bilateral interpretation will determine the potential for agreement. The proposals from Canada and the U.S. to the Uruguay Round yielded some insight into the two countries' interpretations. Leslie Delagran argues that regional subsidies available across sectors (more common in Canada) have few identifiable trade-distorting effects, and should not be subject to countervailing duty. The more *ad hoc* patchwork of U.S. local, regional, and state location incentives is even harder to measure, and may in practice be more sectorally focused. However, the domestically oriented nature of U.S. manufacturing obscures the trade distortion of these subsidies and incentives (while the import-substitution effects may be substantial but un-monitored⁴). The note by Anthony Marconi provides a glimpse of this patchwork, by reference to the set of incentives available in western New York State.

Laura Mangan of the Canada-U.S. Legal Studies Centre (and now of the Baldy Center for Law and Social Policy, also at the University at Buffalo) has done an excellent job of encouraging (and when necessary, cajoling) authors, and of editing papers. Thanks also to Research Assistant Alice Elder who was instrumental in organizing speakers for the symposium and initial editing of their papers and to Dawn Baksh who took on the unenviable task of transcribing the symposium proceedings. Jim McConnell and the Canada-U.S. Trade Center have encouraged and financed this venture, in part with the support of the Canadian Embassy and UB's Canadian-American Studies Committee.

Finally, I sincerely thank the authors for their efforts and their insights.

³ Morici, P. 1990, Industrial policy technology, and the Canada-U.S. Free Trade Agreement. Business in the Contemporary World 3(1): 101-110.

⁴ Grey, R. de C. 1981. Trade Policy in the 1980s: An Agenda for Canadian-U.S. Relations. Montreal: C.D. Howe Institute.

SUBSIDIES IN MANUFACTURING: THE MYTHS AND REALITIES

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Driving across the Peace Bridge last night I was reminded of my first trip to Buffalo. It the mid-1970s, and I was a young corporate development manager. The company I worked for had an operation in Buffalo which was neither efficient nor profitable.

Three options faced us:

1. close the operation;
2. modernize;
3. relocate.

This was my introduction to the world of subsidies and playing business by United States rules in what I erroneously believed was the last world outpost of the free enterprise system.

As I was being courted by the county representatives, I quickly realized I could put together a financial package from state and county funds which would be more attractive to our company than relocating the operation to Canada. This was the beginning. In the months ahead, I found there were even better deals to be made in southern United States.

I am going to talk about some of the myths and realities which surround government subsidies in the American manufacturing sector. My message is that American business is being subsidized, both heavily and pervasively. While the scale of the assistance is large, it is not strategically directed.

The myth is that American business does not accept government subsidies. The reality is that it does. It is interesting to see a new openness by some Americans on this issue. There is a new willingness from American and Canadian politicians and government officials to address directly the question of subsidies. Large quantities of money are involved and, ultimately, we should be asking, "What kind of value are the taxpayers receiving in return?"

A recent article in *Inside U.S. Trade* published a news communiqué by the United States Department of Commerce. The department solicited comments and advice from business and others on the subsidy issue between Canada and the United States, which is part of the unfinished business from the Canada/United States Trade Agreement. The document stated:

"Every country has financial assistance and offers aid programs for its various public policy purposes. ... [m]any in the United States believe that Canada substantially subsidizes its industry and exports and the United States does not. Obviously, the U.S. also maintains assistance programs. Without attempting to resolve this issue here, it is fair to say that any subsidy programs are much

more visible in Canada than they are in the United States. ... Overall, U.S. assistance is less extensive than the sort that is available to its trading partners because of differing attitudes towards the role of government within the private sector."

Time recently featured an article on government subsidies with a focus on the European Community. They cited a study that in the five year period, 1981-1986, the EC provided approximately \$90 billion worth of assistance to various economic sectors within the Community and that 45% was directed at manufacturing. The reality is that in every industrialized economy, including the United States, there is a flow of money from the taxpayers to industrial enterprises.

First, let's consider the general framework concerning our approach to the study of subsidies. We do not attempt to limit our subsidies definition to those which are countervailable under United States trade laws. Rather, to understand the nature of subsidies, one must be aware of all forms of government assistance which flow to business and which improve both competitiveness and the bottom line.

In our approach, we intentionally avoided making judgment as to which forms of government assistance are good and which are bad. Rather, we examined all the forms by which governments provide assistance at all levels to business. In doing so, I am dropping the word "subsidies" and replacing it with "government assistance." This change in wording was one of the first realities to become evident shortly after we commenced our first study of subsidies in a major U.S. manufacturing sector. Our research team was astounded by the number and variety of programs unearthed and by the many direct and indirect forms through which governments of all levels provided assistance to American business.

Government assistance to U.S. business is not diminishing. We noted some reductions of federal government activities in the provision of government assistance during the 1980s, but during the same period the role of the state and local governments increased in the delivery of government assistance programs.

Much of this paper is based upon findings which resulted from studies which Ernst & Young has undertaken in the United States on the subject of subsidies in several important sectors of the U.S. economy. Canada, like most other industrialized countries, has a variety of programs which are offered to enhance the economic development prospects of a particular economic sector or region within the country.

The main difference we found in the delivery of government assistance between Canada and the U.S., is that finding them is a simpler task in Canada. In Canada, government assistance is delivered through direct grants, or is administered through the tax system. It is open and transparent.

In the U.S. it is less apparent. Finding government assistance in the U.S. is a difficult and requires a detective-like approach. Reasons for this include the larger number of jurisdictions, the prevalence of ad hoc rather than legislative funding, a weak paper trail, differences in government budgeting and auditing procedures, and finally the profound American belief that the United States governments do(es) not subsidize business. In Canada

the government issues press releases and politicians often present the cheques. In the U.S. it is much less visible.

In both Canada and the United States we have a federal government system but within the two systems there are many differences. One difference is that the American federal system is more political in nature and in participation at the senior levels than Canada. In the United States, there are 50 states; Canada has 10 provinces. In Canada, local governments are creatures of the provinces and, to a large extent, financially dependent on the host province and have restricted powers. In the United States there are more than 3,000 counties and tens of thousands of individual municipalities. Local governments in the United States have more flexibility and authority compared to their Canadian counterparts.

Students of subsidies are bedeviled by definitions. In our study, we took a rather broad approach and we developed ten categories where government assistance flowed to business in the United States. These categories included:

- (1) **Grants:** direct financial contributions from government to a business;
- (2) **Concessionary financing:** direct loan or loan guaranty by government that provides a business with access to capital at less than market rates of return;
- (3) **Tax concessions:** credits, deductions, exemptions or reductions which result in a business paying lower taxes than would be the case if regular tax rates were applied;
- (4) **Assumption of obligations:** situations where governments assume obligations that a business would otherwise be required to discharge;
- (5) **Regulatory concessions:** situations where governments provide a preferential legal or regulatory environment, or refrain from enforcing laws or regulations, such that business avoids costs or obligations it would otherwise assume;
- (6) **Subsidized services:** services consumed by a business in which the costs are absorbed partially or completely by governments;
- (7) **Preferential government procurement:** procurement practices favouring a domestic firm over its international competitors;
- (8) **Upstream assistance:** provision of assistance to suppliers resulting in lower input costs;
- (9) **Downstream assistance:** assistance to customers resulting in lower input costs; and
- (10) **Trade protection:** tariffs and non-tariff trade barriers or protective regulations that have the effect of insulating a business from international competition.

In 1989, Ernst & Young, Management Consultants in Canada, undertook what we were told was the largest detailed study ever undertaken in terms of a single industrial sector

in the United States, on the field of government assistance. It was comprehensive and incorporated for the first time a detailed examination of the role of state and local governments. It included detailed site investigations.

We were able to conservatively estimate that over \$30 billion worth of government assistance flowed to this sector in the period 1980 to 1988, despite claims by some industry executives and some politicians who represent strong constituencies in this sector, that this industry did not receive a dime of government assistance from the United States' taxpayers during the period.

The \$30 billion broken down among the ten categories previously described.

Grants:	6%	1.8
Concessionary financing:	4%	1.2
Tax concessions:	35%	10.5
Assumptions of obligations:	10%	3.0
Regulatory concessions:	10%	3.0
Subsidized services:	3%	0.9
Preferential government procurement	N/A	N/A
Upstream assistance:	5%	1.5
Downstream assistance:	5%	1.5
Trade Protection:	22%	<u>6.6</u>
	TOTAL	\$30.0 Billion

Our research program did not cover all companies and all production sites, but we believe the \$30 billion is a conservative estimate. There are many indications however, that additional research in this sector would substantially raise this number. The majority of assistance (55%) is drawn from three areas: tax concessions, the assumptions of obligations, and regulatory concessions. Additionally, a further 22% was derived from the trade protection area.

The study of subsidies in both Canada and the United States is under-researched relative to the large volume of dollars involved. These are some of the things we found in terms of the current state of the research on subsidies in the United States.

Previous research in the area we believe seriously understates the role and dollar volume of government assistance in the areas of assumption of obligations, regulatory concessions, preferential government procurement, the role of upstream and downstream assistance, the area of non-tariff trade protection, infra-structure assistance, state grants, and local government tax concessions. Most of the attention has been directed to the provision of grants, concessionary financing (tax exempt bonds) and the area of directed tax concessions.

It is estimated in the past decade that the Department of Commerce in the United States has spent close to \$50 million investigating the unfair trading practices of America's trading partners. I am certain the research investment by America's trading partners on the subsidies field in the United States during the same period is substantially less.

Our work share leads to some observations and questions about government assistance in the U.S. The rhetoric we heard sounds like this: the United States does not subsidize

business and when government intervenes in business in the United States, it is bad, but if the government-intervention is industry-driven, then it is acceptable.

In the United States, government assistance is more implicit and industry-driven. In other industrialized countries such as Canada, government assistance which is industry-driven is more prone to have a regulatory infra-structure orientation. Also the delivery of government assistance is far more politicized in its application than in Canada. Canadian assistance efforts are government-driven and it tends to be grant-oriented. It is also more bureaucratic than political in its administration and is open to all applicants.

The reasons for the discrepancy between the rhetoric and the reality regarding the provision of government assistance in the United States are varied. By accepting the fact that governments in the United States do not systematically assist or subsidize certain sectors of the economy, one is, conversely, recognizing that there is an industrial policy behind it. The United States does, in reality, have an industrial policy, but it is poorly articulated. By better articulating this U.S. industrial policy, such as in the establishment of targets and goals, the United States would be better able to account for the effectiveness of the large investment it is making in the private sector.

In conclusion, I would like to present three questions which should be considered by future researchers in this field.

1. Is the United States political system capable of explicitly recognizing the existence of the industrial policy it presently supports through major government assistance activities?
2. If the answer to the first question is yes, then how might this change the U.S. trade policy agenda?
3. Would the U.S. become more flexible in terms of future negotiations?

There is a lot of work remaining to be done in the future of this subject in both Canada and the United States. I believe the private sector must become much more actively involved and informed in this research area if real progress is going to be made. In a period of deficit financing and declining economy in both countries, there is a risk of doing more of the same based on past practices. The challenge, however, is to ask what are we doing and does this represent the best use of finite financial resources we have available. I suggest that neither counting is receiving the retain of large investments

A SEARCH FOR ECONOMIC AND FINANCIAL PRINCIPLES IN THE ADMINISTRATION OF U.S. COUNTERVAILING DUTY LAW

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Abstract

Using the principles stated in the Proposed Rulemaking regarding countervailing duty law recently issued by the Department of Commerce, this article examines the rational for and rationality of current U.S. countervailing duty enforcement methodology. First, the article shows that the theoretical basis for enforcement which the Rulemaking cites, correction of the distorting effects of subsidies, cannot be used to justify U.S. practice since the assessment of duties does not depend on whether the subsidy is or is not efficient. Second, the article proposes an alternative model which better expresses the goals which underlie U.S. law. Under this "Entitlement Model", the purpose of U.S. law is to protect the financial position American producers would have enjoyed had foreign subsidies not been granted. After developing this model, the article shows that it cannot form the basis for U.S. enforcement methodology since no attempt is made by the U.S. to determine whether the subsidies being countervailed affect the entitlement defined. The article concludes by showing that the difficulties which the Department of Commerce has faced in administering the U.S. law may be traced directly to the errors and inconsistencies in its theoretical approach.

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MANUFACTURING SUBSIDIES AND THE FREE TRADE AGREEMENT: THE NEGOTIATIONS

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I had the unenviable opportunity of negotiating subsidies in the Canada-U.S. Free Trade Agreement and I hope that, before the Working Group that is called for under the FTA really gets going on its subsidies negotiations, the negotiators pay of attention to what has been said by the first two speakers on this subject, Bruce Fountain and Richard Diamond.

Subsidies negotiations between Canada and the U.S. would be a whole lot easier, maybe I should even say they might be feasible, if there were greater recognition in the United States that there is indeed considerable government assistance to industry. Certainly we should get away from the irrationality of the countervailing duty law as it is now applied, not only in the U.S. but also in Canada, because it just does not make any sense.

I am going to speak to you as someone who took part in the negotiations and who, unfortunately, fears that we probably will not have achieved the kind of Nirvana espoused in the previous papers by the time the U.S.-Canada subsidies negotiations resume. I want to look at the problem of subsidies and manufacturing from a negotiator's standpoint and, secondly, to review the current activity within the Uruguay Round of the GATT to see if there is any indication in the U.S. and Canadian proposals that we might have a better future for Working Group negotiations between the U.S. and Canada than we had in the Free Trade Agreement negotiations themselves.

Arguably, there is no very significant issue between the U.S. and Canada, at least in economic terms, over subsidies to manufacturing sectors. While it is true that both countries grant a great deal of assistance in various forms to business, that does not necessarily mean that it is an issue of great magnitude in commercial relations between the two countries. That would be the conclusion if you measure the issue by the extent to which trade disputes have arisen over subsidies to manufacturing. As you have heard, the U.S. has had only a handful of countervailing duty cases on Canadian manufacturing operations since 1980. There have only been four or five of those cases that resulted in any countervailing duties at all, and where there have been countervailing duties, in, e.g., the tire and steel industry cases, with the exception of the *Steel Rail* case, the duties were all below 1 or 2 percent. So there was not really a very significant problem even measured under the current irrational, countervailing duty law. During that same period of time there have been no Canadian countervailing duty cases against U.S. industrial sectors, just the corn case which related to agriculture. I do not want to suggest there have not been important countervailing duty cases by the U.S. against Canada. There were, of course, softwood lumber cases as well as the raspberries cases and pork cases et cetera, but most of those are not in the manufacturing realm.

There is even a possibility, I would suggest, that what significance there is in manufacturing subsidies across the border will decline, i.e., one could hope that the issue of manufacturing subsidies would just wither away bilaterally. The reason for my making such

a suggestion is that the manufacturing subsidies that have caused problems between Canada and the U.S. were nearly always in the form of extremely large grant and loan programs by federal and provincial governments jointly in Canada to locate plants in places where they otherwise would not have been built, at least not in order to manufacture the particular item produced. These projects have included steel mills and tire plants in Nova Scotia. They have been problematic because of the focus placed by both countries on the necessity of being globally competitive. As such, they really cannot afford to put a lot of money into that kind of project. If either country wants to provide assistance to industry, it needs to provide it to industry that is going to be competitive, not to create something just to produce more jobs. It has got to be a competitive industry that can stand on its own once it is created. I would add that that kind of subsidy (job-producing) is probably the hardest kind for any country to defend to its trading partners, as I think both Canada and the U.S. have recognized in the GATT round. Now I am not going to go into the fact that those subsidies were also regional. You are going to hear about regional subsidies in other presentations, but I think there are probably other solutions for regional subsidies.

Additionally, with more cross-border ownership as a result of the progress of the Free Trade Agreement, I think few industries in either country will really want to challenge their competitors across the border. To paraphrase Pogo, I think they will look across the border and say, "We have seen the competition and he is us." There is an example I am familiar with where the industry on the Canadian side of the border and the U.S. side of the border are jointly looking into possible unfair trade practices by producers in third countries. A few years ago there might well have been cases across the U.S.-Canada border in that industry but there will not be now. So, I think the FTA itself will help make the problem diminish. However, having said that it might go away, I now have to tell you it will not go away because subsidies of all kinds, including subsidies to manufacturing, will remain an important political issue even if they cease to be economically important. They, of course, will have to be dealt with by the Working Group under the Free Trade Agreement.

You all know that no agreement on subsidies emerged from the Free Trade negotiations. I would argue that it could not have emerged at that time. So, what are the prospects now? Fortunately, the Uruguay Round has come along, and the U.S. and Canadian subsidies negotiations have been put on hold essentially until at least the outlines of the Uruguay Round subsidies negotiations are clear. My guess is they will not really get off the ground until the Uruguay Round is a done deal. Now, this zig-zag process of doing bilateral subsidies negotiations in the free trade talks, then moving to multilateral subsidies negotiations in the GATT Round, and then coming back to U.S.-Canada subsidies negotiations in the Working Group, has some promise because there is the possibility of making real progress as you move back and forth along the zig-zag path. I think that we will see that the Uruguay Round negotiations turn out to be fortunate for both some atmospheric and some substantive reasons.

On the atmospheric side, I note that the fact that the GATT negotiations were coming up, was itself an obstacle to the U.S.-Canada agreement during the Free Trade talks. I do not want to overstate that, but it should be recognized that the U.S. and, to some extent Canada, was more concerned about getting disciplined on subsidies multilaterally and did not want to do anything during the Free Trade negotiations that might have undercut its negotiating position with the rest of the world in the GATT Round.

The second atmospheric point is that bilateral negotiations between the U.S. and Canada of course face some inherent obstacles. One of those is the asymmetry in the fact that Canada sends 80% of its exports to the U.S. The U.S. sends only about 20% of its exports to Canada. The other essential obstacle in negotiating between Canada and the U.S. is what Bruce Fountain described earlier, that is the different popular perceptions of the government role in industry in the two countries. I would argue, in fact, the role of government in industry is an issue which must be accommodated globally, rather than solely within the Canada-U.S. bilateral context.

The third atmospheric point about the GATT Round is that it has the advantage that most of the proposals that are put on the table during these negotiations are public. During the Free Trade talks, there were substantial efforts on both sides to keep various subsidies proposals secret, and I must say although there were occasional leaks and lots of articles about what was in them, I do not think anybody ever got it right. I think it is an advantage that the U.S. and Canada are now in a position to put their ideas and what their tentative notions of what they might be able to do in the subsidies and countervailing duty area out for the world to see and for the world to contribute to with some creative ideas.

With regard to the substantive side, U.S. and Canadian proposals in the Uruguay Round, I think, give some basis for thinking that when the bilateral negotiations resume they will start on a new and higher plane. Interestingly, there are a number of the proposals in both the U.S. paper and the Canadian paper in the Uruguay Round that reflect a great many of the ideas which were discussed during the FTA negotiations. In this way I think the FTA negotiations contributed to the Uruguay Round positions which will in turn contribute to negotiations bilaterally.

I want to mention a few areas in which I think there is potential consensus between the U.S. and Canada which is based on the proposals they have put on the table in the Round. First, I note that the whole GATT subsidies negotiations are proceeding on the basis of a "traffic light approach." That approach places a subsidy in one of the following categories: prohibited subsidies are described as red light, permitted subsidies being green light, and, in between, a category of actionable subsidies, that is the yellow light. This particular framework effectively narrows the scope of the disputed universe of practices.

The very fact that it is proceeding on that basis probably will help a little bit. I would note it is not a new concept. It has been talked about in every negotiation in the last 10 or 20 years at least. The U.S. did not want to use the traffic light approach in the GATT Round, but they were stuck with it because they had proposed it themselves during the previous GATT negotiations in the Tokyo Round, so they could not really say, "No, that is a lousy idea." They did not want to do it because they did not want to admit that there could ever be something called a permitted subsidy. They wanted to leave open the possibility that any kind of subsidy is potentially actionable even though there might be some kinds that ordinarily would not be actionable.

In any event that is the framework of the whole subsidies negotiations in the GATT Round. Within that framework, the U.S. and Canada have both put forth proposals that do have some similarities. The first point of similarity I would mention is trade-distorting subsidies. Both countries are proposing expanding the parameters of what is prohibited under the GATT subsidies code to include domestic subsidies that under some definition are "trade-

related" or "trade-distorting" in addition to certain export subsidies which are already prohibited. The U.S. is proposing the prohibition of subsidies that are characterized by domestic content, local sourcing, or export performance requirements. The U.S. would also put in the prohibitive category subsidies to firms that have exports accounting for a certain percentage of their sales, that is by some definition a subsidy to an export-oriented firm. The U.S. is also proposing a domestic subsidy that exceeds a certain percentage of a firm's total sales that ought to be prohibited, whether or not the recipient firm exports. This proposal is based on the principle that the size of the subsidy is indicative of its trade-distorting capabilities, i.e., the notion being that if the subsidy is large enough it must distort something somewhere.

The Canadian proposal is vaguer on trade-distortion or trade-relation issues. Nonetheless, it does indicate interest in the idea of putting trade-distorting subsidies on the prohibited list. Under the actionable subsidy category, the two proposals suggest some continuing disagreement, which was no surprise, but also some common ground on how to define an actionable subsidy. A point of particular interest is the issue of specificity. U.S. law has focused for years very strongly on the specificity test, that is, does a subsidy go to a specific industry or group of industries or is it generally available to a whole broad range of industries? It was, of course, the key issue in the softwood lumber case. Canadian law incorporates the specificity test much less expressly; it makes reference to Article 11 of the GATT Code, but it is generally viewed by trade lawyers in Canada that countervail law does incorporate the specificity test to some extent. In Canada's Uruguay Round proposal, Canada wants to "enshrine" specificity as a test of whether a subsidy would be actionable. That does not mean they are in total agreement with the U.S. I suspect they mean that the program should on paper, i.e. *de jure*, be available to specific industries before it would be actionable. Under U.S. law a program would be specific unless it was both *de jure* and *de facto* available to a broad range of industries.

But what is most interesting to me about the specificity issue is that the U.S. proposal does not mention it. U.S. negotiators have been asked why sector specificity is not in the U.S. GATT round proposal, and the answer has been, "Well gee, I do not know. Some other countries have mentioned it, and is not it in the GATT Code anyway?" I am not so sure that the U.S. intentionally left sector specificity out of its GATT Round proposal in the hope of expanding subsidies discipline multilaterally in certain areas beyond those subsidies that are sector-specific. On that one we will have to wait and see, but it will be interesting to watch.

On the other hand, with regard to actionable subsidies, the U.S. and Canadian proposals do seem to concur more on the manner in which countries should be allowed to take action, i.e. in determining the procedural limits once an actionable subsidy is defined. Canada, for example, proposes strengthening the standing requirements under countervailing duty laws and having a sunset clause on countervailing laws. The U.S. would almost certainly in the end accept those kinds of provisions and of course a higher *de minimus* than the ridiculous .5% the U.S. supplies right now.

Under the category of permitted subsidies, Canada proposes that permitted subsidies should include generally available regional subsidies, i.e. those subsidies that are generally available to industries within a particular region. These include infrastructural subsidies that are for general use, adjustment assistance to workers, and assistance to research and development. The U.S. put on its permitted list: basic human services such as education and

health, including national defense which could pose some interesting questions in the negotiations; unemployment insurance and adjustment assistance to workers; a kind of national treatment notion of natural resource subsidies, that is, government provision of extraction or exploitation rights for natural resources would be permitted if those rights sold through an auction process open to everybody; and also infrastructurally-related subsidies if they are generally available both on a de jure and a de facto basis and de minimus subsidies. However, I would like to note something I find very interesting. The U.S. has negotiated steel consensus agreements with most of the major steel producers around the world. The idea behind the consensus agreements was to put discipline on subsidies in the steel sector and then integrate the subsidies negotiations on steel with the GATT subsidies negotiations, and that process is occurring. What is interesting is that some of the steel consensus agreements do contain a provision in which the U.S. agreed that, on limited bases, subsidies covering investment costs for environmental protection and subsidies to research and development could be permissible. I think that this is some indication that the U.S. may be willing to expand the parameters of what may be permitted.

My next-to-last point is that both the U.S. and Canada proposals focus on placing less unilateral action on subsidies, that is less pure countervailing duty enforcement on subsidies, and more a multilateral review or dispute on settlement. The U.S. proposal, for example, keeps the countervail notion intact for actionable subsidies as do a lot of other proposals on the table. Simultaneously, the U.S. proposal suggests there should be multilateral review of a countervailing duty decision to see if the action was taken properly.

Finally, I think both the U.S. and Canadian proposals, and certainly the two if you put them together, suggest that there is a lot of flexibility in approaches that the governments are willing to look at in the subsidies area. There are suggestions that you can have sector-specific agreements; you can cap subsidies; you can exempt certain kinds of subsidies that are seen as useful on both sides of the border. There are a lot of different approaches that could be applied to deal with specific subsidy problems as they are identified later in the bilateral context.

I do not want to overstate the agreement here. It would be Pollyannish to look at the U.S. and Canadian GATT Round proposals and suggest that that means there is going to be a nice, easy subsidies negotiation in the Working Group. I do not think there will be. There are hundreds of differences. I only talked about some of the similarities, but there are hundreds of differences between the U.S. and Canadian approaches in the GATT Round and those differences will surely emerge in the Working Group negotiations. But just as the FTA negotiations seem to have been useful in helping the two countries move ahead on flexibility about dealing with subsidies in the Uruguay Round, I think the process that is going on now multilaterally is going to give them a better head start when the bilateral negotiations resume in a year or two.

REGIONAL DEVELOPMENT SUBSIDIES IN CANADA-U.S. TRADE NEGOTIATIONS

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Regional development subsidies can be seen as both the industrial development activities of sub-federal jurisdictions (and occasionally federal governments) to promote investment in certain regions through locational incentives, and also the variations in program delivery to different regions within a jurisdiction to address disparities in relative economic development.

Regional Development Through Investment Incentives

There have been numerous reports recently in Ontario that New York State is benefitting not only from Canadian shoppers coming to buy cheaper groceries and clothing (perhaps believing that tariffs are already eliminated under the Canada-U.S. Free Trade Agreement (FTA)), but also from Canadian investment going south to take advantage of cheaper rents and a range of investment incentives provided by New York State. Ontario manufacturers have noted to the Ontario government that U.S. states offer attractive packages to operate in their area. These companies are not seeking equivalent incentives from Ontario, but rather are making the pitch that the business environment in Ontario (including building costs, wages and taxes) needs to be competitive or they will be tempted to move out of the country.

For example, South Kentucky Industrial Development Association offers an "innovative program that allows a company to acquire a building, land and improvements at net no cost." In Western New York, the Niagara Mohawk Power Corporation, along with area industrial development agencies, will "provide employee training and skills upgrading programs, lower cost financing programs for building construction or expansion and equipment purchases", and electricity rate incentives, which are lowest for plants located in designated Economic Development Zones. In addition, municipalities in the U.S. provide incentives to attract manufacturing plants, including providing tax relief to such an extent that, in some instances, they have given away their tax base.

The competition for investment between regions exists not just between Canada and the U.S. but, perhaps primarily, among the U.S. states and between Canadian provinces. A range of factors will normally influence the location investment decision, but frequently governments will attempt to lure investors to a particular locale. The FTA does not restrict the use of locational incentives. It does, however, make it more attractive for Canadian and offshore companies to take advantage of incentives offered by U.S. states to service the soon to be tariff-free Canadian market from the U.S.

U.S. states appear to be increasingly active in the investment attraction and promotion field, putting increasing pressure on Canadian provincial governments to offer competitive

business "environments" in terms of taxes and regulation so as not to see an outflow of investment.

Federal and provincial governments in Canada also engage in investment incentives, but because of the high export orientation of Canadian industry (averaging about 40% of shipments for Ontario manufacturing), those firms receiving such funds are far more vulnerable to countervailing duty (CVD) action than an equivalent U.S. firm receiving the same amount of subsidy. Fear of CVD action in the recent "french fry war" in Prince Edward Island had the outcome of having the two companies compete to establish in the province without subsidies. The McCain Company had complained about a provincial subsidy of several hundred million dollars to enable its competitor, Irving, to establish a french fry plant. At the same time, the federal and provincial governments in Canada cannot forswear the use of locational incentives without corresponding restrictions on federal and state governments, if Canada is not to lose investment, production and employment to bidders to the south.

Prohibition of such subsidies appears to be advocated by both the U.S. and Canada in the current multilateral trade negotiations (MTN) of the Uruguay Round of the GATT. This would make many treasuries happy, but will not please economic development officers unless it is clear that such a prohibition can be effectively enforced. Border remedies such as CVD-type remedies may work on Canadian products which have benefitted from prohibited subsidies and are exported to the U.S. However, border remedies are not likely to be effective in addressing U.S. investment incentives which distort trade by replacing Canadian and offshore imports, which would otherwise occur, with domestic production.

This illustrates the problem of import-replacing subsidies, which Canada sees as being just as trade distorting as subsidies to exporting industries. Canadian concerns with U.S. investment incentives can only be addressed through disciplines on subsidies rather than through the use of CVD actions. There still remains the problem for Canada of the enforcement of multilateral disciplines on investment incentives, given Canada's lack of retaliatory power. A European Community solution in which companies receiving unapproved subsidies are ordered by a higher court to pay them back is not likely in the absence of a supra-national political and judicial authority. In any event, addressing import-replacing subsidies is more likely to be successful in the MTN than in the bilateral negotiations called for by the FTA, since the U.S. would hesitate to constrain its use of domestic subsidies solely in a bilateral context.

Regional Development as Income Distribution

What first comes to any Canadian's mind when "regional development" is raised is the allocation of subsidies within a particular jurisdiction to its less advantaged regions. This is seen in Canada as what the GATT Subsidies Code calls "instruments for the promotion of social and economic policy objectives" and therefore an exercise of a legitimate government function. A general transfer of resources from a relatively wealthy part of the country to a less developed region is hard to see as being trade-distorting, since it reduces the overall competitiveness of an economy by transferring resources to a less efficient location in order to achieve a more equitable distribution of income. Regional development can be seen here as subsidies to a range of industries in a particular region, or higher benefits to certain regions within a federal or provincial jurisdiction.

In the application of U.S. countervailing duty law, such a subsidies program would be automatically countervailable because it would be considered "targeted". This has made a wide range of Canadian programs vulnerable to being found countervailable even if they are generally available to all industry within a region. The December, 1989, Court of International Trade decision on Atlantic groundfish confirmed the vulnerability of Canadian federal regional development programs to U.S. countervail, even though specific programs had been designed to offer assistance to less advantaged regions based on non-discretionary criteria, such as low levels of economic activity and high levels of unemployment. Examples of federal programs which allocate funds to specific provinces or regions are: the Atlantic Canada Opportunities Agency, the Western Diversification Fund, Federal Development for Northern Ontario, and separate federal development agreements with individual provinces (e.g., GDAs and ERDAs for tourism, mining and forestry). Some federal programs offer higher benefits for certain regions; for example, one of the programs in question is in the Atlantic groundfish appeal, namely the Industrial and Regional Development Program. Some provincial programs also target regions within a province, for example: rural development agreements in British Columbia or the Ontario Farm Tax Reduction Program, in which eligibility criteria vary by region within the province. Indeed, under U.S. countervailing duty law, a regionally targeted program would be a provincial program available to the entire province except the major metropolitan area. Under this criteria, a tax abatement scheme for all companies in Quebec, except those in Montreal, was found countervailable (softwood lumber).

The U.S. certainly has such regional development programs, such as Economic Development Zones maintained in many states. At the federal level as well, the allocation of defence spending and the activities of the Tennessee Valley Authority, Appalachian Regional Commission, and the Rural Electrification Act, not to mention assistance to Puerto Rico, are clearly aimed at regional development.

Unlike in the U.S., in Ontario it is illegal for municipalities to offer subsidies to local industry either directly or through the tax base. However, any provincial program to a specific region having the same effect as a municipal grant would be considered countervailable under U.S. CVD law. This raises questions about the economic justification for finding regional development subsidies to be automatically trade distorting (since "targeted") and therefore countervailable.

It is unclear how subsidies to a specific region which are available to all industries in that region can be more trade-distorting than a subsidy available to all manufacturers through a jurisdiction. (There remains the question whether generally available subsidies should also be considered trade distorting, or whether in a macroeconomic sense, exchange rate adjustments offset any competitive advantages.)

Regional development subsidies can reduce the overall competitiveness of an economy by transferring resources to a less efficient location in order to achieve a more equitable distribution of income. The ability to put equity ahead of efficiency is, for many Canadians, a legitimate role of government which must be preserved.

Ensuring that regional development subsidies for disadvantaged regions were "non-actionable" was a critical objective for Canada in the subsidies/CVD negotiations of the Canada-U.S. FTA. This remains a negotiating objective in the current Uruguay Round of multilateral trade negotiations and future negotiations under the FTA. Both countries have

agreed to pursue bilateral subsidies/CVD issues initially in the context of the multilateral negotiations, before renewing bilateral discussions on this issue sometime in 1991.

Subsidy/CVD Negotiations

For Canada, eliminating the countervailability of regional subsidies would significantly benefit exports, the benefit being in the removal of the threat of CVD investigations of such programs and the expense and trade disruption that occurs when such programs are investigated.

It would appear that a key objective for Canada in these negotiations would be that regional development subsidies should not be countervailable as long as they are provided on a nondiscriminatory basis within a region. They would have only the industrial "specificity" test applied, as it is to subsidies which are more widely available. The test would then be only whether the subsidy is available on a de jure basis to all industries within a sector on a nondiscriminatory basis (a sector defined as agriculture, manufacturing, natural resources) and, on a de facto basis, whether a significant number of industries take up the benefits. This would ensure that those regional subsidies which are in effect targeted to particular industries, and therefore trade-distorting, are countervailable.

A problem may arise if a region is defined so narrowly as to only encompass a small area, such as an economic development zone. A regional subsidy could then act as a locational subsidy with all industries willing to locate in that area offered an attractive package of incentives. This may be less likely in Canada, since regions for the purposes of regional development subsidies are generally defined quite broadly.

Nonetheless, at what point does a regional subsidy aimed at reducing disparities in income and employment between different regions in a country become a locational incentive which distorts investment decisions? The problem is not whether the region is too large, but whether it is too small. As mentioned earlier, constraints on locational investment incentives are perhaps the preferred method for Canada to deal with the trade distorting aspects of these subsidies, rather than through CVD laws.

Although regional benefit programs rarely provide large benefits on ad valorem basis, and cannot therefore be seen as seriously distorting trade, political perceptions in the U.S. are that regional subsidies are significant, and therefore the U.S. may not be receptive to eliminating the countervailability of regional programs. If regional subsidies are to continue to be regarded as trade distorting in themselves, and therefore countervailable, there are arguments that the amount of subsidy that can be found for regional programs should be reduced. One such argument is that, in calculating the size of regional subsidies, offsets should be allowed for the cost disadvantages of locating in the disadvantaged region. In implementing the Subsidies Code agreed in the Tokyo Round in 1979, the U.S. Administration originally proposed that offsets to cost disadvantages be allowed in calculating the amount of subsidy (as had been Administration practice). However, Congress rejected the proposal. While attractive in theory, offsets may not be workable in practice, not only because the calculation of cost disadvantages would add more complexity and cost to investigations, but also because the U.S. may insist upon "balancing" such offsets with any cost advantages in the depressed region such as lower land and labour costs.

Another alternative arises from the generally small benefits provided by regional programs and offers a practical option, although certainly not one which addresses the fundamental Canadian concerns with the inviolability of regional subsidies as domestic economic and social equity programs. This would be a requirement that regional subsidies would be subject to countervailing duties only if their ad valorem size combined, standing alone, is more than de minimis. Only rarely have Canadian regional subsidies examined in a U.S. investigation been found to exceed the de minimis level. Hopefully, with the experience of a few investigations after such a change, U.S. petitioners would become less likely to raise regional subsidy allegations. This alternative at least recognizes the unique nature of regional subsidies by immunizing them, at low levels, from countervailing duties. The issue of regional development subsidies will remain a litmus test in Canada for the progress of multilateral and subsequent bilateral subsidies/CVD negotiations. The success of Canadian negotiators will likely be measured by their ability to eliminate the vulnerability of Canadian regional development programs to U.S. countervail.

REGIONAL DEVELOPMENT SUBSIDIES: THE CASE OF WESTERN NEW YORK

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It has become apparent to me through the various discussions that subsidies in Canada consist mostly of direct federal transfer payments to regions and provinces, and sometimes to industries and firms often in cooperation with provincial governments. As such, Canadian subsidies are very visible. Industries in regions in the United States compete without similar direct federal government subsidies. In fact, there are subsidies in the United States; many industries and regions in the United States are indirectly assisted by state and municipal programs. They are just less visible. These programs give advantages to certain sectors which may not exist in a completely free market economy.

Western New York clearly benefits from indirect state and municipal subsidies. New York State provides both financial and non-financial assistance. Financial assistance can take several forms. First, the State provides below-market-rate loans, loan guarantees, and in some instances, grants directly to companies. Second, the State provides financial support for infrastructural projects sponsored by companies and/or municipalities. Third, the State provides money to support research and development. Fourth, the State financially assists Western New York companies through a multitude of tax set-ups. And, finally, the State supplies resources for employee training programs. Non-financial assistance is equally important, and can also take several forms, for example, building selection assistance, export trade demonstration projects, and permit assistance. Much of the State assistance is delivered through the Western New York Economic Development Corporation (WNYEDC).

Let me focus on recent projects to demonstrate the importance of state subsidies to the Western New York economy. WNYEDC's responsibilities can be categorized in three areas: Regional Strategic Planning, Industrial Effectiveness Program Assistance and Project Initiation and Management.

Regional Strategic Planning Responsibilities

With the initiation of the U.S.-Canada Free Trade Agreement (FTA) in January 1989, Governor Mario Cuomo and Vincent Tese, the State Economic Development Director, asked WNYEDC to take a lead role in coordinating the regional responsibilities under the FTA. In the early part of 1989 WNYEDC formed the Canada Council, an advisory panel of public and private sector representatives to assist WNYEDC's directors and staff in examining the free trade issues. The Council undertook a number of initiatives during the year. For example, the Council just issued an assessment and recommendation on the Niagara River border crossings for the Western New York region. It also received a study on the economic integration of Southern Ontario and Western New York commissioned from the Center for Regional Studies at the State University of New York at Buffalo, and continues to examine free trade impact on regional air and rail cargo traffic, and the region's highway infra-structure. The Council

also has published and will again publish resource guides for business services in exporting for the region's businesses.

As an outgrowth of the Canada Council's activities, the Western Economic Development program, through the five county industrial development agencies in Western New York, was the catalyst for the formation of the Western Region Corporation. With that, the WNYEDC put together two successful grant applications, one for the New York State revolving loan trust fund to lend up to an estimated \$60,000 per company in 1990 until the funds run out actually for start up funds for exporting to small and medium sized companies. We were also successful with a \$75,000 grant to the New York State Department of Economic Development to hire two individuals to assist small and medium sized companies in the maze of exporting -- these are first-time exporters.

In addition to these accomplishments, the WNYEDC developed numerous other strategies, from a marketing program for the Greater Buffalo International Airport to assisting minority and women-owned businesses.

Industrial Effectiveness Program

The Industrial Effectiveness Program (IEP) is the second major responsibility of the WNYEDC. The IEP was created in 1987 to help manufacturing firms in a region to achieve world-class manufacturing status. The IEP provides assistance to companies to help management and workers evaluate their competitiveness and prepare a plan for increasing their productivity. In 1989, the IEP program assisted over 38 companies in the region. Of particular concern during the year was the instability of the domestic auto industry and recent layoffs in Western New York plants. There are 29,000 Western New York workers directly employed in the auto industry and supply base. To address the problem, we assembled leaders of industry, labor, education, and research. As a result of the Western New York Auto Forum, the auto industry firms in the region have begun to coordinate a strategy to improve their competitiveness.

Project Initiation and Management

Finally, Western New York Economic Development Corporation's third primary objective is to assist companies in assessing the economic development program of New York State and a responsibility which I referred to earlier as Project Initiation and Management. The staff of WNYDEC, together with the staff from the New York State Department of Economic Development, worked with individual companies to custom tailor packages of assistance which best suit the companies needs while meeting the State's goal of strengthening companies and creating jobs. Since its formation in 1984, WNYEDC has assisted 125 projects representing state assistance of more than \$95 million. In 1989, the Western New York region, which has 2.8% of the State's population, received over 30% of all funds awarded under the state's economic development programs. These projects had a total dollar value of \$39 million in state assistance. Some of the companies receiving assistance include such companies as Moog, Servotronics, American Precision, and Fisher-Price (which unfortunately recently shut down a plant).

Other projects not related to any particular company but still falling under this category include such projects as: general marketing, outreach to Canadian and offshore

Other projects not related to any particular company but still falling under this category include such projects as: general marketing, outreach to Canadian and offshore companies to consider locating in the Western New York region; public funding for the World University Games; and specific marketing for the Niagara Falls International Airport for air cargo.

This overview of the Western New York Economic Development Corporation demonstrates that businesses in Western New York receive a great deal of assistance from the State. Although it is perceived that there are fewer direct federal subsidies in the United States than Canada, there are numerous state subsidies especially in New York as well as subsidies from local governments which I have not covered today. Although less visible, these indirect state and local subsidies play a very, very important role in supporting the business community in Western New York.

