The WTO Perspective on Subsidies in International Trade;

by

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I. Introduction

Not long after the end of the Second World War economists and policy makers started considering free trade as a method of maximizing welfare, and also as a means of finding solutions to social and political problems. After the formation of the GATT in 1947 and WTO in 1995, governmental policies of the member states have continued moving forward to a system of free trade.

The majority of nations have started following liberal trade policies, both in their pursuit of domestic economic objectives and while contributing to world trade. When government policies start inducing a system of liberal market economy, they have to modify the underlying economic concepts of government, and further make it suitable to cotemporary cross border trade requirements. First, *government has to agree not to increase the existing levels of tariffs* and second, *when existing tariffs are lowered, it is likely that an even greater number of industries* (domestic and foreign) *will face the need to adjust to the competitive market situations*. With the newly developed market conditions, nations start competing with each other for profitable international business. Consequently, they resort to policies of granting aid and subsidies, so as to maintain a dominant position in the market.

As far as obligations under the WTO are concerned, all members are automatically bound by all the multilateral trade agreements, including the "Agreements on Agriculture and Subsides and Countervailing Measures (ASCM)," as well as the "Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)".[1]Additionally, member states, while framing domestic policies, should ensure that WTO subsidy provisions are not breached. In so oing it is also necessary for WTO members to bear in mind the provisions of Article 31(1) of the Vienna Convention on the Law of Treaties.[2]

In practice, there is invariable use of subsidies by nations even for minor reasons. Over time this practice is substantiated by legal precedent, ironically, indifferent to the vagueness of their purpose. The indiscriminate use of subsidies is contrary to the basic objectives of the WTO and enhanced legal complexities follow. It has led to the demand for broader legal support for various other subsidies with unclear objectives. To understand the far reaching effects of subsidies in international trade, we start with discussing state aid.

[1] Marc Benitah. (2001). P.3, The Law of Subsidies under the GATT/WTO System. Great Britain:Kluwer Law International.

[2] *Article31 (1)* of the Vienna Convention provides " A treaty shall be interpreted in good faith with the ordinary meaning to be given to the terms of treaty in their context and in the light of its object and purpose."

The impact of subsidies and state aid in international trade can be divided in two stages. A noticeable aspect of such aid and subsidies is that they improve the initial conditions of an enterprise and later, these aids and subsidies act as a factor for export promotion.

In order to understand market practices better, it is necessary to distinguish between state-aid and subsidy. Although, the two terms are different they have some commonness also. More significantly, the legal approach towards these two terms varies.

1.1 State-aid and Subsidy

A subsidy can generally be viewed as the opposite of tax. From the broader perspective of industrial and trade production, it is a payment by government to consumers or producers, which makes the factor costs received by the producers greater than the market price charged by them. There can be several reasons for giving subsidies, for instance subsidies may be given on the grounds of income distribution or to supplement the incomes of producers or consumers."[3] The subsidies that are provided to consumers and producers are not restricted to financial or fiscal benefits, but may also include para - fiscal aid (for example, by adopting export promotion policies), provided from public and private accounts. These kinds of concessions often result in externalities and finally end up as subsidies either in explicit or implicit form. For comprehensive understanding of the term "subsidy" in relation to trade practice, and its effects, it is necessary to consider terms such as "aid", "bounty" and "grant" on a collinear basis.[4] As per the practice in general, the term "subsidy" can be construed as conforming the very broad meaning, inclusive of bounty or grant, primarily depending upon the conditions, and objectives of the policies. The mere conferral of most kinds of benefits to producers would qualify as a subsidy, since as soon as it is (legally) established that a "generous gift" has been given, a subsidy would exist.[5]

As a matter of fact, such a wide interpretation is commonly not used to determine trade distortion (distortion as defined under the WTO treaty provisions) in international trade. While attempting to differentiate between state-aid and subsidy, one realizes the legal complexities, because the motive behind the aid can be elusive and with vague legal justification. From the perspective of WTO law, state-aid is not invalid as such, but its precise proportions, when validity ceases, is difficult to ascertain, as market forces are influenced by many hidden factors. The WTO ASCM does not differentiate between state aid and subsidy.

[3] John Black. (2004). P. 451,Oxford dictionary of Economics, New Delhi: Oxford University press.

[4] Webster's New World Dictionary defines "grant" as "something granted" (or given) and "bounty" as "something given freely as a generous gift."

[5] WEBESTER'S NEW WORLD Dictionary. P587 (3d college ed 1988). Reference quoted from. E. Kwaku Andoh. (Jul. 1992). P. 1519 Vol. 44, No. 6. Countervailing Duties in a Not Quite Perfect World: An Economic Analysis, *Stanford Law Review*.

Therefore, in an attempt to elaborate on the relationship between state-aid and subsidy, reference can be given of Articles 87 and 88 of the EC Treaty provisions[6].

Some authors are of the view that EC institutions have consistently differentiated the notion of aid in EC law from the notion of subsidy in WTO Agreements.[7] The most common justification for providing state-aid is "social necessity." In practice, there are situations where aid is given to support policy measures, which is in the larger interest of society. In these cases, the social benefit can overshadow the prohibition against subsidies based on the use of funds from public accounts. Since the WTO does not have any specific human rights agreements, it is necessary to refer to some basic aspects of sociological jurisprudence in order to substantiate the legal justification for state-aid.[8] Sociological jurisprudence is concerned with speculating about society in the light of factual and observational data and with making and administering law with reference to the needs of society. [9] Relevant here would be to apply Roscoe Pound's idea of *social engineering* and Ihering's idea in his book *Der Zweck im Recht* translated into English as ("Law as a means to an End"). An instance of judicial justification for state-aid on social grounds can also be noted in the case of *Preussen Elektra A.Gv Schleswag*,[10] where the validity of aid given by a state was challenged.

[6] *Article 87 and 88 of the EC Treaty* (ex Article 92-93 EC) set rules on state-aid that distort trade between the EC Member States. *Article 87, (1).* Save as otherwise provided in this treaty, any aid granted by a Member State or through state resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common market.

Article 88
The Commission shall, in cooperation with Member States, keep under constant review all systems of aid existing in those states. It shall propose to the latter any appropriate measures required by the progressive development or by the functioning of the common market.

[7] Marco.M. Slotboom. (2002).P.518, Subsidies in WTO and in EC Law Broad and Narrow Definitions. *Journal of World Trade.* Netherlands. See also, J.F.Beseler & A.N.Williams, (1986). Anti –dumping and Anti-subsidy Law. The European Communities. London: Sweet &Maxwell, at s.5.2.2 .See for a differentiation between the two notions after the entry into force of WTO Agreements T-55/99,CETM v. Commission [2000] ECR, II-3207, at s.50, where the court of First Instance of the EC (the "ECFI") observed without any further explanation, "The reference to the concept of 'Subsidy' within the meaning of the WTO Agreement on Subsidies and Countervailing Measures has, as the Commission submits, no relevance whatsoever to the classification of the measure in question as State aid within the meaning of Community law."

[8] WTO follows basic human rights principles, that are part of international law and are also within the domain of Vienna convention on the law of treaties. We can draw this analogy from the trade sanctions being applied to save human rights. Vienna Convention on the law of treaties, "Article 53" 'A treaty is void if, at the time of its conclusion, it conflicts with a peremptory norm of general international law. For the purpose of the present Convention a peremptory norm of general international law is a norm accepted and recognized by the international community of States as a whole as a norm from which no derogation is permitted and which can be modified only by a subsequent norm of general international law having the same character'.

[9] Dias R.W.M. (1964), P. 442. Jurisprudence, London: Butterworths & co (publishers) Ltd.

[10] See case C-379/98, *Preussen Elektra v Schleswag* AG, [2001] ECR I- 2099.

The court in this case justified the statutory provisions of member states of (EU) that require private electricity suppliers to purchase electricity produced from renewable energy sources and later distribute the financial burden between the electricity suppliers and a private network of electricity operators.[11] The commission in fact, maintains that state aid which can render competition rules ineffective is prohibited. This also includes adoption or enactment of any policy instrument by the legislative bodies.

"In this case, aid is provided for the use of renewable energy source that is producing electricity and promoting protection of environment by reduction in the emission of greenhouse gases. So, the policy is designed mainly to achieve the environment objectives rather than tampering with fair competition. This illustrates the extent of legality for state aid, and its distinction from a subsidy; which is signified here as trade distorting."

Although, this ruling supports grant of aid by the government, specifically on social grounds, the overall effects on trade because of aid, subsidies or any public measure adopted or followed by the government, cannot be ignored. There can be social, political, cultural economical and several other reasons for these kinds of aids, but they have also some limitations. Despite social justifications, we also have to bear in mind that public measure that has the effect of conferring a selective advantage on an undertaking or sector is not relieved of its quantity as an aid by the reason of the fact that it was adopted for a social purpose.[12] [1] In *French Republic v Commission of European Communities*[13] it was concluded that "the social character of assistance is not sufficient

[11] Para 63 The Commission maintains that, in order to preserve the effectiveness of articles 92 and 93 of the Treaty, read in conjunction with article5 of the EC treaty (now article10EC), it is necessary for the concept of state-aid to be given in such a way as to include a support measure which, like those laid down by the amended Stromeinspeisungsgesetz, (Stromeinspeisungsgesetz is a German term in English, it is Electric Transmission Act) are decided upon by the state but financed by private undertakings. It draws that argument by analogy from the case law of the Court of Justice to the effect that Article 85 of the EC treaty (now 81EC), read in conjunction with Article 5 of the treaty, and prohibits Members from introducing measures, even of a legislative or regulatory nature, which may render the competition rules applicable to undertakings ineffective.

Para 73 The use of renewable energy sources for producing electricity, which a statute such as the amended Stromeinspeisungsgesetez is intended to promote, is useful for protecting the environment in so far as it contributes to the reduction in emissions of greenhouse gases, which are amongst the main causes of climate change which the European Community and its Members states have pledged to combat.

Para 74 Growth in that use is amongst the priority objective which the Community and its Member States intend to pursue in implementing the obligations which they contracted by the virtue of United Nations Framework Convention on Climate Change, approved on behalf of the community by Council Decision 94/69/EC of 15 December 1993(OJ1994 L33, p.11), and by virtue of protocol of the third conference of the parties to that convention, done in Kyoto on 11December 1997, signed by the European Community and its Member States on 29April 1998 see inter alia Council Resolution 98/C198/01 of 8 June 1998 on renewable sources of energy (OJ 1998 C 198,p.19, and Decision No 646/2000/EC of the European Parliament and of the Council of 28 February 2000 adopting a multiannual programme for the promotion of renewable energy sources in the community (Altener) (1998 to 2002) (OJ 2000 L79,p.1)

[12] Case C-241/94, *France v Commission, ' Kimberly Clark'*, [1996] ECR I-4551 paragraph 21; Case-75/97, *Belgium v Commission*, [1999] ECR I- 3671, paragraph 25; Case C-251/97, *France v Commission*, [1999] ECR I –6639, paragraph 37.

[13] *Case C-241/94French Republic v Commission of European communities.*

to exclude it from categorisation as state aid for the purpose of Article 92(1) of the treaty. The main criteria to draw the distinction between justifiable state aid and unjustifiable, is the effect of it rather than its aims and objectives.[14]

> In the case of *Italy v Commission*,[15] the European Court of Justice, in reply to primary Italian claims,[16] stated that aid granted by states or through state resources that affect or can affect competition is incompatible with the common market.[17]

Although, the basic elements for state-aid and subsidy are the same, state- aid cannot be confined to positive benefits only. It also covers other measures with similar characteristics. The concept of aid is wider than that of a subsidy, as it embraces other indirect benefits, such as to mitigate the expenses which are normally included in the budget of an undertaking.

When establishing the basis for aid or subsidy, legislative bodies need to bear in mind mainly the consequences in the context of international trade. With the intensification of competition in international trade, the tendency to grant, state-aid and subsidies is higher. This further complicates the investigation and analysation of the practice followed by member nations of the WTO. Legal doctrines solely, are not enough to derive objective conclusions, hence economic concepts are used.

1.2 Economic aspects

It is well said, that for trade to be fair, there must be evidence about domestic costs and prices. Economic concerns about subsidies relate to the fact that they can distort trade and prevent markets from attaining optimal resource allocation. For better allocation of resources, market conditions should not be biased. Countries basically engage in international trade for two basic reasons. First, countries trade because they are different from each other. Nations, like individuals, can benefit from their differences by reaching an arrangement in which each does

[14] In this case "Kimberley Clark, company whose main business was to manufacture and processing of cellulose wadding. As a part of restructuring operation, the company decided to concentrate solely on the manufacture of paper handkerchiefs and to modernize its industrial equipment, which led to the reduction of workforce from 465 to 207. An agreement was concluded between the state i.e. FNE (National Employment fund) and Kimberly Clark, to fund the part of the cost of this new plan. Para5, "The commission decided that the FNE intervention constituted state aid, since such agreements are negotiated with undertakings encountering employment problems. The FNE contributions, which is financed out of the state budget is determined case by case depending to the financial situation of the undertaking. It also stated that such aid was liable to distort competition and to affect the trade between member states, there by failing within the scope of Article 92 (1) of the EC treaty."

[15] See C-6/97, Italy v Commission [1999] 1 CMLR 1357, paragraph 61.

[16] See C-6/97 Italy V Commission, Para 10, Judgment of the Court (sixth chamber) 1999.The Italian Republic claims that the tax -credit scheme does not constitute state-aid in compatible with the Common market, since there is no allocation direct or indirect of state resources which distort or threatens to distorts competition by affecting intra-community trade.

[17] C-6/97, Italy v Commission, [1999] 1 CMLR 1357paragraph 14, 15.

the things it can do relatively well. Second, countries trade to achieve "economies of scale" in production. That is, if each country produces only a limited range of goods, and specializes, it can produce each of these goods on a larger scale and hence more efficiently than if it tried to produce everything.[18] For a better understanding of the impact of subsidies, a distinction needs to be drawn between export subsidies and domestic subsidies. Domestic subsidies have some legal justification so long as it is within the legal parameters of state aid and are meant not for any profit-oriented trade. It is also noticeable, that in several instances domestic and export subsidies are either convergent or complement each other. An export subsidy has a direct impact on the terms of trade because it counters, in whole or in part, the tariffs levied on the product by the importing nation. At later stages, it also has the effect of capturing the domestic market of the importing countries.

A domestic or production subsidy, on the other hand, is one granted to a firm regardless of exports. This type of subsidy has less of an impact on trade.[19] It could be that these domestic subsidies reduce the factor cost and in a way help increase exports, so that they converge to attain the same objective.

The main concern about subsidy in international trade is the market distortions caused by resorting to subsidies in trade practices. This goes contrary to the principle of free-trade-through-fair-trade –rule.[20] The two prominent distortions are:

(1) for the country importing the subsidized product, there is unfair competition between the imports (that are cheaper due to a subsidy) and the competing unsubsidized (domestic) products of domestic producers. The reduced price of imported products due to a subsidy may injure domestic producers and workers. The subsidy could demonstrably cause serious injury to competing domestic producers. These issues fall mainly within the subject area of microeconomics.

(2) The economic case of currency-value-devaluation (C.V.D) is mainly one of macroeconomics. Economists have observed that, "an undervalued currency has an effect similar to an import tax, a tariff, or to export subsidies."[21] This is so because under valuation (or an artificially cheap

[18] Paul R.Krugman &Maurice Obstfeld.(1999). P.11, Fifth edition . International Economics (theory and policy), U.S.A: Addison-Wesley Publishing Company.

[19] Mitsuo Matsushita, Thomas J.Schoenbaun & Petros C.Mavroidis.(2003).P.261,First ed, The World Trade Organization_Law Practice and Policy. Great Britain: Oxford University Press.

[20] The main aim of the WTO is to promote free trade. Although fair trade principles, not the part of prevalent trading concepts in WTO agreements, but act as complementary to free trade principles. Subsidies and Dumping practices do not hamper free trade but effect fairness in trade practices to the extent that it can effect the basic objectives of WTO. To derive legality of action against Subsidies and Dumping, fairness in trade act as a yard stick so that it does not effect the competition agreed between the parties.

[21] Dominick Salvatore,.(1987). P.13, The New Protectionist Threat to World Welfare. New York: Elsevier Science Publishing Co, Inc.

currency) of a currency makes exports cheaper, which, in turn, could make governments impose higher tariffs on imports. Persistent currency under valuation induces import competition and export promotion. The example of the China-US trade relationship is relevant here. It is believed by most researchers that China has kept the value of its currency artificially cheap, thus implicitly subsidizing its exports and taxing imports. "This view is bolstered by China's large accumulation of official US dollar reserve."[22] In support of this argument, we can analyse the trade statistics of China, and notice that exports have grown faster than imports. In comparison, US imports have grown faster than exports, resulting in a trade deficit.[23]

When devaluation is viewed as a policy instrument that switches demand from foreign to domestic goods, and with the latter, from tradable to non-tradable, and as a policy that switches output from supplying to the domestic market to exports, then tariffs, tighter import quotas, export subsidies, and so forth can be considered substitutes for devaluation.[24]

Economic analysis reveals also another aspect. A framework of perfect competition in the domestic market makes it difficult for undertakings engaged in international trade to always respond strategically in their own favour. In such situations, markets yield to the conditions of imperfect competition. Imperfect competition is characteristic both of industries in which there are only a few major producers, and of industries in which each producer's product is viewed by consumers as strongly differentiated from those of rival firms. In imperfect competition, undertakings are aware that they can influence the prices of their products and that they can sell more only by reducing their price. Under these circumstances, each firm views itself as a price setter, choosing the price of its product, rather than being a price taker.[25] In a perfectly competitive market, monopoly profits are competed away. Usually, it is imperfect competition that prevails in the market and in that case large firms usually have an advantage over smaller ones, thus the markets tend to be dominated either by one firm (monopoly) or by few firms i.e. oligopoly. When increasing returns enter trade practice, then, markets usually become imperfectly competitive in the long run.

[22] On 21 July 2005, Chinese government announced that it would no longer peg the yuan to the U.S dollar. For reference see, Chad P.Bown, Meredith A.Crowley, Rachel Mc Culloch & Daisuke J. Nakajima., (2005),P.5 4 Q. The US trade deficit made in China.,Economic Perspectives, Federal Reserve Bank of Chicago.

[23] For reference see, United Nations Conference on Trade and Development. Dispute settlement WTO 3.7 Subsidies and Countervailing Measure, P. 3, US merchandise trade deficit with China alone accounted for about $162 billion in 2004, or nearly one- quarter of the total U.S trade deficit, up from a negligible in mid 1980s.

[24] Supra .P. 48, note 19

[25] Paul R.Krugman & Maurice Obstfeld. International Economics (theory and policy). (2000). P.122, Fifth edition USA: Addison-Wesley Publishing company.

Where oligopoly prevails, it can be assumed that undertakings in a country are symmetric,[26] as well as, asymmetric since most industries consist of a few large undertakings and a great number of smaller undertakings. As Helpman and Krugman suggest, "there is a need for models of strategic trade policy under asymmetric oligopoly that allow firms within a country to have a different marginal cost of production."[27] The analysis of strategic trade policy under asymmetric oligopoly was pioneered by Collie (1993), who extended the Brander and Spencer's (1985) model of profit-shifting export subsidies to allow for cost differences between undertakings within a country.[28] With cost asymmetries, a selective export subsidy scheme that discriminates between undertakings would be superior to a uniform scheme, if it were feasible. Collie notes, that if the government could use a selective policy then it would be optimal to subsidize the most efficient undertaking and impose a prohibitive tax on all the others.[29]

There are certain welfare effects linked to tariffs and subsidies. Under oligopoly, as Brander and Spencer (1984) have shown, tariffs can be used to extract rent from foreign firms and to shift profits from foreign to domestic firms.[30] Furthermore, a subsidy could increase the welfare of a country by improving its terms of trade, if it leads to a reduction in price. Since the price exceeds the marginal cost in the oligopolistic industry, a subsidy will increase the domestic country's welfare by shifting profits to increases the domestic producer's surplus by increasing the output of the domestic industry. Basically, it improves the terms of trade by reducing the cost of production. Subsidy will enhance trade and welfare by shifting profits. This will induce the producer to increase production for exports.

[26] Symmetric is used to refer that all firms within a country have identical costs of production, for details see "Tariffs and Subsidies under asymmetric oligopoly: Ad valorem versus specific instruments"by David R.Colle Cardiff Business School, Cardiff University. Vol 74 No.3 (June 2006). P. 314, UK: The Manchester School. Blackwell Publishing Ltd.

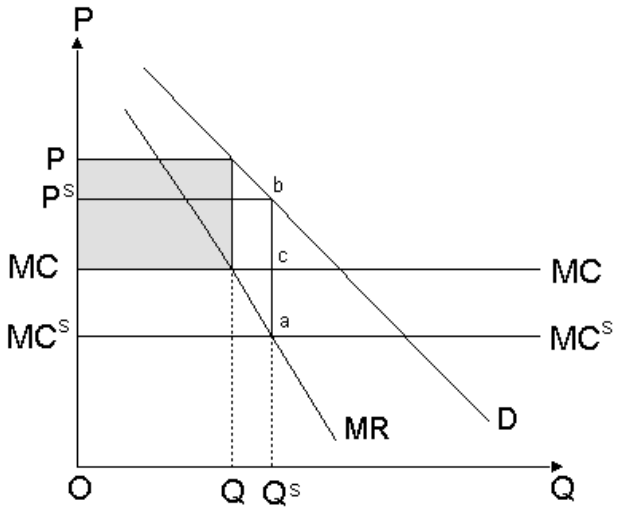
[27] Ibid. p.314 note 24.

[28] Ibid. p.315.note 25.

[29] Ibid.p.316.note 26.

[30] Ibid.p.322.note 27.

Figure representing how subsidy increases domestic monopoly profits.[31]



In the above figure, where D is foreign demand, MR is marginal revenue from foreign sales, and the intersection between MC and MR determines the profit-maximizing quantity of exports, Q. Price is set at P, and monopoly profit per unit is the difference between P and MC along the price axis. Total monopoly profits extracted from foreign market are the shaded area. A specific export subsidy (government subsidy of X dollars per unit of output) to the local monopoly firm lowers its marginal costs to (MCs), reduces the export price from P to (Ps) (in other words, "our" terms of trade deteriorate) and raises quantity to (Qs). Economic profit appropriated from foreign markets increases to the rectangular area bounded by points (MCs), to (Ps), a, b. The subsidy cost to the government is the rectangular area bounded by MC, MCs, a, c. It is smaller than the gain in monopoly profit. The difference between the gain in monopoly profit and the cost of the subsidy is the net gain to the country. Its size depends on the shape of the demand curve. Again, information on the cost structure and the demand elasticity is needed to determine the optimal size of the subsidy, the subsidy that would maximize the excess of appropriated profits over subsidy cost.

As the differences between state-aid and subsidy are narrow, analysing the production function can be extremely helpful. The production function can be separated into two stages. In the first stage, intermediate inputs and a primary composite of capital and labour are used in fixed proportion to the output. In the second stage, capital and labour are combined through a CES (Constant Elasticity of Substitution) function to form the primary composite depending upon

[31] The figure, from, The New Protectionist Threat to World Welfare Dominick Salvatore.(1987). P.321New York: Elsevier Science Publishing Co, Inc .

the profit.[32] With the help of subsidy one can get these factors at a cheaper price and that can help export promotion. So far as support is given for the production function to subsist and that also categorized on certain basis, it can be brought under the term aid. One has to analyze the intrusive character of this support.

Defining and identifying a trade-distorting subsidy is, however, only the first step. The next step would be to decide, if the trade distorting subsidy should be removed. The criteria that can be used to determine if a subsidy is trade-distorting can primarily be based on the efficiency principle of economics. [In the mentioned figure, it is assumed that export subsidies and import substitution subsidies are trade-distorting. In fact, they are prohibited under Article 3 of the Subsidies Agreement]. However, the debate on subsidies and their removal is a slightly more complex process and one which needs relativity to positive and negative externalities.

II. Subsidies under the GATT and the WTO

2.1 Subsidies during the GATT period

The issue of subsidy was given great significance in the current WTO negotiations where as, it was not very widely discussed in the GATT. Nowhere, in Article XVI of GATT 1947, is the term "subsidy" defined. There is only a general description about subsidies as trade practice.[33]

[32] Drusilla K. Brown, Alan V.Deardorff & Robert M. Stern. (January 23, 2001). P.3, Discussion papers No 468.CGE Modeling and analysis of Multilateral and Regional Negotiating Options, University of Michigan. Research seminar in international Economics. School of Public policy. University of Michigan.

http://www.spp.umich.edu/rsie/workingpapers/wp.html.

[33] Article XVI Section A- Subsidies in General. 1)If any contracting party grants or maintains any subsidy, including any form of income or price support, which operates directly or indirectly to increase export of any product from, or to reduce imports of any product into, its territory, it shall notify the contracting parties in writing of the extent and nature of the subsidization, of the estimated effect of the subsidisation on the quantity of the effected effect of the subsidization on the quantity of the affected product or products imported into or exported from its territory and of circumstances making the subsidization necessary. In any case in which it is determined that serious prejudice to the interest of any other contracting party is caused or threatened by any such subsidization, the contracting party granting the subsidy shall, upon request discuss with the other contracting or parties concerned, or with the contracting parties, the possibility of limiting the subsidization.

Section B Additional provisions on Export subsidies 2)The contracting parties recognize that the granting by a contracting party of a subsidy on the export of any product may have harmful effects for other contracting parties, both importing and exporting, may cause undue disturbance to their normal commercial interests, and may hinder the achievement of the objectives of this agreement.

3) Accordingly, contracting parties should seek to avoid the use of subsidies on the export of primary products. If, however, a contracting party grants directly or indirectly any form of subsidy which operates to increase the export of any primary product from its territory, such subsidy shall not be applied in a manner which results in that contracting party having more than an equitable share of world export trade in that product, account being taken of the shares of the contracting parties in such trade in the product during a previous representative period, and any special factors which may have affected or may be affecting such trade in products.

The two leading trade blocks influencing GATT policies; the EC and the US, may serve as examples in order to explain the practice of subsidy. Wide ambiguities between the EC and US on the interpretation of this Article made it impossible to define the term during the Tokyo Round. In the absence of the definition of subsidies, the US, on the one hand, and the EC and other GATT contracting parties, on the other hand, had divergent opinions, regarding the question of whether or not government measures involving a charge on the public account exclusively, were to be considered subsidies.[34] Although not specifically from the WTO, we can further analyze the differences with reference to some cases, where the issue is discussed: for instance in the case of *Zenith Radio Corp.v. United States*.[35]

> The petitioner in this case, contended that certain imported products benefited from bounties or grants paid by Japan. Japan imposes a commodity tax (an indirect tax) on those products when they are sold in that country but "remits" the tax when the products are exported, and also refunds any tax paid on the shipment of a product on subsequent exportation. Relying on, *Downs. V. United States*,[36] the Customs Court ruled in the petitioner's favour. The Court of Customs and Patent Appeals reversed the decision.
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> In the case of *Fediol*, the ECJ observed that[37]:
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> It should be pointed out that the concept of subsidy in Article 3 of EEC Regulation No 2176/84[38] is not expressly defined, either in that regulation or in other community measures. However, an "illustrative list" of export subsidies, referred to in Article 3(2) of the regulation, is annexed to the regulation. It also follows from Article 3(3) of said regulation, which expressly excludes from the concept of subsidy the exemption of a product from certain export charges or taxes, that the concept of a

4) Further, as from 1January 1958 or the earliest practicable date thereafter, contracting parties shall cease to grant either directly or indirectly any form of subsidy on the export of any product other than primary product which subsidy results in the sale of such product for export at a price lower than the comparable price charged for the like product to buyers in the domestic market. Until 31December 1957no contracting party shall extend the scope of any such subsidization beyond that existing on 1stJanuary 1955 by the introduction of new, or the extension of existing, subsidies.

5)The contracting parties shall review the operation of the provisions of this article from time to time with a view to examining its effectiveness, in the light of actual experience, in promoting the objectives of this agreement and avoiding subsidization seriously prejudicial to the trade or interests of contracting parties.

[34] Marco M Slotboom. (2002). P.518, Subsidies in WTO and in EC Law Broad and Narrow Definations. *Journal of World Trade. Kluwer law international. Netherlands.*

[35] *Zenith Radio Corp.v. United States*, 437 US. 443(1978).

[36] *Downs. V. United States*, 187 US 496.

[37] Case 188/85, Para 12and 13

[38] Council regulation EEC no 2176/84 was amended by council regulation EEC no 1761/87.On 11th July 1988 the EEC council adopted regulation EEC no 2423/88 which replaced council regulation EEC no 2176/84 as amended.

> charge covers not merely cases in which the State advances funds, but also those in which it waives recovery of tax debts thereby introducing an exception to a generally applicable rule of taxation.[39]

Comparing this situation, with that in the US, the US employs a broader definition for the term subsidy. It disregards the question whether a reuirement of a charge on the public-account was involved, and focused on the benefit provided by the disputed measure to its recipient. Under US law, an export subsidy may be roughly defined as any government programme or practice that increases the profitability of sales by export, but which does not necessarily increase the profitability of sales for domestic consumption. "Government practice that cannot be characterized as export subsidies are countervailable under US law only if they satisfy the statutory definition of a domestic subsidy."[40] This means that a domestic subsidy, that is otherwise not countervailable, can be challenged if it is indirectly meant for the promotion of export. In other words, regardless of whether a government measure represented a charge on the public account, the US would consider a measure of another GATT contracting party, countervailable, if the measure confers a benefit to a specific industry.[41] It must provide some advantage to the producer that was otherwise not available. The way, the issue was handled in these cases shows both definitional and procedural inconsistencies in settling on a definition of subsidies.

However, the EC (and other GATT contracting parties) took the position that "as far as international trade is concerned, the crucial characteristic of a subsidy is that it should involve a financial contribution by the government. The list annexed to Regulation (EEC) No 2176/84 makes it clear that any subsidy must involve a charge on the public account."[42]

[39] Article 3(2) Subsidies bestowed on exports include, but are not limited to, the practice limited in the Annex.

Article 3(3) The exemption of a product from import charges or indirect taxes, as defined in the notes to the annex, effectively borne by the like product and by materials physically incorporated therein, when destined for the consumption in the country of origin of export, or the refund of such charges or taxes, shall not be considered as a subsidy for the purposes of this regulation.

[40]A. Sykes. U.S.C.A§ 1677(5)(West 1980 & Supp .4 Dec 1988). P.203. Countervailing Duty Law: An Economic perspective. 89 *Columbia Law Review*. (The identification of export subsidies may prove quite troublesome in practice. See generally G.Hufbauer & J.ERB, subsidies in International Trade (1984). P45-88 (identifying and describing types of export duties.)

[41]Ibid, P. 204. (The targeting criterion –commonly known as the "specificity test" or the "general availability test"- ensures that many of the familiar activities of the governments are not characterized as "subsidies". For example, public education, government-financed highway and railway systems, national telecommunications networks, and even national defence activities provide economic benefits to domestic producers, but these benefits ordinarily accrue to a wide range of industries. Thus, such activities usually are not countervailable. In contrast, a special programme to educate workers in the semiconductor industry or a special rail rate for the coal industry might well be countervail able.

[42] See case 188/85, *Fediol v Commission,* EEC Regulation No2176/84.(Supra note. 35)

Drawing parallel between US and EU law on subsidies, it seems that under US law any kind of government support for export promotion can lead to subsidy, whereas under EC law financial support should be from public fund so as to be considered as subsidy. Leaving aside the US rules on subsidies, practically speaking, any type of government programme can confer a domestic subsidy if it meets two criteria; it must be sufficiently targeted "to a specific enterprise or industry, or group of enterprises or industries," and second, it must provide some opportunity or advantage to the targeted producers that would not otherwise be available to them in the marketplace.

2.2 Describing Subsidies in Relation to the WTO

As in previous GATT conferences, talks about subsidies ended, without developing a comprehensive definition therefore. Consequently, another attempt was made to achieve detailed rules that would be applicable to all WTO members during the Uruguay round.

The agreement establishing the World Trade Organization incorporates several annexes containing various WTO agreements. Annex 1A, encompasses the multilateral agreements on trade in goods. One of these agreements is the ASCM. This agreement deals with the issue of subsidies very widely. However, the policy making bodies of member states are also bound by the Vienna convention on the law of treaties, Article 26 and Article 27 for the adoption and implementation of ASCM.[43]

The ASCM sets forth the rules and certain conditions that WTO members are able to invoke in case of injuries due to the practice of granting subsidies.[44] Moreover, it provides detailed rules on the concept of subsidies, actionable subsidies and defines the material injuries caused. The ASCM serves two main purposes: 1) it tries to discipline the use of subsidies and 2) it gives legal competency and regulates the actions countries can take to counter the effects of subsidies. Subsidies and countervailing agreement of the WTO plays a vital role in achieving the basic objective of free trade, supported by fair trade principles.[45] So far as remedies are concerned, the ASCM, which is binding on all WTO members, is divided into XI parts and VII Annexes.[46] Part 1 sets out the definition of subsidy and introduces the key concept of "specificity;" the test

[43] Article 26 of the Vienna convention on the law of treaties. "Every treaty in force is binding upon the parties to it and must be performed by them in good faith."

Article 27 "A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty."

[44] For detail reference see, Articles 7 and 11 of the ASCM .Article 7, deals with remedies. Article 11 deals with initiation and subsequent investigation to determine the existence , degree and effects of any alleged subsidy.

[45] Supra note.18

[46] For reference see, www.wto.org. Subsidies and countervailing duties.

of which is whether the subsidy is available only to an enterprise or industry or group of enterprises and industry.[47]

Article 1.1 of the ASCM defines subsidy.[48] It spells out the elements that the concept covers. Generally, a subsidy is deemed to exist, if there is a financial contribution by a government or any public body and if a benefit is thereby conferred. Thus, there are two separate basic elements. The first element of this definition is concerned with whether the government made a "financial contribution", as defined in Article 1.1(a). The focus of the first element is on the action of the government in making the "financial contribution". That being so, it seems logical that the second element in Article 1.1 is concerned with the "benefit…conferred" on the recipient due to that government action. Thus, subparagraphs (a) and (b) of Article1.1 define "subsidy" in two different contexts: first, the action of granting authority and second, to what is conferred on the recipient.[49]

The term benefit is very wide. To know if there exist some relationship between benefit and subsidy, it is imperative to consider whether the financial contributions place the recipient in a more advantageous position. What is significant here is its relationship with the export. Export orientation, is relevant and a significant factor, when considering a subsidy that distorts international trade principles under the WTO. Further, a subsidy under ASCM is classified as: 1) Non-actionable, 2) actionable and 3) prohibited.[50] Even though, subsidy is well classified, there are differences of opinion between developing and developed countries on this issue; an issue that follows the north-south divide.

[47] Mitsuo Matsushita, Thomas J. Schoenbaun &Petros C.Mavroidis. (2003). First ed. P264, The World Trade Organization Law Practice and Policy.Great Britain: Oxford University Press.

[48] *Article 1* Definition of Subsidy

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

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

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

(ii) government revenue that is otherwise due is foregone or not collected (e.g, fiscal incentives such as tax credits);[48]

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

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

(a) (2) there is any form of income or price support in the sense of Article XVI of GATT1994; and

(b) a benefit is thereby conferred.

[49] Appellate Body report, Canada-Measures Affecting the Export of Civilian Aircraft (Canada-Aircraft),WT/DS 70/AB/ R, para 156.

[50] For detail reference see www.wto.org.

III. The North -South divide on "subsidies"

More than two hundred years ago, Adam Smith highlighted the benefits of free trade and David Ricardo in the early nineteenth century elaborated the theory of comparative advantage. This was a distinct shift from the mercantilist philosophy that emphasized the desirability of nations achieving a favourable balance in terms of trade - an export surplus, that is impossible for all to accomplish simultaneously and this has acted as a latent factor for subsidies being a contentious issue between developed and developing countries. Even though, the ASCM recognizes exceptions for infant industries, national defence and other exigencies, there are stll many issues of contention between developed and developing member states of the WTO.

Considering the wide differences in the economic conditions of the member states of WTO, there are provisional grounds for the relaxation of subsidies. Article 27 of the ASCM gives special and differential treatment to developing countries. Article 27 is divided into 15 clauses, but the focus here will be on the first five clauses, as they outline the concessions for developing nations. Clause 1 of article 27, specifically recognizes the role of subsidies in economic development. Creating opportunities for economic development is one of the key objectives of WTO. Clause 2, explicitly exempts the developing and least developed countries from the general prohibitions mentioned in article 3 of ASCM. This exemption undoubtedly has reasonable justification. During the time when WTO came into existence, most of the developing and least developed country economies were based, by and large on the agriculture and cottage industries. This consentration acted like a structural hurdle in the process of industrialisation. Promoting rapid industrialisation required strong policy support for a certain period of time. This exemption is supported for the period of five years in case of developing countries and eight years in case of least developed countries. Clause 4 of article 27 allows, after consultation with the committe, extension of the period of exemption depending upon such like requirement. However, to maintain the balance between rule-based free trade, and extra privileges given to developing and least developed economies, the latter should be time bound. In case the member state seeking the exemption, has acquired market competency in an exporting product, it can phase out the export subsidy for that product as per the process mentioned in clause 5 of Article 27. Phasing out a subsidy, after obtaining market competitiveness is significant, as otherwise it can lead to the practice of dumping. In addition, it is necessary to mention Article 29 sub-paragraphs 1, 2 and 4 because they cover flexibilities for countries-in-transition.[51]

s[51] *Article 27(1)* Members recognize that subsidies may play an important role in economic development programmes of developing country members.

Article 27(2) The prohibition of paragraph 1(a) of Article 3 shall not apply to

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

In comparing the reasons for providing subsidies between the developed and developing nations, one of the significant reasons for the use of subsidies among developing nations, is an attempt to overcome market imperfections. It is highly probable that the domestic industry (of a developing nation) will have to face already existing market domination, because of economies of scale and other externalities, while competing with multinational firms. Developed countries, on the other hand, try to solve their economic problems such as unemployment, lagging growth, industrial outsourcing by sometimes imposing restrictions on imports and by subsidizing exports.

3.1 Doha Conference 2001

The fourth WTO ministerial conference was held in Doha. WTO members remained deeply divided. The issue of the subsidy for agriculture was a major bottleneck between developed and developing countries.[52]Additionally, there was also a proposal from developing countries that

Article27.(3) The prohibition of paragraph 1(b) of Article3 shall not apply to developing country Members for a period of five years, and shall not apply to at least developed country members for a period of eight years, from the date of entry into force of WTO agreements.

*Article 27.(4)*Any developing country Member referred to in paragraph 2(b) shall phase out its export subsidies within the eight –year period, preferably in a progressive manner. However, a developing country member shall not increase the level of its export subsidies, and shall eliminate them within a period shorter than provided for in this paragraph when the use of such export subsidies is in consistent with its development needs. If a developing country members deem it necessary to apply such subsidies beyond the 8 year period, it shall not later than one year before the expiry of this period enter into consultation with the committee, which will determine whether an extension of this period is justified, after examining all the relevant economic, financial and development needs of the developing country member in question. If no such determination is made by the committee, the developing country Member shall phase out the remaining export subsidies within two years from the end of the last authorized period.

Article 27.(5) A developing country Member which has reached export competitiveness in any given product shall phase out its export subsidies for such product(s) over a period of two years. However, for a developing country member which is referred to in annex VII and which has reached export competitiveness in one or more products, export subsidies on such products shall gradually be phased out over a period of eight years.

Article 29.1 Members in the process of transformation from centrally –planned into a market, free-enterprise economy may apply programmes and measures necessary for such a transformation.

Article 29.2 For such Members, subsidy programmes falling within the scope of Article 3, and notified according to paragraph 3, shall be phased out or brought into conformity with Article 3 within a period of seven years from the date of entry into force of the WTO Agreements. In such a case, Article 4 shall not apply. In addition during the same period :(a) subsidy programmes falling with in the scope of paragraph 1(d) of Article 6shall not be actionable under Article 7;

(c) With respect to other actionable subsidies, the provisions of paragraph 9 of Article 27 shall apply.
29(4) in exceptional circumstances Members referred to in paragraph 1 may be given departures from their notified programmes and measures and their time frame by the committee if such departures are deemed necessary for the process of transformation.

[52] The inclusion of developing country Members in the WTO list is based on recent data from the World Bank on GNP

they should not have to face countervailing measures or other actions in case of subsidies for basic development necessities. These can be described as subsidies with "legitimate development goals." This includes support for regional growth, technology research and development, production diversification, development and implementation of an environmentally friendly method of production. Developing nations also showed their serious concern regarding new commitments. They found these commitments, not giving enough "policy space" to them according to the respective situation and circumstances of the member states. It was emphatically pointed out that developed nations have gone through several stages before reaching their present status. Developing nations proposed that subsidies which are provided for technological improvement and for the eradication of poverty, social and environmental problems should be considered inline with sustainable development and hence, should not be considered trade distorting. The conference finally ended up agreeing on some relaxations.

Ministers affirmed that the governments of the least developed countries be allowed, to pay subsidies that are essential for basic industries. This relaxation covers actionable subsidies, and consequently both developing and developed countries thus have the flexibility to finance their exporters, consistent with their specific development needs. Members also agreed that more time should be given to some developing countries to phase out their export contingent subsidies. Finally, ministers instructed the subsidies committee to give some of the developing countries more time to phase out subsidies; those are based on the requirement to export according to the procedures in a committee document.

3.2 The Hong Kong Conference in 2005

Besides other issues, trade subsidy was also discussed during the Hong Kong conference. Ministers affirmed the decisions and declarations accepted during the Doha conference. Agriculture subsidies were again a primary matter of discussion. There were proposals by some of the members that exemptions, to the general prohibitions on the use of subsidies, needed to be phased out. Member states agreed to eliminate most of the subsidies by the end of December 2013. The policy measures that were indirectly connected to export subsidies were also discussed in detail. These issues relate to e.g. export credits and insurance programmes.

One suggestion was to strictly define these policies so as to avoid supporting export promotion. As the main policy objective of WTO is to promote free trade, so to maintain consistency between policy and practice, was the prevalent reason to hold the opinion restricting the role of state trading enterprises during this conference. These state trading enterprises have influential

per capita. Annex VII of Subsidies and Countervailing Measure agreement allows some developing nations to pay export subsidies to a certain extent. Among them is a group which is eligible so long as their GNP stays below U.S $ 1000 per capita. This is subject to the agreement among the Member States regarding the method of calculation.

market status in most of the developing countries. State trading enterprises supported by government policies, such as tax concessions and other forms of aid that reduces the costs of factors of production, in a way cumutatively lead to export subsidies. Restricting the further increase in proportion of subsidies was agreed between the member states, but providing special aid for food in certain areas, or dealing with an emergent situation was supported overwhelmingly. Additionally, subsidies on cotton products was also discussed This resulted in quota free access to cotton exports from least developed economies. The structural reforms for African cotton producers and exporters were also widely supported. As continuing practice, the importance of special and differential treatment was recognised and reaffirmed. Flexibilities provided to small economies also seek the support of the majority of the member states during this conference.

3.3 Practice followed by developing and developed countries.

When it comes to applying or interpreting the subsidy- related provisions, the perspectives of developed and developing countries also differ. This can be observed in the case below.

In the case of *India –Quantitative Restrictions on Import of Agricultural, Textile and Industrial Products*[53]

The US claimed that India had been unjustifiably maintaining quantitative restrictions on imports of products falling under 2714 tariff lines at the eight-digit level of HS96. In reply, India claimed the balance-of-payment crisis justification, as its economy had been almost totally closed to imports 15 years previously. It has not been possible for India to make an assessment of the exact amount of demand for imports. Regarding the foreign-currency reserve crisis, India made the point that the reserve problem for developing hinders the economic development programmes. The foreign reserves held by India vary according to its development policies. In reply to queries by the parties, the IMF finally concluded that "Macroeconomic policy measures would need to be complemented by structural measures. In general, the benefits of trade- policy reforms are greater when accompanied by domestic economic reforms …"Recently, the General Council of the WTO has made a change in Article 27.4(ASCM) that deals with special and differential treatment of developing country members.

We will now consider the practice followed by developed nations for the sake of comparison and getting the picture from the other side. Developed countries often use the subsidies that

[53] *India –Quantitative Restrictions on Import of Agricultural, Textile and Industrial Products*: (WT/DS90/R). The case was decided, not in India's favour, [we have found that India's balance- of- payments situation was not such as to allow the maintenance of measures for balance-of payments purposes under the terms of Article XVIII: 9 that India was not justified in maintaining its existing measures under the terms of article XVIII: 11 and that it does not have a right to maintain or phase out these measures on the basis of other provisions of Article XVIIIB which it invoked in its defence. We therefore conclude that India's measures are not justified under the terms of Article XVIIIB]

fall under the heading of non-actionable subsidies. Article 8, of the ASCM widely covers non-actionable subsidies, also known as green-light subsidies. We may refer to Article 87(3) of the EC Treaty. Article 87(3) supports aid for economic development, execution of an important project of common European interest, development of economic activities or of a certain economic interest. Apart from these, state- aid is partially given to instruments such as the Common Agricultural Policy funds; aid granted by supranational organizations, such as the European Space Agency; and defense and public works. These aid provisions serve as an institutional infrastructure for economic promotion.

Even though these aids are meant for economic development, one cannot ignore these aids effects on the markets. As there is no strict line of demarcation between state-aid and subsidy, state- aid is used as an instrument to support industries.

In the EU, several forms of subsidies are used to directly promote targeted economic activities – especially, regional development, since new EU members are at lower levels of development when they first join. The most relevant subsidies from the EU structural funds are as mentioned. European Commission (EC) budgeted € 196 billion to the structural Funds for 2000 to 2006, of which €26.2 billion were used in 2003.The Structural Funds reserved €13 billion for research infrastructure and networks, innovative business start-ups, and technical up-grading of SMEs.[54]

We can also use the practice followed by the US, the most developed economy as an example. The US has a long history of providing financial support for research development and energy sectors. This includes not only direct financial support, but also para-fiscal support through the provisions of legislative acts. Legislation very much reflects the objectives of the government, for example the Price Anderson Act[55]. The main purpose of the Price-Anderson Act is to ensure the availability of a large pool of funds (currently about $ 10 billion) to provide prompt and orderly compensation to members of the public who incur damage from a nuclear or radiological incident no matter who might be liable. The Act provides "omnibus" coverage, that is, the same protection available to a covered licensee or contractor extends through indemnification to any persons who may be legally liable, regardless of their identity or relationship to the licensed activity. As the Act channels the obligation to pay compensation for damages, a claimant need not sue several parties, but can bring their claims to the licensee or contractor. Additionally, there are several investment tax credits and production credits designed to benefit renewable technologies. These include the Investment Energy Tax Credit,

[54]Francisco Aguayo,Ayala, & Kevin P.Gallagher.P.18.Preserving Policy Space for Sustainable Development. . International Institute for Sustainable Development, by Program on Science, Technology and Development, EL Colegio de Mexico.

[55] The Price –Anderson Act was enacted into law in 1957and has been revised several times. It constitutes Section 170 of the Atomic Energy Act .The latest revision was enacted through the "Energy Policy Act of 2005" and extended it through December 31, 2025.

established by the Energy Tax Act of 1978, and the Production Tax Credit (PTC), authorized under Energy Policy Act.[56]

It really seems difficult to achieve the basic objectives of the WTO, if nations already in an advantageous position try to take advantage under the heading of green-light subsidies. The green-light subsidies get exempted by the provisions of Article 8 of the ASCM. As an example article 8.2 (a) immunizes subsidies given for research activities conducted by firms or higher educational or research establishment. Article 8.2(b) supports government assistance to disadvantageous regions. The developed nations already have an export surplus and these supports will put them into further advantageous situations. As far as agricultural subsidies are concerned, this question is very crucial for African nations. By providing subsidies to their own farmers, developed nations try to dominate the agricultural market. This practice very much affects the African continent because agriculture, along with raw materials are their main exports. The foreign exchange earned through those exports helps them get technology. These issues are crucial and are often raised in the conferences. Some midway agreeable to both sides needs to be evolved to resolve the crisis.

IV. Conclusions

Even though it is clear that subsidies and state- aid affect competition, we cannot ignore the fact that there are occasions when subsidies and state aids may be necessary. There seems a need to exempt several kinds of aids and subsidies. The most plausible argument for this being, the fact that the economic inequalities are very wide among the Member States. Here, we also have to ensure that these concessions are not abused. First, while making comparative discussion between subsidy and state- aid one can realize the analogous properties. It becomes the inherent responsibility of the Member States to follow the principle of good faith. To cover the gap, some legal checks and balances are provided by the ASCM, for example, Annex VI, provides procedures for on the spot investigation. It is also obligatory for legislative bodies of the Member States, to follow the line of reasoning behind granting flexibilities under the enacted provisions. Here, critics of the WTO may raise their concern about the sovereign values of domestic policies, but one has to keep in mind the international norms and their implicit and explicit justifications as well. Nowadays, there is a growing tendency among the developed nations to restrict import from developing nations. It is quite obvious that if indebted developing countries are to meet their economic interests obligations and to repay their debt they must be allowed to increase their export. An effect of continued protective policies adopted by developed nations might be the revival of protectionist sentiment in the developing nations.

[56] Marshall Golberg.Research report, Federal Energy Subsidies Not all Technologies created equal, July 2000.No11 P.14.

Considering the fundamental economic realities, we cannot deny the need for subsidy, but it has to be allocated in a disciplinary manner and with the WTO as an institution acting as a control mechanism. Those favouring the ideology of free trade have always criticized subsidies as a means of government control that eventually effects competition. Certainly, there is some truth in this argument but we cannot ignore the economic logic behind the government interference. When the market fails, policy instruments are deployed to correct the distortions. So, we can also consider subsides as a tool to correct market distortions. A government intervention in the case of negative externalities is also justified, such as in case of pollution, over- production etc. The main point of contention, quite often remains export subsides, (whether direct or in direct). As already mentioned in the text, it improves the relative business position of the exporting nations. There is a need to think constructively and objectively about the reasons behind these relaxations, whether they are for developing or developed nations. The principles of free trade along with fair trade should go together. In the wake of globalization, people have undoubtedly, become outward looking, but we cannot ignore the ethics and principles that have laid the foundation for the socio -economic and political structure of the nations.