CHAPTER VII

POLICY MEASURES

A. Policies related to market access

Access to foreign markets is a prerequisite for a country to attract export-oriented FDI. The liberalization of trade and investment is in itself an important factor explaining the growth of such FDI, with production being distributed more in line with the comparative advantages of different locations. Liberalization is still continuing at the multilateral, regional and bilateral levels and offers new opportunities for developing countries. At the same time, the recent slowdown in the world economy and corporate strategies in favour of relocating production to lower-cost locations (Part Two) have led to a rise in protectionism. The growing use of anti-dumping, countervailing and safeguard measures, and of other non-tariff barriers is worrisome in this respect, as is the widespread use of investment incentives by developed economies. These and other investment-related trade measures (UNCTAD, 1999b) can create obstacles to exports from developing countries and make it difficult for them to attract export-oriented FDI (box VII.1).

Box VII.1. Potential obstacles to market access

There are a number of ways for a country to protect its market from foreign competition and to hinder a shift of production to lower-cost locations. The post-Uruguay Round protection pattern is characterized by a large number of tariff peaks concerning products of export interest to developing countries in agriculture, food, textiles, apparel and some medium-technology products. Tariff escalation too, is a pervasive feature in both developed and developing countries and concerns both agricultural and industrial goods (Cernat et al., 2002).

Resistance in a home country to the relocation of labour-intensive activities to developing countries can slow down the restructuring process and trigger measures that may counteract efforts to liberalize trade. Such tendencies are accentuated by an economic slowdown, which forces firms to search for new ways of cutting costs; this may, in turn, lead to various contingent protection measures and the use of incentives and subsidies to discourage relocation.

Safeguard measures as well as *anti-dumping and countervailing duties* may lead to investment diversion, and have the ultimate effect of restricting access to importing markets. Their availability in the trade policy arsenal and their increasing use by a larger number of countries create uncertainties in market-access opportunities in these countries and may discourage investment in exporting locations. In many cases, the mere threat of such measures or their initiation (with the imposition of provisional measures) may be enough to protect the importing country. Conversely, the availability and use of safeguard measures as well as of anti-dumping and countervailing duties may attract investment towards the importing country, since exporting firms may seek to avoid the risk of being hit by such measures through local production.

Business concerns in this area are exacerbated by the unpredictability of the outcome of trade-remedy law proceedings. Present practices appear to put developing countries and economies in transition, at a disadvantage (Moran, 1998). The number of anti-dumping initiations rose from 157 in 1995 to 330 in 2001 (with a peak of 356 in 1999). In 2001, the largest number of such initiations were related to "base metals and articles of base metals" (128), followed by "products of chemicals of allied industries" (65). During the period 1995-2001, the developing countries most affected by anti-dumping initiations were China and the Republic of Korea, with 255 and 138 cases respectively brought against them.[a]

Home-country *incentives* and *subsidies*, aimed at retaining or hindering the relocation of existing production by domestic or foreign investors may similarly reduce the likelihood of export-oriented FDI flows to developing countries or economies in transition. In the light of the weaker economic performance of the world economy, the willingness of developed-country Governments to provide new support to their ailing industries may increase.

Source: UNCTAD.

[a] www.wto.org/english/tratop_e/adp_e/adp_e.htm#statistics/.

In some industries, special trade schemes continue to have an important influence on the allocation of export-oriented FDI. The analysis in Part Two showed that many of the "winners" in export competitiveness have benefited from trade arrangements that give them privileged access to key markets, notably in the United States and the European Union. This applies in different ways to low-technology industries (e.g. garments), medium-technology industries (e.g. automotive) and high-technology industries (e.g. electronics).

The so-called production-sharing schemes are important tariff arrangements that can affect the location of export-oriented FDI linked to international production systems. These have been adopted by many developed countries for the treatment of outward processing operations. Production-sharing initiatives are typically driven by home-country firms' need to respond to increased competition, especially from low-cost locations. Developing countries have traditionally acted swiftly with complementary host-country measures – such as maquiladora regimes, free trade zones, industrial parks and other incentives (see also section VII.F) to attract this type of production. These operations invariably involve the export of various components from the home country to undergo further processing and/or assembly, and their subsequent re-import into the home country in the form of finished or semi-finished products. In such cases, a distinction is made for customs purposes between the value of the original component produced domestically and the value added abroad; only the latter part of the value is subject to duty. Both the United States and the European Community have such schemes.[1]

In some cases, these have encouraged the establishment of offshore processing bases. In the case of the United States, the principal products involved in production-sharing have been apparel, television sets, other electronic products, autoparts and semiconductors. Economies in which production-sharing operations take place include Mexico, a number of Caribbean countries, Malaysia, the Philippines, the Republic of Korea and Taiwan Province of China (USITC, 1999). The European Community system has contributed to the establishment of assembly operations in a number of developing countries, chiefly in the Mediterranean region and CEE, including the Czech Republic, Morocco, Poland, and Tunisia (Yeats, 2001). As in the case of the United States, production-sharing operations involving EU firms have tended to be concentrated in labour-intensive industries such as textiles and clothing, footwear, some types of machinery and mechanical appliances, vehicles, processed food and leather products (ECE, 1995, p. 113).

Production-sharing is expected to remain of significant interest to developed-country firms seeking to maintain their competitiveness in industries in which tariffs and labour-intensive assembly continue to be an important cost element. For example, the majority of United States imports from Canada and Mexico that incorporate United States-made parts no longer take advantage of production-sharing provisions as they are already eligible for duty-free treatment under NAFTA. It should be noted, however, that, from a developing-country perspective, production-sharing schemes generally do not allow for the expansion of local inputs other than labour. In this sense, such schemes do not encourage the creation of linkages between foreign investors and domestic suppliers.

Whereas production-sharing schemes do not generally give preferential treatment to specific countries, there are other trade arrangements that do, with implications for the location of export-oriented activities. Many LDCs and other developing countries benefit from preferential access to developed-country markets in many export-oriented industries (Hughes and Brewster, 2002).[2] Any preferential trade treatment that a country enjoys in export markets may increase the willingness of TNCs to set up export-oriented production there. Conversely, countries not covered by such schemes are in effect discriminated against. The benefits have sometimes been big enough to influence the location of investments.

There are a large number of such non-reciprocal preferential schemes, including the Generalized System of Preferences, the European Community's trade preferences under the Cotonou Agreement, the Caribbean Basin Initiative, and, more recently, the European Union's Everything-but-Arms Initiative and the United States' African Growth and Opportunity Act (AGOA).[3] Moreover, the location of export-oriented FDI has also been affected by a number of regional integration schemes, such as free trade areas and customs unions. Two of the most important are NAFTA (which was preceded by a bilateral free trade

agreement between the United States and Canada) and the European Union and its association agreements. A number of the "winner" countries mentioned in Part Two, including the Czech Republic, Hungary, Ireland, Mexico, Poland and Spain have benefited from such schemes in their efforts to attract export-oriented FDI.

The impact of trade preferences given to beneficiary countries depends, to a large extent, on the rules of origin attached to them. Rules of origin arising from regional trade agreements or other preferential schemes determine the national origin of a product for the purpose (among others) of granting preferential treatment. Rules of origin are often based on the level of domestic value added and/or of local content. When such rules are too stringent in either of these two dimensions, they can limit the investment pull of the preferential scheme. If affiliates are constrained in using inputs sourced from the international market or are required to undertake activities for which the host country is not well suited, the benefits of the preferential scheme may fail to motivate export-oriented FDI.

This aspect is well illustrated by AGOA. One of the key elements of AGOA, unlike other preferential schemes, is a special provision that allows African countries with an annual GNP of under $1,500 ("lesser developed beneficiary countries") to use third-country fabric inputs until 2004. Some preliminary evidence suggests that a number of beneficiary countries – notably Lesotho, Madagascar and Malawi – have seen inflows of export-oriented FDI linked to AGOA (Part One, box III.4). For example, companies from Taiwan Province of China are the main foreign investors in Lesotho's garment industry. The textiles used are imported primarily from East Asia. After 2004, however, to benefit from preferential access under AGOA, the fabrics will have to be of United States or AGOA-beneficiary-country origin.

For some beneficiary countries, AGOA has led to a rapid increase in their exports of some products to the United States market. This is partly due to the sudden opening of the protected textile and apparel market in the United States, thus giving beneficiary countries an edge over competitors. However, benefits from AGOA appear to have been unevenly distributed so far, with a handful of countries being the main gainers. Moreover, as the possibility of sourcing fabric inputs from third countries is limited to four years, there is a risk that the beneficiaries' advantage will be short lived. The policy challenge for these countries is to prepare for an eventuality of no trade preferences, either by developing the domestic capacity to provide the necessary inputs, by attracting FDI into these stages of production, or by finding competitive sources of inputs in other AGOA beneficiary countries. This situation is similar to that of countries that attracted export-oriented FDI – thanks to unused quotas for export to countries that restricted access for textiles and clothing products – under the Multi-fibre Arrangement. As these quotas are to be completely phased out by 2005 (box VII.2), there is an obvious risk of the relocation of existing investment to countries that offer more competitive conditions.

Box VII.2. The phasing out of the Multi-Fibre Arrangement

The textile and clothing industry was exempted from the general provisions of the GATT and regulated by the Arrangement Regarding International Trade in Textiles, commonly known as the Multi-fibre Arrangement (MFA). This Arrangement allowed importing countries to establish quantitative restrictions on the imports of textiles and clothing to prevent disruptions in their national markets. In 1995, half of the apparel imports to the United States were subject to quotas (ECLAC, 2000).

The MFA was discontinued as a result of the Uruguay Round. International trade in textiles and clothing is now regulated by the Agreement on Textiles and Clothing. This Agreement lays out a process of liberalization of bilateral import quotas in four broad product groups (tops and yarns, fabrics, made-up textile products and clothing) over a 10-year period ending on 1 January 2005. The obligation to phase out existing quantitative restrictions applies to the four countries or groups of countries that maintained such restrictions under the MFA: Canada, the European Union, Norway and the United States. Generally, most of the apparel products to be liberalized have been left to the last phase, thereby allowing maximum adjustment time to the importers' apparel firms.

A number of developing countries (e.g. Bangladesh) managed under the MFA to attract export-oriented FDI, especially from countries constrained by the quota allocated to them (e.g. the Republic of Korea). By 2005, the recipients of such FDI risk losing it unless they become internationally competitive.

Source: UNCTAD.

Preferential trade agreements and offshore production schemes will play a declining role as tariffs and quota restrictions fall but, as long as such barriers exist, they remain relevant for the location of export-oriented FDI. Thus policy-makers need to be aware of any opportunities still available from such schemes, while also understanding their limitations, particularly with regard to linkage creation. In addition, in the light of the continuing erosion of preferential margins, countries may be well advised to prepare for a situation without such privileges. Trade preferences alone do not provide a sustainable basis for developing competitive export industries (with or without FDI), but they do offer a temporary window of opportunity. Countries that can offer the most competitive conditions for export production in a given industry stand to gain as preferential schemes disappear, and the beneficiaries of such schemes thus need to strengthen their capabilities in areas in which they can claim comparative advantages. This is the focus of the rest of this chapter.

B. Improving access to imported inputs

Foreign affiliates active in export markets can be significantly affected by the host country's trade regime. Efficiency-seeking FDI often involves international trade (internal or external to TNCs), with significant flows of intermediate and finished goods sourced in different locations. Export-oriented FDI falls into this category, especially when it is a part of the international production systems of TNCs (see Part Two). Trade liberalization in general can make a host country more conducive to export production. For export-oriented foreign affiliates, any tariff or other (for instance quantitative) restriction on imported inputs affects efficiency and cost, and schemes to reduce or eliminate barriers to foreign inputs increase the attractiveness of a host country. There are a number of specific measures to reduce the costs of accessing foreign inputs, even without general trade liberalization. Special attention is given in this section to various ways of relieving exporters of the burden of taxes on imported inputs, notably through duty drawbacks and exemptions.

The duty drawback system is a commonly used method of relieving import duties imposed on goods used for the production of exports. A "drawback" is a refund of duties or taxes paid against certain imported merchandise upon re-export. Drawbacks thus make some imported material duty-free, thus encouraging production in the country granting it. The imported goods eligible for duty-free treatment can include raw materials and other inputs consumed in the production process as well as the energy, fuels and oil used for production. An important issue for developing countries is the treatment of indirect exporters, namely domestic suppliers that use imports to produce the inputs they supply to exporters. They should also be able to claim duty-exempt imports to remain competitive vis-à-vis foreign suppliers so as not to hamper the formation of local linkages (Felker and Jomo, 2000). Kenya, Mexico, Taiwan Province of China and the Republic of Korea are examples of economies that allow drawback refunds for indirect exporters (Jenkins and Kuo, 2000).

One problem with a drawback system is that its administration is cumbersome and prone to abuse. When goods are first imported, they are not specifically earmarked for use in the production of exports, and this determination is all the more difficult as manufacturers often produce for the local as well as the export market. Only the exporter knows the quantity of materials used in the production process. The customs administration has either to take the exporters' calculations or specify arbitrary (and usually inaccurate) input-output coefficients for each item produced. Furthermore, customs administrations are naturally reluctant to refund money that has already entered their coffers. The ensuing delays in payments can generate cash-flow problems for exporters.

An alternative is the duty exemption or suspension system. Under such a system, the customs administration sets up accounts for individual importers. Import duties are recorded in the account and held as liabilities, cancelled upon export. This avoids exporters having to pay taxes up front only to be refunded at an uncertain later date. The problem of determining what has been imported for what purpose and what duties have been assessed is made more transparent

through the use of the individual accounts. Sometimes the suspension is granted only if a firm already has an export order. Furthermore, to make sure that importers pay duties if they do not export, some customs administrations require importers to provide guarantees in the form of bonds, securities, bank drafts or the like. For instance, in Mexico, the original suspension system did not provide for a requirement for bonds or bank guarantees and was widely abused. Then in 1999, Customs Bank Accounts were introduced, into which direct and indirect exporters deposit an amount equal to the taxes under suspension in interest-bearing bank accounts. The customs authority releases the funds upon approval of the claim for duty remission on the inputs used to produce exports (Jenkins and Kuo, 2000).

C. Trade facilitation

Beyond the tariff treatment of imported inputs, countries have engaged in broader efforts of trade facilitation. Trade facilitation aims at developing a consistent, transparent and predictable environment for international transactions, based on internationally accepted customs and practices that simplify procedures, standardize physical facilities and means, and harmonize trade and transport laws and regulations (box VII.3). Trade facilitation measures are intended to speed up the movement of goods and trade information across borders, thus bolstering growth while enhancing security. They cut across a wide range of areas such as regulations and controls, business efficiency, transport, information and communication technologies, and the financial sector, and involve traders, banks, insurers and other actors engaged in international trade, along with customs authorities.

The effective implementation of such measures lowers transaction costs and improves the capacity of developing countries to supply competitive goods and services to global markets. Recent studies show that transaction costs saved by trade facilitation could range between 2 and 15 per cent of transaction values (OECD, 2001a). Owing, to information technology, among other things, it is now possible to improve transport efficiency dramatically at modest costs, given the political will to reform procedures and confront vested interests. In particular, simplification measures by customs and other agencies can make an important contribution to realizing development objectives. The introduction of electronic customs clearance systems, risk assessment techniques (as against the inspection of individual consignments), pre-arrival processing and post-release audit all cut time and other costs and reduce the scope for error. By way of example, Chile, at the March 1998 WTO Symposium, estimated savings of $1 million each month through automation and a greater use of risk assessment. Thus, while some countries are concerned over the start-up costs involved in introducing computerization or training in the use of risk assessment, the experience of Chile and others has shown that costs can be recovered over time through greater efficiency and increased tax collection.

Box VII.3. Trade facilitation: what are the concerns?

During a WTO symposium on trade facilitation (March 1998), traders voiced a number of concerns that can be summarized under five headings:

- Excessive documentation requirements;
- Lack of automation and inadequate use of information technology;
- Lack of transparency, with unclear and unspecified import and export requirements;
- Inadequate procedures, especially a lack of audit-based controls and risk-assessment techniques; and
- Lack of cooperation among customs and other government agencies, which thwarts efforts to deal effectively with increased trade flows.

Practical recommendations and guidelines for a trade facilitation strategy cover three major areas of work to foster transparency, predictability and uniformity:

- Harmonization of laws and regulations;
- Simplification of administrative and commercial formalities, procedures and documents; and
- Standardization of transport means: modal infrastructure (related to sea, road, rail and air) including interfaces between different modes of transport (e.g unit loads and handling equipment), commercial practices and services, and information technology.

Source: UNCTAD.

Trade facilitation was added to the WTO's agenda at the first Ministerial Conference in December 1996. The Doha Ministerial introduced a new phase for WTO work on this issue, by providing for negotiations after the Fifth Ministerial in September 2003 and by mandating the Council for Trade in Goods to embark on a comprehensive work programme.[4] The underlying rationale for future negotiations is identified as the recognition of "the case for further expediting the movement, release and clearance of goods, including goods in transit, and the need for enhanced technical assistance and capacity building in this area".[5] The Council for Trade in Goods was mandated to "review and, as appropriate, clarify and improve relevant aspects of Articles V, VIII and X of the GATT 1994",[6] but also to "identify the trade facilitation needs and priorities of members, in particular developing and least-developed countries". Ministers also committed themselves "to ensuring adequate technical assistance and support for capacity building in this area".

UNCTAD has developed practical solutions to some of these issues, such as the Advance Cargo Information System (ACIS) (box VII.4). Another initiative to reduce the costs of trading goods is UNCTAD's customs reform, modernization and automation programme, ASYCUDA (box VII.5).[7]

Box VII.4. The Advance Cargo Information System

ACIS is a system designed to produce management information to address multimodal cargo transit and transport problems[a]. It is a real-time proactive system providing transport operators with reliable, useful and immediate data on transport operations, including information on the whereabouts of goods and transport equipment. The resulting performance indicators enable management to remedy operational deficiencies and, at the national and subregional levels, provide data for macroeconomic planning of the transport sector. As of mid-2002, 14 countries had benefited from ACIS installation.

A comprehensive evaluation undertaken in 1999 by the Tanzania Railway Corporation (UNCTAD, 2001d) shows that improvements in service and benefits to customers were:

- Wagon movements closely monitored so that cargo is delivered on schedule;
- Ability to inform customers on status and whereabouts of their cargo "live";
- Ability to trace/control wagons so that the supply of wagons to customers is more reliable;
- Possibility of detecting wagons not paid for;
- Possibility of calculating daily revenue; and
- Availability of daily freight-loading statistics.

Source: UNCTAD.

a For more information on ACIS, visit www.unctad.org/en/techcop/tran0105.htm.

Box VII.5. UNCTAD's ASYCUDA Programme

By mid-2002, the ASYCUDA computer software programme had been installed in over 80 developing countries and economies in transition (including 31 LDCs)[a]. It is designed to streamline and reduce customs forms and procedures. It is based on, and incorporates, recommendations and standards (including those related to the Document Layout Key), codes and other standards of the Economic Commission for Europe (ECE) and the World Customs Organization (WCO). The basic idea is to rid the customs system of outdated procedures and practices and incorporate international practices and standards, so as to increase a country's customs revenue through reduced costs and faster clearance.

In 1999, a new module of the ASYCUDA++ version was developed to manage customs transit procedures. The implementation of ASYCUDA in the Philippines, funded by a World Bank loan, has been a show case model, with outstanding results: revenue collection has significantly increased, and release time has been reduced from four days to four hours (an average for consignments routed through the green customs channel). The project was part of a large modernization project that was driven and monitored by the management of the Philippine's Bureau of Customs. UNCTAD is now phasing out its involvement, as the Bureau of Customs has taken on full ownership and responsibility for ASYCUDA operations in the country.

Source: UNCTAD.

a For more information on ASYCUDA, visit www.asycuda.org.

D. Export performance requirements

One approach taken by some Governments to promote more exports by foreign affiliates is to impose export performance requirements. The intention of such requirements is to make foreign affiliates export a larger share of what they produce than they would otherwise do.[8] Export requirements are permissible under WTO law and notably the TRIMs Agreement.[9] However, linking these requirements to the receipt of an advantage, for example in the form of an incentive, will be prohibited for developed countries and generally for middle-income developing countries as of 1 January 2003 (for details, see section VII.E). Moreover, some regional and bilateral agreements explicitly restrict the use of export performance requirements.[10] In addition, under the TRIMs Agreement, WTO members are not allowed to impose trade-balancing requirements that limit an enterprise's imports to an amount related to the volume or value of the locally produced goods that it exports.

There is limited evidence on the use and impact of export requirements (UNCTC, 1991). A recent survey of European business executives indicated that more than half the respondents had encountered export requirements when investing abroad, notably in Brazil, China, India and Mexico, but also in other locations (Taylor Nelson Sofres Consulting, 2000). The same study concluded that these requirements were considered an obstructive barrier by companies, particularly by those in the automotive industry.

Export performance requirements have been applied to remedy market-information failure and sluggishness on the part of TNCs to seize export opportunities, as well as to deal with restrictive business practices (Moran, 1998). Some evidence suggests that export requirements have been effective in changing the investment behaviour of TNCs. By making market access contingent on exporting, for example, some TNCs appear to have reconsidered the orientation of their activities in favour of exporting. Significant impact from government intervention of this kind has been observed in the automotive, electronics and petrochemical industries in various countries (Moran, 1998). Sometimes, different combinations of export performance requirements and incentives have helped to induce one or more "first mover" firms to reorient their international production systems and establish new export platforms. The success of the first mover may trigger similar decisions by other firms in the same industry and lead to additional export-oriented FDI in the same location.[11] A study analysing the determinants of export orientation of foreign affiliates of United States and Japanese TNCs in 74 countries, in seven branches of manufacturing over the 1980-1994 period, found that export commitments imposed at the time of entry had a significant positive effect (Kumar, 1998; 2002). The study concluded that export requirements imposed by host Governments may prompt foreign affiliates to seek product mandates from their parent firms. Such requirements may be particularly effective in host countries with large domestic markets that have the potential to absorb all the output.

This is not to say, however, that the imposition of an export performance requirement is advisable under all circumstances. First, it is clear that TNCs generally dislike performance requirements; so there is a risk of losing investment. Second, given the limitations under WTO law, countries may find it increasingly difficult to use this policy measure (section V.B.3.b). To maintain profitability under a "biting" export-performance requirement, a firm has to be compensated in some way to keep the share between exports and local sales above the limit judged commercially justified by the company. Hence, while export requirements can take different shapes and forms, they have normally been tied to some kind of advantage in order not to deter inward FDI.[12] In an increasingly competitive environment, and in the light of WTO rules, the use of mandatory export performance requirements is more and more likely to give way to policy dialogue and informal persuasion.

Empirical evidence on the use and impact of export requirements remains too limited to draw conclusive policy lessons. More analysis is needed to ascertain the extent to which such requirements are currently used and the effect they might have on FDI inflows and on the export performance of foreign affiliates.

E. Incentives

1. The evolution of incentives

In most countries that have successfully attracted and benefited from export-oriented FDI, the provision of incentives has been an integral part of government policy (the Irish experience is presented in box VII.6). Whether in connection with special economic zones or independently of them, Governments have offered financial, fiscal and other incentives to attract firms to certain locations.[13]

The degree to which incentives actually influence investment decisions is debatable. Various studies suggest that to the extent they do, it is mainly in export-oriented projects with a number of equally plausible locations (UNCTAD, 1996; 2000a; Wells and Allen, 2001; Morisset and Pirnia, 2001). In such cases, incentives may be what tips the balance. They may also help to attract a "first-mover investor" who is then followed by competitors or suppliers (Moran, 1998). Obviously, incentives-based competition risks a "race to the top" in incentives and a "race to the bottom" in regulatory measures, as countries feel obliged to keep up with one another. Such a race increases the risk that the cost of incentives might exceed the return to society.

In other situations, incentives are specifically targeted to correct market failures. The prime example is the presence of externalities. In industries characterized by economies of scale, rapid innovation and technology spillovers, subsidies are tempting (Doraisami and Rasiah, 2001). Incentives may also be offered to compensate for deficiencies and distortions in a host country's business environment (e.g. poor infrastructure and red tape). This is one of the main rationales for setting up EPZs (section VII.F).

The main argument against incentives is related to the costs involved. These include the opportunity costs of granting incentives instead of using the same resources for improving the infrastructure or educating the workforce. While remedying failure, an incentive may create others.[14] It is also difficult to assess whether an incentive has been welfare enhancing. First, it is hard to determine whether an investment was in fact the result of an incentive; second, even when this can be ascertained, the quantification of positive effects (on exports, technology transfer and employment) and negative effects (in increasing economic distortion and the potential for corruption) remains difficult.[15]

The use of incentives in promoting FDI has evolved over time. Developed countries frequently employ financial incentives (such as outright grants), whereas fiscal measures are more common in developing countries (which cannot afford a direct drain on the government budget) (UNCTAD, 1996; 2000a).[16] While comprehensive and comparative data on the use of subsidies in developed countries are unavailable for the most recent years, a rising trend, at least until the mid-1990s, has been documented (UNCTAD, 1996; Moran, 1998; Oman, 2000). There are also more recent examples of subsidies involving large sums of money offered by national or sub-national Governments to foreign investors with export-oriented projects. For example, in 1996 Dow Chemical received a subsidy of $6.8 billion for an investment in the petrochemical industry

Box VII.6. The evolving use of incentives in Ireland

In the Irish development strategy, investment incentives have complemented efforts at improving the economic fundamentals. Profits from exports were originally not taxed. Subsequently, in 1981, a corporate income tax rate of 10 per cent was introduced that applied to manufacturing and certain service industries, as well as to firms located in the International Financial Services Centre or the Shannon Free Zone. The 10 per cent tax rate will apply to existing investors until its expiry in December 2010 when a universal 12.5 per cent rate will apply.

As in many other developed countries, the Government has also provided financial grants. These have not been tied to exports but, since the Irish market is very small, projects in any case, have a high export content. Such grants have been negotiated on a project-by-project basis, with larger grants generally given to high-value-added and more skill-intensive projects. Projects located in less developed areas also receive bigger grants. R&D grants have been used to help existing companies move up the value chain and become more strategically important to the parent company.

Source: UNCTAD, based on O'Donovan, 2001.

in Germany, amounting to $3,400,000 per job to be created (table VII.1). In Alabama (United States), Honda Motor Co. received an incentive package in 2000 worth $158 million to help build a $400 million mini-van assembly plant, initially employing 1,500 people; and in March 2002, Hyundai received a $118-million bond issue to begin producing vehicles in 2005 (www.timesdaily.com, 3 April 2002). This evidence suggests that the trend observed until the mid-1990s continued thereafter.

Incentives have been an important element in the FDI strategies of some developing countries as well, especially those successful in attracting export-oriented FDI. These countries have often adopted a targeted approach to attracting FDI. Variations of "pioneer" company status or targeted "thrust industries" are frequently used as a basis for the granting of benefits. Singapore has used carefully targeted incentives to encourage the expansion of TNCs in certain industries, notably high-technology ones and those performing specific export-oriented activities. The country offers a 10-year tax holiday to "pioneer firms" producing goods and services not currently produced in Singapore, and expanding companies may enjoy up to 20 years of tax holidays (FIAS, 2001). In Malaysia, companies that meet the requirements for "pioneer status" enjoy a full tax holiday for five years (box VII.7). Costa Rica similarly uses investment incentives in its efforts to attract export-oriented FDI.[17] In China, foreign affiliates (including export-oriented ones) are offered various tax incentives. The corporate income tax on enterprises is generally 33 per cent. Foreign affiliates with contracts for operating periods of 10 years or more are exempt from income tax for two years after making profit, and eligible for a further 50 per cent reduction in their tax liability for the three subsequent years. Moreover, for foreign affiliates in special economic zones and economic and technological development zones, the income tax rate is 15 per cent.[18] Technologically advanced foreign affiliates may, upon the expiration of the enterprise income tax exemption and reduction period, enjoy a further 50 per cent reduction in the income tax rate for three years. Similarly, export-oriented foreign affiliates may, upon the expiration of the enterprise income tax exemption and reduction period, benefit from a 50 per cent reduction of their income tax if the value of their exports exceeds 70 per cent of the total production value. However, if these companies are located in a special economic zone or an economic and technological development zone and already pay an income tax rate of 15 per cent, the tax will be levied at 10 per cent.[19]

Table VII.1. Estimated incentives for selected FDI projects, 1995-2000

(Dollars)

Year of incentive	Country of project	Investor	Amount per job
1995	Brazil	Volkswagen	54 000-94 000
1995	United Kingdom	Siemens	51 000-190 000
1996	Brazil	Renault	133 000
1996	Brazil	Mercedes-Benz	340 000
1996	Germany	Dow	3 400 000
1996	Israel	Intel	300 000
1996	United Kingdom	Hyundai	190 000
1996	United Kingdom	LG	48 000
1997	India	Ford	420 000
1997	United States	Shintech	500 000
1997	United States	Daimler Benz	100 000
1998	United Kingdom	Ford	138 000
1998	United Kingdom	IMR	63 400
1998	United Kingdom	Dupont	201 000
1998	United States	Toyota	69 000
2000[a]	Canada	Mosel Vitelic	450 000
2000[a]	Israel	Intel	350 000
2000	United States	Honda	105 000

Source: Adapted from Loewendahl, 2001b, pp. 108-109.
[a] Planned

Some developing countries offer incentives only for the production and export of non-traditional goods, to encourage a shift towards new industrial activities. In Uganda, the Government has specified that wholesale and retail commerce, public relations and food processing, insofar as they are aimed solely at the domestic market, will not receive incentives. In Bangladesh, export-oriented projects in the garments and agro-based industries are given preferential interest rates, and can obtain tax holidays of 5-7 years depending on their location. Industrial undertakings not enjoying a tax holiday can obtain an accelerated depreciation allowance. Bangladesh also offers specific incentives to export-oriented activities. A large number of developing countries provide preferential treatment to investment projects related to the export of services, notably in the tourism industry, and, less frequently, business services including regional headquarters, international procurement offices, distribution centres and the like (UNCTAD, 2000a).

Box VII.7. The use of investment incentives in FDI targeting: the Malaysian experience

The Government of Malaysia has continuously revised the structure and nature of its incentives in the light of evolving national development objectives. By broadly linking incentives and the provision of specialized infrastructure facilities to skills development and technology upgrading, the Government was able to exploit changes in TNC strategies to improve Malaysia's competitive position. The evolution of the system of incentives in Malaysia reflects a shift from general investment promotion to a focus on high-technology sectors and industrial clusters.

- In 1958, the Pioneer Industries Ordinance provided tax holidays for periods ranging from 2 to 5 years to import-substituting industries producing a wide range of consumer and resource-based manufactured goods (such as food, beverages and tobacco, printing and publishing, building materials, chemicals and plastics).
- In 1968, the Investment Incentives Act (IIA) replaced the Pioneer Industries Ordinance: additional incentives were introduced to encourage employment creation, dispersal of industries and investment in capital-intensive projects. Incentives provided were Pioneer Status, Labour Utilization Relief and Locational Incentives (that offered tax relief for 2-10 years), and Investment Tax Credit that offered tax credits ranging from 25-40 per cent of capital expenditure.
- In the 1970s, FDI promotion focused on labour-intensive and export-oriented industries. Ten EPZs were established by Malaysia's state governments to attract FDI seeking low-cost sites for the assembly and export of electronic products, as well as textiles. These zones offered subsidized infrastructure, expedited customs formalities, and freedom from import duties and export taxes. EPZ firms are also exempted from equity-sharing guidelines. The 1975 Licensed Manufacture Warehouse programme extended this treatment to individual factories set up outside the zones.
- In 1986, the Promotion of Investments Act (PIA), replacing the IIA, introduced a new incentives regime to attract more export-oriented FDI. This included:
  - A pioneer status (PS) tax holiday of five years, with an extension of five more years for selected activities, including export-oriented FDI and FDI in the electronics sector;
  - An investment tax allowance (ITA);
  - An abatement of adjusted income for manufactured exports, small-scale companies, compliance with Government policy on capital participation and employment in industry, and the use of domestically-produced materials in the manufacture of exports;
  - An export allowance;
  - A double deduction of expenses for the promotion of exports; and
  - An industrial adjustment allowance.

  Other non-fiscal incentives included:
  - Import-duty exemptions for exporting firms (outside EPZs and licensed manufacture warehouse programmes), under the Customs Act; and
  - Foreign equity ownership: 100 per cent allowed in projects exporting at least 80 per cent of production; majority allowed in projects exporting at least 50 per cent of production.

- In the 1980s, a Reinvestment Allowance (RA) was introduced under the Income Tax Act to encourage investors, both foreign and local, to reinvest in the country. Initially, the RA was in the form of a deduction from statutory income of an amount equivalent to 25 per cent of qualifying capital expenditure incurred for purposes of reinvestment (defined as expansion of production capacity, diversification, upgrading, automation, modernization of production facilities), up to a maximum of 70 per cent of statutory income.
- In the 1990s, in response to massive FDI inflows, the Government revised the incentives regime to place greater emphasis on the quality of investment, as measured by technology content and value added. The goal was to transform assembly-dominated industries into more locally integrated industrial clusters.
- In 1990, tax incentives were extended to "regional operational headquarters" which provided management, logistics and coordination services to foreign affiliates in the region.
- In 1991, an overall review of incentives was undertaken aiming at streamlining incentives, strengthening revenue generation, and encouraging the development of competitive and resilient industries. The incentive system was modified to make its impact more selective and effective. Major changes were:
  - The scope of the PS tax holiday was reduced: exemption of only 70 per cent of statutory income, and a five year tax holiday;
  - An investment tax allowance was allowed as a tax deduction up to a maximum of 70 per cent of statutory income;
  - Special incentives were introduced to promote high-technology projects, strategic projects, R&D, training, industrial linkages and the development of the Multimedia Super Corridor (more targeted and value-added operations); and

/...

Box VII.7. The use of investment incentives in FDI targeting: the Malaysian experience (concluded)

- Various abatement schemes, including export incentives were abolished as they were less effective and inconsistent with WTO obligations.

Four performance requirements were used to evaluate applications for PS/ITA: (i) value added of 30-50 per cent; (ii) local content levels of 20-50 per cent; (iii) technology level (as measured by the proportion of managerial, technical and supervisory staff); and (iv) industrial linkages (in the main assessed qualitatively).

- In 1995, labour-intensive projects were de-emphasized and the approval of manufacturing projects was based on capital investment per employee. Manufacturing projects having a capital investment per employee of less than 55,000 Malaysian ringgit were categorized as labour-intensive and would not qualify for manufacturing licences or tax incentives, unless they met one of the following criteria: value added of more than 30 per cent; 15 per cent of workforce in managerial, technical and supervisory positions; location in promoted areas; or projects undertaking promoted activities or manufacturing high-technology products.

  High-technology projects in areas of new and emerging technologies (with local R&D expenditure equal to 1 per cent of sales within three years of start-up and 7 per cent of the workforce comprising scientific and technical staff) enjoy a five year tax holiday on 100 per cent of statutory income or an ITA of 60 per cent on qualifying capital expenditure incurred within five years.Specific activities to be promoted under the high-technology designation were: advanced electronics; equipment/instrumentation; biotechnology; automation and flexible manufacturing systems; electro-optics and non-linear optics; advanced materials; optoelectronics; software engineering; alternative energy sources; and aerospace.

- In the late 1990s, the RA was reviewed and made more attractive: the rate of the allowance was then increased to 40 per cent, and subsequently to 60 per cent of qualifying capital expenditure to be offset against statutory income. The period of eligibility for the incentive was restricted to five years, and subsequently extended to 15 years effective from 2002.

- In the period 2000-2002, new incentives and changes introduced included the following:
  - Pre-packaged or customized incentives for high-quality investments (in the form of fiscal as well as non-fiscal incentives);
  - Additional incentives to promote targeted sectors such as food production, machinery and equipment, and resource-based industries; and
  - New incentives to promote key manufacturing-related services such as logistics, market support and centralized utility facilities.

- Other incentives/policies/support facilities available include:
  - Tax deductions for expenditure on training, R&D, environmental protection and information and communication technology;
  - Duty exemptions on imported materials/ components and machinery and equipment;
  - Subsidized industrial land or infrastructure facilities in free zones/licensed manufacturing warehouses/industrial estates;
  - Direct funding mechanisms for high-technology industries (inter alia through venture capital funds and training grants);
  - Liberal foreign equity ownership for export-oriented projects;
  - Expatriate employment; and
  - Incentives for business support operations such as the establishment of operational headquarters, international procurement centres and regional offices/centres.

- In 1993, the Human Resources Development Fund (HRDF), was launched, aimed at encouraging direct private-sector participation in skills development and operating on the basis of a levy/grant system. Manufacturing companies have to contribute 1 per cent of employees' monthly wages to the fund. Employers who have paid the levy will qualify for training grants from the fund to subsidize training costs for their Malaysian employees.

The actual impact of the incentives offered is hard to assess, although it appears that incentives have been an important element in attracting TNCs to Malaysia. Some studies, however, suggest that the Government has not had enough capacity to survey and monitor firms' actual performance in fulfilling the technology-related conditions for investment promotion (Felker, 2001). Others estimate the potential revenue foregone in the late 1980s to be in the order of 10 per cent of manufacturing value added, or 1.7 per cent of GDP, and argue that, while the incentives may have helped to attract export-oriented investment and generate employment, some incentives are likely to have been overgenerous, and perhaps even redundant in some cases (Doraisami and Rasiah, 2001).

Source: UNCTAD, based on information provided by the Malaysian Industrial Development Authority (MIDA); Felker, 2001; Doraisami and Rasiah, 2001.

In order to encourage more exports by existing investors, some tax authorities have taken a flexible approach to tax-deductible expenses. For example, both Malaysia and Singapore have allowed double deduction for tax purposes of international travel, marketing and related expenses (UNCTAD, 2000a). In addition to fiscal and financial incentives, there are also regulatory incentives, such as the relaxation of ownership restrictions. In some countries, the acceptable level of foreign equity participation has been linked to the level of export, as in Malaysia before July 1998, (since then the policy has been relaxed).[20] In Thailand, in 1987 the Government relaxed the requirement of Thai majority ownership in projects exporting 80 per cent of their output, and allowed full foreign ownership. In 1998, in the aftermath of the Asian financial crisis, equity restrictions were suspended for all new FDI projects (Felker and Jomo, 2000).

2. WTO rules on export subsidies

There is one important requirement in the WTO system that will have a significant impact in the immediate future on the use of incentives in promoting export-oriented FDI: to make their domestic regulation conform with the WTO rules, many developing country members will have to adapt some of their current incentives schemes in the light of the prohibition of export subsidies contained in the WTO Agreement on Subsidies and Countervailing Measures (the SCM Agreement).[21] While such measures have been prohibited in developed-country members since the SCM Agreement came into force, the prohibition will apply after 31 December 2002 to all developing-country members not referred to in Annex VII of the SCM Agreement and not granted an extension of the transition period.[22] The complexity of the issue and its relevance for strategies to attract and upgrade export-oriented FDI make it important to review the rules in some detail.

Article 1 of the SCM Agreement defines the concept of "subsidy" and establishes disciplines on the provision of subsidies. The definition contains three basic elements: (i) a financial contribution (ii) by a Government or any public body within the territory of a WTO member (iii) which confers a benefit. All three of these elements must be satisfied in order for a subsidy to exist. Fiscal incentives may constitute subsidies within the meaning of the SCM Agreement as the concept of "financial contribution" includes "government revenue ... otherwise due [that] is foregone or not collected (e.g. fiscal incentives such as tax credits)". Financial incentives, such as the direct provision of funds through grants and subsidized credits, may also constitute subsidies, as the concept of a "financial contribution" includes a "government practice [that] involves a direct transfer of funds (e.g. grants, loans and equity infusion ...)". Finally, the provision of land and infrastructure at less than market prices may constitute a subsidy, as the concept of "financial contribution" includes "a government provid[ing] goods or services other than general infrastructure, or purchas[ing] goods".

To the extent that subsidies, as defined by the SCM Agreement, are provided on a "specific" basis as defined in Article 2 of the Agreement, they are subject to the SCM Agreement's provisions. There are four types of "specificity" within the meaning of the SCM Agreement:

- Enterprise-specificity: a Government targets a particular company or companies for subsidization;
- Industry-specificity: a Government targets a particular sector or sectors for subsidization;
- Regional specificity: a Government targets producers in specified parts of its territory for subsidization; and
- Prohibited subsidies:[23] a Government targets export goods or goods using domestic inputs for subsidization.

Hence, the two categories of prohibited subsidies are export subsidies and import-substitution subsidies (as defined in Article 3).

a. Prohibited and actionable subsidies

Clearly, investment incentives meeting the definition of a subsidy and granted, contingent upon an investor's export performance are export subsidies prohibited under the SCM Agreement (subject to the special and differential treatment described below). The Illustrative List of Export Subsidies, provided in Annex I to the SCM Agreement,

identifies a number of such measures. For example, the full or partial remission of direct taxes (e.g. income taxes) and social welfare charges, specifically related to exports, is an export subsidy. While the exemption or remission of indirect taxes on the export product, such as value-added tax (VAT) is permitted, the exemption or remission upon export of prior-stage cumulative indirect taxes on certain items (such as capital goods) is also considered an export subsidy. Similarly, while a member may provide remission or drawback of import charges on goods incorporated into an export product, the provision of duty remission on capital goods or on goods not used for the production of the exported product, contingent upon export performance, is an export subsidy. Furthermore, "simplified" drawback schemes which are common in developing countries (e.g. providing a "drawback" that is a fixed percentage of the f.o.b. value of the exports and not linked to the duty actually paid on imported inputs) would likely also be considered to constitute export subsidies, as would the provision by Governments of goods or services to exporters on terms more favourable than those available to producers for the domestic market.

A number of other "specific" investment incentives other than those meeting the definition of prohibited subsidies are also subject to the disciplines of the SCM Agreement. In other words, even if not prohibited, incentives that meet the definition of a specific subsidy and that cause "adverse effects" as defined by the SCM Agreement may be challenged through the WTO dispute settlement mechanism and potentially subject to compensatory action (be "actionable").

Most subsidies, such as production subsidies, fall into the "actionable" category. Actionable subsidies are not prohibited, but are subject to challenge in the event that they cause adverse effects to the interests of another WTO member. There are three types of adverse effects:

- Injury to a domestic industry caused by subsidized imports into the territory of the complaining WTO member. This is the sole basis for domestic countervailing action.
- Serious prejudice. This usually arises as a result of adverse effects (e.g. export displacement) in the market of the subsidizing WTO member or in a third-country market. Thus, unlike injury, it can serve as the basis for a complaint related to harm to a WTO member's export interests.
- Nullification or impairment of benefits accruing under the GATT 1994. Nullification or impairment arises most typically when the improved market access presumed to flow from a bound tariff reduction is undercut by subsidization.

Again, however, developing country members are entitled to special and differential treatment that shields them from certain challenges.

It should be noted that the SCM Agreement is an agreement on trade in goods listed in Annex 1A of the WTO Agreement and thus only regulates subsidies in the goods sector. (The General Agreement on Trade in Services (GATS) does not deal specifically with export subsidies – see box VII.8). Moreover, the disciplines of the SCM Agreement may not be easily applied to all kinds of investment incentives, in particular locational incentives. The SCM Agreement is concerned with trade in goods, which, by definition, occurs only after an investment has been made. Two areas – "adverse effects" and remedies – illustrate this point. Under the SCM Agreement, the adverse effects of subsidization generally relate to distortions of trade flows of subsidized goods (i.e. the extent to which subsidies increase the level of exports from, or reduce the level of imports into, the subsidizing country member and thereby harm producers of like goods in another member). In the context of investment, because the granting of an incentive may pre-date production, often by a considerable period, such an after-the-fact measurement of adverse effects is unlikely to exercise discipline over the provision of investment incentives. A similar issue arises in the context of remedies. By the time production and export have commenced, incentives aimed at attracting investment may have ended. In this situation, neither a recommendation to withdraw or modify a subsidy under the WTO dispute settlement mechanism, nor the application of a countervailing duty to the exported goods in the context of a domestic action, would be likely to "undo" or change an investment that has already been made.

Box VII.8. The treatment of subsidies in the GATS

GATS treats investment as one of the four modalities for the provision of services. Article I:2 of the GATS defines "trade in services" as encompassing four modes of supply, including the supply "by a service supplier of one Member, through commercial presence in the territory of any other Member" (mode 3). The term "commercial presence" is defined in Article XXVIII(d) as "any type of business or professional establishment, including through (i) the constitution, acquisition or maintenance of a juridical person, or (ii) the creation or maintenance of a branch or a representative office, within the territory of a Member for the purpose of supplying a service". As a consequence, the GATS covers forms of establishment which correspond to the notion of FDI.

The only provision of the GATS specifically dealing with subsidies is Article XV. It recognises that, "in certain circumstances, subsidies may have distortive effects on trade in services", and negotiations have begun with the aim of developing "the necessary multilateral disciplines to avoid such trade-distortive effects". "The negotiations shall also address the appropriateness of countervailing procedures." Any rules on distortive subsidies would have to be very complex and would present severe practical enforcement difficulties. And, indeed, subsidies relating to the supply of services "in the exercise of governmental authority" could not be disciplined (art. I.3 (b)). Furthermore, "such negotiations shall recognize the role of subsidies in relation to the development programmes of developing countries and take into account the needs of Members, particularly developing country Members, for flexibility in this area".

As it stands, the GATS does not contain any definition of subsidy. If any member "considers that it is adversely affected by a subsidy" it can request consultations which "shall be accorded sympathetic consideration" (art. XV). The GATS thus permits subsidies as such, including subsidies contingent upon the export of services and other investment incentives. However, the most-favoured-nation obligation applies to subsidies because they are covered by the definition of "measure". National treatment commitments also apply, unless they specifically exclude subsidies. In the service sectors for which commitments have been made, and subject to any conditions or qualifications set out in its Schedule, a WTO member must therefore administer its subsidy schemes in a manner that accords the services and service suppliers of other members treatment no less favourable than that accorded to its own like services and service suppliers.

The Working Party on GATS Rules deals with this issue. A few examples of potentially trade-distortive subsidies have been mentioned in areas such as cultural, educational and health services, transport, telecommunications, postal and financial services, construction, software and information services, advertising, tourism, export credits and R&D.

In the light of the close interaction between trade in goods and services, two further points are worth noting. First, the provision of subsidized services to producers of goods is disciplined by the SCM Agreement. In the Illustrative List on Export Subsidies (Annex I to the SCM Agreement) "internal transport and freight charges on export shipments" are mentioned, and "the provision by governments... of services for use in the production of exported goods". Second, the fact that a subsidy pertains to the services sector does not necessarily mean that other WTO agreements, and in particular the SCM Agreement, do not apply.[a] A WTO member cannot circumvent the prohibition of export subsidies, for instance, by casting the subsidies as relating to the services provided by domestic firms in the context of an outward processing operation. Since the subsidies are contingent upon the export of the assembled products, the SCM Agreement would apply.

Source: UNCTAD.

[a] The Appellate Body confirmed this in EC-Banana when it stated that: "Certain measures could be found to fall exclusively within the scope of the GATT 1994, when they affect trade in goods as goods. Certain measures could be found to fall exclusively within the scope of the GATS, when they affect the supply of services as services. There is yet a third category of measures that could be found to fall within the scope of both the GATT 1994 and the GATS. These are measures that involve a service relating to a particular good or a service supplied in conjunction with a particular good. In all such cases in this third category, the measure in question could be scrutinized under both the GATT 1994 and the GATS" (WT/DS2/AB/R, para. 221)

Specific subsidies within the meaning of the Agreement can also give rise to the imposition of countervailing duties against the subsidized imported goods by WTO members according to their own domestic legislation. Part V of the SCM Agreement sets forth certain substantive requirements that must be fulfilled to impose a countervailing measure, as well as in-depth procedural requirements regarding the conduct of a countervailing investigation and the imposition and maintenance in place of countervailing measures. The main requirement is that a member may not impose a countervailing measure unless it determines that there are subsidized imports, there is injury to a domestic industry, and there is a causal link between the subsidized imports and the injury.

b. Special and differential treatment

As mentioned above, the so-called Annex VII countries (namely, LDCs and certain other WTO members listed in the Annex until such time as their GNP per capita reaches $1,000) are exempted from the prohibition of export subsidies. Other developing-country members have an eight-year period (i.e. until the end of 2002) to phase out their export subsidies (and they cannot increase the level of their export subsidies during this period). With respect to import-substitution subsidies, LDCs have eight years, and other developing-country members five years, to phase out such subsidies. There is also more favourable treatment with respect to actionable subsidies.[24] However, developing countries, other than Annex VII countries, that attain "export competitiveness" for a particular product have two years from the date they achieved export competitiveness to phase out export subsidies for such a product, while Annex VII countries have eight years. "Export competitiveness" is deemed to exist when the export share in the particular product reaches 3.25 per cent of world trade for two consecutive years.

Furthermore, Article 27.4 of the SCM Agreement provides for the possibility of extending the eight-year time limit. It states that:

> "If a developing country Member deems it necessary to apply such subsidies beyond the 8-year period, it shall not later than one year before the expiry of this period enter into consultation with the Committee [on Subsidies], which will determine whether an extension of this period is justified, after examining all the relevant economic, financial and development needs of the developing country Member in question. If the Committee determines that the extension is justified, the developing country Member concerned shall hold annual consultations with the Committee to determine the necessity of maintaining the subsidies. If no such determination is made by the Committee, the developing country Member shall phase out the remaining export subsidies within two years from the end of the last authorised period."

This conditional possibility of extension has created some uncertainty with regard to the future application of many incentive schemes frequently used, for instance in the context of EPZs and similar zones.

c. Doha results

In the context of discussions on the implementation of the Uruguay Round agreements and the preparation of the WTO Ministerial Conference in Doha in 2001, negotiations took place on the need to put the extension of the transition period on a firmer basis. The issue was positively resolved with the Decision of 14 November 2001 taken at Doha on Implementation-related issues and concerns[25] which: "Having regard to the particular situation of certain developing-country Members, directs the Committee on Subsidies and Countervailing Measures to extend the transition period, under the rubric of Article 27.4 of the Agreement on Subsidies and Countervailing Measures, for certain export subsidies provided by such Members, pursuant to the procedures set forth in document G/SCM/39."

The decision provides a specific procedure for the extension of export subsidies by certain developing-country members on an annual basis until 31 December 2007 (plus two further years to complete the phase-out). The implementation procedure set forth in the Decision shows a certain preference for small countries and weak exporters by establishing eligible programmes.[26] Programmes enjoying an extension shall not be modified to make them more favourable than they were as of 1 September 2001. Hence, this standstill provision does not allow developing-country WTO members to introduce new schemes. The Annex VII country members, however, can introduce new schemes, as they enjoy a full exemption from the prohibition relating to export subsidies. Twenty-nine members have requested an extension of the transition period for their export subsidy programmes.[27]

3. Implications for the future use of incentives

What are the options facing host countries that wish to use incentives to attract export-oriented FDI? As far as the members referred to in Annex VII are concerned, the use of export subsidies remains unrestricted under WTO law. Thus these members can, if they so desire, continue to use export subsidies, including those provided in EPZs (see below). For other developing-country members with the exception of those that

obtain an extension of the transition period beyond 1 January 2003, export subsidies (related to goods) will have to be eliminated as required under the SCM Agreement. And even those obtaining an extension of the transition period cannot increase the level of their export subsidies, are subject to the prohibition in respect of particular products if they achieve export competitiveness in such products, and will need to consider what to do once the transition period expires.[28]

The challenge for developing countries wishing to use incentives as part of their efforts to promote export-oriented FDI is to weigh carefully the benefits and costs involved. Subsidies should not be used as an isolated measure to attract export-oriented FDI, but rather as a part of a broader "policy package". In countries in which incentives have played a role in efforts to promote inward FDI, they have typically complemented a range of other measures such as those aimed at enhancing the level of skills, technology and infrastructure. To compensate for major deficiencies by offering incentives may not always be a wise strategy as it increases the risk of public funds being spent on projects that do not offer the externalities needed to warrant the incentives in the first place. Without efforts to improve the business environment to make it more conducive to investment and the upgrading of the production of existing foreign affiliates, as well as to embed FDI into the local economy through linkages, the risk increases that investors will leave as soon as the incentives expire.

The discrepancy noted between developed and developing countries in the mix of financial and fiscal incentives they use may in effect make developing-country WTO members more exposed to countermeasures under the WTO rules. While both forms of subsidy are covered by the SCM Agreement, there are certain important distinguishing features worth noting:

- Financial incentives given as cash grants up front may be particularly attractive from the perspective of a recipient, as they cut the initial costs of an investment and thus lower the risk of a project. By contrast, a corporate tax holiday or a reduced tax rate will have an impact only when an investment starts generating profits. In industries characterized by rapid change and high volatility (as in the case of the semiconductor industry), the benefit from tax holidays is much more uncertain as compared with an up-front cash grant.
- It may be more difficult to show that an outright cash grant given as a locational incentive to an (export-oriented) activity has had an adverse effect on the interests of another WTO member. Since fiscal measures, on the other hand, last over an extended period of time, there may be more opportunities for other WTO members to assess the impact of a fiscal incentive and seek remedies.
- There is additional uncertainty from the fact that a member may be requested to withdraw a tax holiday deemed inconsistent with the provisions of the SCM Agreement. By contrast, the Agreement does not, in general, provide for the repayment of subsidies.[29]

Moreover, while the SCM Agreement considers market access problems relevant in meeting the adverse effects test (thus allowing for a remedy), it does not consider investment access problems equally relevant. A country may thus not be able successfully to bring a complaint about locational incentives that divert investment flows away from its market (Beviglia Zampetti, 1995; Brewer and Young, 1997). Hence many of the subsidies offered by countries for new investment projects, which come in the form of locational incentives under the headings of R&D, regional development or other goals, and which appear to be more widely used by developed economies, may not be tackled under the SCM Agreement.

From the perspective of using incentives to facilitate an upgrading of export activities, there may be a case for making incentives offered to foreign affiliates or domestic firms "non-actionable" in the WTO if and when they can be shown to have a clear developmental impact in developing countries (*WIR01*, p. 171).[30] This may involve, for example, the creation of more and deeper linkages, the provision of technology, and the training of local suppliers and their personnel. However, to avoid free riding, firms receiving incentives would have to commit sufficient resources on a long-term basis. In some host countries, TNCs have helped remove obstacles and facilitated upgrading (e.g. by way of training and the development of infrastructure) in collaboration with the relevant level of government (*WIR01*).[31]

In general, an open and transparent process, with regular reporting and accounting of the costs of the incentives used and accompanied by an assessment of their effectiveness, reduces the risk of unwanted effects (Hughes and Brewster, 2002). In this context, the type of incentive offered can also be considered. For example, infrastructure improvements (which also benefit domestic firms) may be better than fiscal incentives (which only kick in when an investment is on-stream), and these in turn may be better than financial incentives (which are offered up front). Moreover, when granting incentives, Governments can consider including a "clawback" provision stipulating that the incentives awarded are to be returned if requirements are not met.

An alternative to the provision of tax incentives may be an overhaul of the tax package as a whole, including statutory rates, depreciation and other deduction rules, loss-carry-forward rules, inflation accounting (if relevant), fairness and ease of administration, and, finally, any tax credits, allowances, holidays and other exemptions. Some economies have abolished specific tax incentives and, instead, chosen to offer a low corporate tax rate across the board. Hong Kong, China, is a classic example. It offers no tax holidays to export-oriented foreign investors, but its basic tax rate is 16.5 per cent and imports come in duty-free. Other examples include Estonia (box VII.9), Lebanon, Mauritius and, more recently, Ireland (box VII.6, Morisset and Pirnia, 2001; O'Donovan, 2001).

Box VII.9. Estonia: attracting export-oriented FDI by providing an enabling environment

Estonia represents an interesting case of a small economy that has managed to attract a large amount of export-oriented FDI, partly by pursuing export-friendly policies but without the use of special incentives for targeted industries.

Soon after regaining its independence, the Government of Estonia decided to abolish all customs duties and to rely primarily on a uniform, flat tax for both corporate and personal income, and a value-added tax. The elimination of customs duties greatly simplified and speeded up customs procedures, reducing costs and risks for firms involved in international trade. The Government eschewed efforts to target specific industries through either subsidies or investment incentives, which avoided problems of bureaucratic discretion and the distortion of investment decisions. For established companies (foreign or domestic), the Government offers grants and soft loans for infrastructure development and retraining of employees (outside the capital city area) and for R&D activities. These financial supports can amount to up to 75 per cent of investment costs.

The country has developed an open regime for FDI, abolishing most restrictions and approval requirements for FDI, and allowing foreign ownership of land. In the latter half of the 1990s, the Foreign Investment Law was repealed and FDI policy relied instead on the Company Law, the Securities Law and related legislation to govern all investment, without distinction between foreign and domestic investment. In addition, the country introduced liberal immigration procedures for foreign investors, in order to reduce bureaucratic delays and uncertainties. As a result, the FDI regime in Estonia became one of the most open and non-discriminatory in the world.

Estonia has been a very strong performer in both export growth and FDI inflows. Even after the completion of Estonia's privatization programme, the country has been able to maintain high levels of inward FDI by attracting export-oriented greenfield investments as well as M&As. In 2001, 9 of the top 10 exporters in Estonia were foreign affiliates. Other factors contributing to the favourable conditions offered by Estonia include relatively low-cost but high-skilled labour and its association agreement with the European Union.

While the Estonian Investment Agency (EIA) does not provide targeted incentives, it still engages in targeting. The Agency is currently concentrating on three industries: machine building (subcontracting mainly for the automotive industry), electronics (especially information and communication technology) and services (in particular shared-service centres). Aftercare of existing investors, by supporting their expansion needs and/or helping them develop clusters (the whole value chain approach), is also a priority.

Source: UNCTAD, based on information provided by the EIA and FIAS.

F. Export processing zones

Since the 1950s, EPZs have became increasingly popular in both developed and developing countries as a policy instrument for the promotion of export-oriented FDI.[32] In fact, most of the "winners" identified in Part Two have established at least one (and usually more than one) kind of EPZ and these accounted for a large share of non-primary manufactured exports in a number of them (box VII.10). As of 1997, about 850 zones of various sorts operated in both developed and developing countries (WEPZA, 1997; ILO, 1998), and the number has increased substantially since. In the developing world, the majority of them are located in Asia.

The concept of "EPZ" encompasses many different types of zones (e.g. free-trade zones, duty-free zones, free-investment zones, offshore zones), reflecting the variety of activities performed in the zones. These include bonded warehousing, export processing, assembling, border or port trade and financial services. However, despite these variations, export-oriented manufacturing has been the main focus of most zones. While zone firms can be domestic, foreign or joint ventures, FDI generally plays a prominent role. Zones can be publicly or privately owned and managed. In the past few years, the number of private zones has been increasing, thus contributing to the overall growth in the number of zones around the world.

In the Philippines, for example, involving the private sector in the development of economic zones helped the Government overcome obstacles related to inadequate funding and a lack of qualified personnel. Since 1995, 40 privately-run economic zones have been established under the Philippines Economic Zone Authority. All costs for the development of roads, utilities, standard factory buildings, waste water facilities and other infrastructure development were borne by private-sector developers. The Philippines Economic Zone Authority handles the provision of incentives. In each of the privately-run zones, it assigns personnel to administer incentives for enterprises registered with the Authority. Between 1994 and 2001, employment in these zones increased from 229,650 to 708,657, and exports expanded from $2.7 billion to $19.5 billion.[33]

One possible definition is to refer to EPZs as fenced-in industrial estates specializing in manufacturing for export and offering their resident firms free-trade conditions and a liberal regulatory environment (World Bank, 1992). Another is to describe them as industrial zones with special incentives set up to attract foreign investors, in which imported materials undergo some degree of processing before being re-exported (ILO, 1998). In any case, EPZs are clearly delimited and enclosed areas of a national customs territory, often at an advantageous geographical location (Madani, 1999) with an infrastructure appropriate for carrying out trade and industrial operations and subject to the principle of

Box VII.10. The role of EPZs in exports: evidence from selected countries

There is evidence suggesting that EPZs have played an important role in the export performance of many countries. As one expert (Radelet, 1999, p. 14) put it:

"Perhaps the most compelling piece of evidence in support of platforms is that the vast majority of manufactured exports in the successful economies utilized at least one of these facilities. *Simply put, manufactured exports did not expand rapidly in any country except through one of these facilities.* In Taiwan [Province of China], and [Republic of] Korea, for example, essentially all manufactured exports were either produced in a zone or a bonded warehouse, or used duty exemption/drawback systems. The vast majority of China's manufactured exports come through the special economic zones. In Malaysia, as much as 75% (in 1979) of all manufactured exports were produced just in EPZs, (and the share still exceeds 55%); most other manufactured exports go through bonded warehouses or use duty exemptions (Sivalingam, 1994). Over 95% of Mauritius' manufactured exports are produced in EPZs. In Kenya, 75% of manufactured exports use at least one facility, with the vast majority depending on the duty exemption system. Exports from Mexico's maquiladoras account for over 50% of total manufactured exports, and a much larger share of manufactured export growth. In the Dominican Republic EPZ exports account for 80% of all exports, and almost all manufactured exports (Warden, 1999a and 1999b)."

Source: Radelet, 1999.

customs and fiscal segregation. Typically, customs services are streamlined and red tape is kept to a minimum, often through one-stop shopping for permits and investment applications. Licensed enterprises within the zones produce exclusively or mainly for foreign markets. Incentives frequently available in EPZs include:

- Duty drawbacks or exemptions from import duties on raw materials, intermediate inputs and capital goods used in the production of exported products;
- Exemptions from the payment of sales tax on exported products as well as on all goods and services domestically purchased and used in their production;
- Tax holidays, tax rebates or reduced tax rates on corporate income or profits, linked to the export performance of companies or to the percentage of exports in total production; and
- The provision of subsidized services such as land, office space, utilities (water, electricity, etc.) and other facilities.

Bonded factories or warehouses share some of the characteristics of EPZs. To reduce the likelihood of fraud caused by selling duty-free imports in the domestic market, firms are required to post some guarantee. As in the case of EPZs, bonded factories are now often allowed to sell some of their production for domestic consumption.[34] In that case, they are asked either to pay duty on the inputs used or duty as applicable on the final goods. A large number of bonded factories are found in economies such as Hungary, Kenya, Malaysia, Mauritius, Pakistan, Taiwan Province of China, and the Republic of Korea, where they have been quite successful in promoting exports. In Taiwan Province of China, for instance, bonded factories are also common in science-based industrial parks (Jenkins and Kuo, 2000).

The nature of EPZs is evolving and definitions (unless broad) do not capture the dynamics of the phenomenon. As already noted, in recent years, the export requirement has been relaxed in many countries, thus allowing for significant domestic sales. More domestic companies are now established in the zones and efforts are being made by Governments to encourage more linkages between foreign affiliates and domestic firms, as well as to encourage training of local employees and development of technical and technological infrastructure.

Experience shows that EPZs can be successful in earning foreign exchange, increasing employment and developing export competitiveness (boxes VII.11 and VII.12). However, the performance of EPZs depends

Box VII.11. FDI in some developing country EPZs

Data on FDI in EPZs exist for only a small number of countries. Judging by the experience of some ASEAN countries, which had 130 EPZs at the end of 2001 (ASEAN Secretariat, 2002),[a] the relationship between the location of foreign affiliates and the location of EPZs seems, in general, to be weak. However, there are some exceptions. In the Philippines, the share of FDI flows to EPZs rose from 30 per cent of the total in 1997 to 81 per cent in 2000. In Bangladesh also, EPZs are known to have attracted considerable FDI in flows in 2000, $54 million out of the $170 million in total FDI inflows were registered in the EPZs in Chittagong and Dhaka (JETRO, 2002)[b].

In Latin America, the maquiladoras received 31 per cent of the total manufacturing FDI in Mexico between 1994 and 2001.[c] No similar data are available for other countries in the region. However, in terms of value added, maquila plants (both domestic and foreign) in six Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and Dominican Republic) accounted for between 9 per cent (Guatemala) and 43 per cent (Dominican Republic) of the industrial GDP in 1996. Foreign firms were responsible for between 35 per cent (El Salvador) and 84 per cent (Dominican Republic) of the capital of maquila plants (Buitelaar and Padilla, 2000). In Costa Rica, some three-quarters of all foreign affiliates are located in EPZs.[d]

Source: UNCTAD.

[a] FDI under the auspice of the Philippine Economic Zone Authority, the Subic Bay Metropolitan Authority and the Clark Development Corporation are considered FDI in EPZs.

[b] Increases in the cumulative value of FDI between August 2000 and August 2001. FDI in the Monla EPZ is also included but it is still very small.

[c] "Maquila" in Mexico is an administrative status awarded by the Government to companies engaged in an industrial or service process for merchandise of foreign origin, imported temporarily for transformation or value added, and subsequent re-export.

[d] Information obtained from the Proyecto de Desarrollo de Proveedores in Costa Rica.

very much on other policies, policies that go beyond incentives and aim at enhancing human resources and creating the infrastructure necessary to attract and upgrade export-oriented FDI. There are zones that have been successful, as in China, the Dominican Republic, Mauritius and Singapore. On the other hand, there are many that have failed to attract substantial investment and where outlays have far exceeded social benefits. In Kenya, for instance, EPZs established at great expense have lain mostly idle. The small size of the regional Common Market for Eastern and Southern Africa, inadequate infrastructure in Kenya, the appreciation of the domestic currency and rising labour costs have together resulted in much smaller volumes of exports than expected (Jenkins and Kuo, 2000). However, there was an improvement in the performance of Kenyan EPZs in 2001, following the introduction of the AGOA initiative (Kenya, EPZA, 2001).

A comprehensive cost-benefit analysis of zones is difficult to undertake. In particular, some potential long-term and structural contributions to the local economy are more difficult to appraise as they derive from dynamic gains that can only be realized over time and through deliberate effort, such as learning and absorbing foreign technologies and transforming the pattern of economic growth from an inward-looking to an outward-looking one (Johansson, 1994; Ge, 1999a). Furthermore, costs such as environmental degradation and foregone revenues are difficult to quantify and may reveal their extent only over time. An additional cost and danger is the risk of "leakage" of duty-free goods into the domestic market. This has the potential to undermine the development of backward linkages by preventing local enterprises from emerging or it can even destroy local enterprises.

In terms of human capital, EPZs can contribute to the domestic economy if foreign investors engage in substantial training and if the workplace encourages learning by doing, as in Singapore and the Philippines (Rhee, Katterbach and White, 1990; ILO, 2001). This increases the productivity of the local work force. Furthermore, learning can also occur at the managerial and supervisory level, thus potentially fostering local entrepreneurship. This is important since firms in developing

Box VII.12. EPZs in Hungary

Foreign affiliates account for about 80 per cent of the total exports of Hungary. Many of the TNCs investing in Hungary have chosen to locate their export activities in one of the "industrial free trade zones" in the country. Unusually, the investing firms, not the national authorities, choose the location for a zone. As a result, the Hungarian industrial free-trade zones are more geographically dispersed than EPZs in other countries, although investors have preferred to establish their zones in the most advantageous sites. In 2001, 63 per cent of them were located in north-western Hungary, close to the Vienna-Budapest highway, 26 per cent to the south-east of Budapest, mostly along the M3 motorway, and 11 per cent in the metropolitan zone of Budapest. Within four years (1997-2001), the number of such zones increased by 40 per cent, to 125. Practically all firms operating in these zones are affiliates of electronics, software or automotive TNCs, including Audi, Opel, IBM, Nokia, Philips and Flextronics.

The first legal framework for the industrial free trade zones was established by the 1988 Law XXIV/1988 on Foreign Investment. Such zones are separated from the national customs territory by a licence issued by the authorities. All firms that meet the criteria are eligible without discrimination. Activity in a zone is also subject to licensing. The zones enjoy a special status for customs, trade and foreign-exchange regulations. In contrast to some other countries, Hungary allows duty- and VAT-free imports to the zones, not only of materials and parts but also of equipment and investment goods used for manufacturing. Only goods not directly used in manufacturing are subject to duty. Firms can hold their capital and keep their books in foreign currency but are subject to Hungarian taxes, with the exception of VAT. Since January 1993, at least 2000 m^2 of territory are required to establish an industrial free-trade zone and permission from the Ministry of Finance is necessary for selling or buying a zone.

The zones have been among the engines of export growth and modernization in Hungary. Success in attracting some leading TNCs has recently been followed by a wave of first-tier suppliers. The zones usually draw fully foreign-owned greenfield investments. Of the exporting foreign affiliates, those located in the zones have shown particularly strong trade dynamism. Between 1996 and 2001, their exports grew more than five times as compared to a doubling of Hungary's exports as a whole. In 2001, the zones accounted for 44 per cent of the country's total exports, more than 90 per cent of which go to the European Union (annex table A.VI.2).

Source: UNCTAD, based on Antalóczy, 1999.

countries often lack the production and marketing know-how required to enter world markets.

However, since EPZ production processes often involve low skills and low technology, particularly in the garment and footwear industries and in the assembly of electronic components and light machinery goods, training is limited. Countries that have encouraged low-quality FDI in the hope that human capital could be improved once they have attracted sufficient productive resources, have found it difficult to escape the low-value-added trap. Low-quality FDI involves firms with few linkages with the domestic sector, low potential for technology spillovers and short-term horizons. Such firms invest little in productivity and skills development (ILO, 2001). Moreover, the learning that does take place may be limited to industrial discipline and routine. Labour-intensive processing industries generally compete on price, and labour is often seen more as a cost to be contained than as a resource to be developed. While wages tend to be higher, on average, in the zones than in the rest of the economy, there is considerable variance, and conditions of work are at times affected by lax labour, safety and health regulations. Employers in EPZs generally use pay-incentive schemes that entail longer hours of more intensive work than non-EPZ enterprises (box VII.13). In these zones, trade unions are generally barred from organizing to improve the conditions of workers (ILO, 1998; *WIR99*, box IX.5). In contrast, zones with coherent and comprehensive policy frameworks, provisions for human resource development, good working and living conditions, and stable labour relations attract quality investors (ICFTU, 1999).

EPZs may furthermore contribute to the upgrading of physical capital. Successful zones are those for which Governments have created an efficient and competitive industrial infrastructure. While this may only be available to a limited number of firms (foreign or domestic), it can have important demonstration and catalytic effects. A successful and well-integrated zone can also be considered a laboratory for, and a spur to, policy reform. As confidence is gained, the zone framework can be replicated in other parts of the country and the early investors start to move out of the original zone. For instance, the successful development of the initial zones in China prompted demands for similar zones elsewhere. In addition, pressures, not just for spreading but also for deepening policy and institutional reforms, are likely to mount over time. For instance, demand for trade-related financial services may rise, forcing the financial sector to perform. These forces may in turn lead countries onto a path towards greater economic efficiency (Ge, 1999a). For instance, in Malaysia, EPZs are thought to have had a favourable impact on the regulatory framework and the business environment (Sivalingam, 1994).

The industrial composition of producers within EPZs and other zones is also evolving. Whereas they used to be dominated by low-technology, labour-intensive, manufacturing activities, many are now moving into new areas. Among the most advanced of the new kinds of zones is the one in Kaohsiung, Taiwan Province of China; it began with simple sewing in 1967, expanded to fashion garments, then to electronics assembly and then to electronic design, testing and R&D, and is now moving into the business of hosting corporate headquarters and global logistics centres (OECD, 2001a). Indeed, among developing-country WTO members, this trend may be accelerated by the WTO disciplines in the area of export subsidies.

More specifically, as mentioned above (section VII.E), apart from the developing-country members listed in Annex VII of the SCM Agreement (namely LDCs and members listed in Annex VII, until their per capita GNP income reaches $1,000), WTO members will have to eliminate export subsidies as of 1 January 2003, with the exception of those granted an extension of the transition period.[35] And even those granted an extended transition period need to consider what to do once it expires.[36] Subsidies linked to the export of services are, in principle, not prohibited and this may favour a shift towards service-oriented activities. The possibility of offering other specific incentives that do not meet the definition of prohibited subsidies remains but, as noted above, any "specific" subsidy that causes adverse effects to another WTO member's interests is actionable and potentially subject to remedial action.[37] In particular, subsidized exports to another WTO member may be subject to countervailing measures if they cause, or threaten to cause, material injury to a

domestic industry that provides a product in the importing member. The provision of such subsidies therefore remains risky.[38]

The options available to developing-country members not included in Annex VII are: (i) to maintain incentives for EPZ companies but eliminate the conditionality of restricting sales in the domestic market; or (ii) to establish for all domestic companies a new system of incentives that is not contingent upon export performance in either law or fact (Roessler, 2001, pp. 33-34). Moreover, WTO rules permit the use of border tax adjustments. Thus, EPZs can continue to exempt exports by companies in these zones from indirect taxes (such as sales taxes), border taxes (e.g. consular fees) and import charges. Duty drawbacks and duty exemptions are thus permissible. While duty drawback schemes may not include capital goods used to produce exported goods, many smaller WTO members may have little or no domestic production of such capital goods, and thus could consider simply lowering or eliminating import duties on such goods.

Box VII.13. EPZs and the "race to the bottom"

As EPZs have become an important part of export-oriented industrialization, critics have charged that competition for export-oriented FDI using EPZs contributes to a "race to the bottom", as it involves a deliberate lowering of social and environmental standards. More specifically, along with incentives such as tax holidays, duty-free imports and good infrastructure, EPZs offer abundant and relatively cheap labour, sometimes with exemptions from national regulation on labour protection.

Substandard labour conditions can emerge from the repression of rights such as freedom of association and collective bargaining, and from unregulated terms and conditions of employment. These situations in the zones may result from a lack of enforcement by Governments of labour laws or regulations that, in principle, apply in the zones as well as in the rest of the country, or from exemptions or variances in labour laws or regulations applicable in the zones compared with those applied elsewhere (ILO, 2001, Part I, paras. 151-55). Responses from a sample of 125 Governments, workers and employers' organizations reported that many countries apply the same labour laws in EPZs as elsewhere (ILO, 2001); another report found, however that, in practice there were severe restrictions on rights to organize in EPZs (ILO, 2000a).

The issue of practices in EPZs was recently covered in the ILO Seventh Survey on the Effect Given to the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy (ILO, 2001). In one Latin American country, workers reported that enterprises in EPZs have destroyed ecosystems and lowered relative wages. In general, worker views were that there has been no transfer of skills from foreign affiliates operating in the country. The ILO's Committee on Freedom of Association has also examined cases involving blacklisting and massive dismissals that highlight the unwritten understanding that unionization is unacceptable in zones.[a] The country has since set up a specialized Labour Inspectorate to protect freedom of association in the zones. In one African country, government views were that foreign enterprises have taken advantage of the weak enforcement of safety and health regulations to operate at a much lower level of standards. EPZs in the country were granted exemptions from health and safety (which are due to be removed) and this acted as an incentive to investors. In another African country, government views were that workers in EPZs receive less favourable treatment than elsewhere and that women working in these zones had to work overtime and at night (ILO, 2001).

By contrast, the views of an Asian Government were that foreign investors played a key role in identifying skills needed so that these could be developed through training programmes. There has also been a skills transfer between foreign affiliates and domestic industry in that country. Foreign affiliates have initiated measures to improve existing practices in EPZs, for example through a gains-sharing programme that provides benchmarks for foreign and local companies operating in the same industry line (ILO, 2001).

The fact that some countries view limiting labour and environment standards as an incentive to FDI in EPZs may indicate a need for collective action involving a variety of actors to limit the risk of a possible "race to the bottom".

Source: UNCTAD, based on information provided by ILO and Christian Aid.

[a] See ILO, CFA No.1658 (1993) and No. 1732 (1994) both available on http://ilolex.ilo.ch:1567/

Finally, efforts should be made to provide improved industrial infrastructure and services and a skilled labour force. As this involves cost, countries may still see an advantage in creating and maintaining special designated areas – as islands of efficiency and as steps towards expanding such facilities more widely in the country as the economy develops. Traditional EPZs can thus become redundant over time and transform themselves into industrial parks or other formations more integrated with the rest of the economy. Indeed, such zones may eventually become parts of industrial clusters (section VII.G), especially when combined with additional efforts to build institutional capacity and upgrade human skills.

Notes

1 See USITC, 1999 and europa.eu.int/comm/taxation_customs/customs/customs.htm.

2 Some developing countries also extend preferences to other developing countries and LDCs, for instance, under the Global System of Trade Preferences.

3 For more information on these and other preferential trade schemes see www.unctad.org/gsp/index.htm; www.agoa.gov; www.ustr.gov/regions/whemisphere/camerica/cbi.shtml; europa.eu.int/comm/development/cotonou/agreement_en.htm.

4 The text agreed on by Ministers in Doha states: "… negotiations will take place after the Fifth Session of the Ministerial Conference…on the basis of a decision to be taken, by explicit consensus, at that Session on the modalities of negotiations" (WTO Document WT/MIN(01)/Dec/17, para. 27).

5 Ibid.

6 These articles deal with transparency, public information, formalities associated with importing and exporting, and goods in transit.

7 ASYCUDA is short for Automated SYstem for CUstoms Data.

8 Obviously, an export performance requirement would be redundant if a firm were to export the same or more without government intervention.

9 An important ruling by a panel in a GATT dispute settlement proceeding between the United States and Canada clarified this point in 1984. In Canada, a panel considered a complaint by the United States regarding certain types of undertakings that were required from foreign investors by the Canadian authorities as conditions for the approval of investment projects. These undertakings pertained to the purchase of certain products from domestic sources (local content requirements) and to the export of a certain quantity or percentage of output (export performance requirements). The Panel concluded that the local content requirements were inconsistent with the national treatment obligation of Article III:4 of the GATT but that the export performance requirements were not inconsistent with GATT obligations.

10 Examples include the United States-Israel FTA (1985); NAFTA (1994); the Canada-Chile FTA (1997); the Mexico-Nicaragua FTA (1997); and the FTAs between Mexico, El Salvador, Guatemala and Honduras (2000) (UNCTAD, 2001f)

11 For the case of Taiwan Province of China, see Wade, 1990.

12 Advantages awarded in this context include tariff protection against import competition, duty rebates on imported inputs, fiscal and financial incentives.

13 Generally, financial incentives include grants, subsidized credits and insurance at preferential rates; fiscal incentives are tax holidays, reduction or exemption of taxes on profits, capital, labour, sales, value added, particular expenses, imports and exports; and other incentives range from subsidized infrastructure to market preferences and other preferential treatment (UNCTAD, 1996; 2000a).

14 Detailed studies of the use of tax incentives to promote investment in Brazil, Indonesia, Malaysia, Mexico, Pakistan, Thailand and Turkey found that such instruments often led to distorted investment decisions, partly because they discriminated between firms that showed losses in early years and those that did not, and between relatively capital-intensive activities and relatively labour-intensive activities (Moran, 1998).

15 A study of the impact of tax incentives in Indonesia found that, although they may have helped to attract some FDI into the country, that might otherwise not have come, the costs to the taxpayer were far in excess of the benefits of the additional investment (Wells and Allen, 2001).

16 The most commonly used fiscal incentives in developing countries are tax holidays and reductions in the standard corporate income tax rate. These are followed by duty exemptions and drawbacks, accelerated depreciation, specific deductions from gross earnings for tax purposes, investment and reinvestment allowances, and deductions from social security contributions (UNCTAD, 2000a).

17 For information on a new incentive scheme in Poland, see box III.10 (chapter III) of this *WIR*.

18 The same applies to enterprises that are deemed high- or new-technology enterprises.

19 Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (effective 1 July 1991); Rules for the Implementation of the Income Tax Law of the People's Republic of China for Enterprises with Foreign Investment and Foreign Enterprises (effective 1 July 1991).

20 The old policy stated that companies exporting 80 per cent or more of their output were allowed to be fully foreign-owned; companies exporting 20-79 per cent of their sales could have up to 79 per cent of the equity in foreign hands; and other companies could have up to 30 per cent equity. The policy will be reviewed again after 31 December 2003 (Cheng, 2001).

21 In the WTO context, the term country includes any separate customs territory member of the WTO.

22 The countries referred to in Annex VII are the LDCs and those WTO members listed in Annex VII(b) until their GNP per capita reaches $1,000. Apart from the LDCs, the list includes Bolivia, Cameroon, Congo, Côte d'Ivoire, Dominican Republic, Egypt, Ghana, Guatemala, Guyana, India, Indonesia, Kenya, Morocco, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka and Zimbabwe. In addition, Honduras was included in the list through a rectification in 2001. WTO members agreed at Doha "that Annex VII(b) to the Agreement on Subsidies and Countervailing Measures includes the members that are listed therein until their GNP per capita reaches US$1,000 in constant 1990 dollars for three consecutive years" (see WTO document WT/MIN(01)/Dec/17, para.10.1).

23 Prohibited subsidies are deemed to be specific (Article 2.3 of the SCM Agreement).

24 For example, certain subsidies related to developing-country members' privatization programmes are not multilaterally actionable. With respect to countervailing measures, developing-country members' exporters are entitled to more favourable treatment with respect to the termination of investigations where the level of subsidization or volume of imports is small.

25 WTO Document WT/MIN(01)/Dec/17.

26 "Programmes eligible for extension pursuant to these procedures ... are export subsidy programmes (i) in the form of full or partial exemptions from import duties and internal taxes, (ii) which were in existence not later than 1 September 2001, and (iii) which are provided by developing country Members (iv) whose share of world merchandise export trade was not greater than 0.10 per cent ..., (v) whose total Gross National Income ("GNI") for the year 2000 as published by the World Bank was at or below US$ 20 billion, ..." WTO Document G/SCM/39.

27 The following WTO members have made requests on the basis of the procedures in G/SCM/39: Antigua and Barbuda; Barbados; Belize; Bolivia; Costa Rica; Dominica; Dominican Republic; El Salvador; Fiji; Guatemala; Grenada, Honduras; Jamaica; Jordan; Kenya; Mauritius; Panama; Papua New Guinea; Sri Lanka; St. Kitts and Nevis; St. Lucia; St. Vincent and the Grenadines; Suriname; Uruguay. Other requests under Art. 27.4 have been made by Colombia; El Salvador; Panama; Thailand and Uruguay (see WTO Document G/SCM/40/rev.2 of 13 March 2002).

28 It should also be recalled that neither the original transition period nor its extension will protect a member from the possible application of countervailing measures in respect of subsidized exports.

29 For an interesting, albeit isolated, jurisprudential development admitting the possibility of repayment, see Australia – Subsidies provided to producers and exporters of automotive leather – Recourse to Article 21.5 of the DSU by the United States, WTO/DS126/RW, 21 January 2000.

30 A proposal to consider subsidies linked to the pursuit of development goals non-actionable has been noted in the decision on "Implementation-related issues and concerns" adopted at the WTO Doha Ministerial Meeting (WTO Document WT/MIN(01)/Dec/17, para. 10.2).

31 Training programmes with the active participation of TNCs to upgrade the product quality and productivity of domestic companies have been set up in Indonesia, Ireland, Malaysia, Singapore and Wales (United Kingdom) (*WIR99*; *WIR01*).

32 For a discussion of EPZs, see, Wall (1976), Ping (1979), Pollack (1981), Jayawardena (1983), Spinanger (1984), Sklair (1985) and Rondinelli (1987). More specific studies include Warr (1984) about a zone in the Republic of Korea; Leinbach (1982) and Warr (1987) about the EPZs in Malaysia; Kumar (1987) about the zones in India; and Wideman (1976) about the zones in the Philippines. Germidis (1980), Basile and Germidis (1984), UNIDO (1980) and UNCTAD (1985) describe EPZs in developing countries, including in Brazil, Egypt, Mauritius, Mexico, Peru, Tunisia and Sri Lanka. Jenkins, Esquivel and Larraín (1998) review the experience of EPZs in Central America. Studies of the special economic zones in China include Chang (1986), Chu (1985), Crane (1990, 1993), Fewsmith (1986), Harding (1987), Howell (1993), Kleinberg (1990), Li and Zhao (1992), Oborne (1986), Solinger (1984), Stoltenberg (1984), Sit (1986, 1988), Sklair (1985), Wong (1987) and Ge (1999b).

33 Information provided by the Philippines Economic Zone Authority.

34 As early as 1983, maquiladora firms in Mexico were allowed to sell up to 20 per cent of their production on the domestic market (Buitelaar and Padilla Perez, 2000). In Mauritius, companies are not located in specified areas and may sell up to 20 per cent of their production duty-free, subject to authorization by the Industry Ministry (WTO, 2001a).

35 Arguably, the last sentence of Article 27.4 of the SCM Agreement would allow WTO members, which had requested but been denied an extension two additional years to phase out their export subsidies. If this is correct, then such members would have until 1 January 2005 to phase out their export subsidies.

36 Most of the members that have made a request for extension have done so in relation to export-subsidy programmes used in the context of EPZs.

37 Although the only subsidies granted or maintained by a developing-country member that may be subject to a dispute settlement challenge based upon serious prejudice are export subsidies.

38 However, as noted above, in the context of locational grants not, de jure, contingent upon export, and when the granting of an incentive pre-dates production and export, it may be more difficult to prove adverse effects of the incentives on trading partners.