

**Committee on Trade and Environment**

NEGOTIATING HISTORY OF FOOTNOTE 61 OF THE AGREEMENT ON SUBSIDIES  
AND COUNTERVAILING MEASURES

Note by the Secretariat

1. This paper has been prepared at the request of the Committee on Trade and Environment for a factual account on the negotiating history of footnote 61 of the WTO Agreement on Subsidies and Countervailing Measures. Section I of the paper reproduces footnote 61 and notes its link with Annex I of the Agreement on Subsidies and Countervailing Measures. Section II of the paper provides a negotiating history of the footnote.

I. FOOTNOTE 61 OF THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

2. Footnote 61 of the Agreement on Subsidies and Countervailing Measures ("Agreement") is part of Annex II of the Agreement, and clarifies the coverage of the term "inputs consumed in the production process". It states: "Inputs consumed in the production process are inputs physically incorporated, energy, fuels and oil used in the production process and catalysts which are consumed in the course of their use to obtain the exported product."

3. Annex II of the Agreement provides "Guidelines on Consumption of Inputs in the Production Process", which address the issue of indirect tax rebate or remission or drawback of import charges on "inputs that are consumed in the production of the exported product". These aspects are mentioned in items (h) and (i) of Annex I of the Agreement, which contains an "Illustrative List of Export Subsidies". According to items (h) and (i) of Annex I, export subsidies are provided, *inter alia*, in the following situations:

- "(h) The exemption, remission or deferral of prior-stage cumulative indirect taxes [footnote omitted] on goods or services used in the production of exported products in excess of the exemption, remission or deferral of like prior-stage cumulative indirect taxes on goods or services used in the production of like products when sold for domestic consumption; provided, however, that prior-stage cumulative indirect taxes may be exempted, remitted or deferred on exported products even when not exempted, remitted or deferred on like products when sold for domestic consumption, if the prior-stage cumulative indirect taxes are levied on *inputs that are consumed in the production of the exported product* (making normal allowance for waste) [footnote omitted]. *This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II.* [emphasis added]
- (i) The remission or drawback of import charges [footnote omitted] in excess of those levied on imported *inputs that are consumed in the production of*

*the exported product* (making normal allowance for waste); provided, however, that in particular cases a firm may use a quantity of home market inputs equal to, and having the same quality and characteristics as, the imported inputs as a substitute for them in order to benefit from this provision if the import and the corresponding export operations both occur within a reasonable time period, not to exceed two years. *This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II and the guidelines in the determination of substitution drawback systems as export subsidies contained in Annex III.*" (emphasis added)<sup>1</sup>

4. The reference to the term "inputs that are consumed in the production of the exported product" in Annex I provides a basis for Annex II and footnote 61 of the Agreement. Thus, the negotiating history of footnote 61 focuses primarily on the text of items (h) and (i) of Annex I.

## II. NEGOTIATING HISTORY OF FOOTNOTE 61 IN THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

5. Annex I in the Agreement is a counterpart of Annex I in the Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade (hereinafter the "Tokyo Round Subsidies Code"). In the Tokyo Round Subsidies Code, items (h) and (i) of Annex I contained the term "goods that are physically incorporated in the exported product" instead of "inputs that are consumed in the production of the exported product".

6. In the initial phase of the negotiations during the Uruguay Round, some delegations expressed a need to examine and clarify the Illustrative List contained in Annex I of the Tokyo Round Subsidies Code. For example, the following statements were made in this regard: "Experience has shown that there is currently no agreement among Code Signatories on the scope of Article 9, as well as the role and effect of the 'Illustrative List' associated with Article 9. These points should be clarified through the review"<sup>2</sup>; and "Clarification of the scope of Article 9 of the Code regarding export subsidies on products other than certain primary products is required. The content of the Illustrative List should also be clarified".<sup>3</sup> A checklist of issues for negotiations prepared by the Secretariat noted that: "There is growing doubt in some quarters that the Code's treatment of border tax adjustments (that is, the assumption that non-excessive remission of indirect taxes on exported products is trade neutral) reflects the true economic effect of such adjustments. Accordingly, the Agreement's current treatment of this practice should be re-examined".<sup>4</sup>

7. A number of aspects were considered in the discussion on subsidies pertaining to inputs incorporated into a product traded internationally. For example, in the context of non-actionable subsidies, the EC had proposed that<sup>5</sup>:

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<sup>1</sup>Annex III provides "Guidelines in the Determination of Substitution Drawback Systems as Export Subsidies".

<sup>2</sup>MTN.GNG/NG10/W/1.

<sup>3</sup>MTN.GNG/NG10/W/8.

<sup>4</sup>MTN.GNG/NG10/W/9/Rev.2.

<sup>5</sup>MTN.GNG/NG10/W/7.

"(iv) Indirect subsidies:

These are subsidies given on inputs which are *subsequently incorporated into a product traded internationally*. In circumstances where the subsidy conferred on the input product is generally available or where the input itself is generally available to a wider range of users, the downstream product should be considered not to have benefitted from actionable trade-distorting subsidies." (emphasis added)

8. The first formal proposal that rebate of indirect taxes or drawback of import charges on inputs should not be deemed as export subsidies was submitted by India<sup>6</sup>. The proposal was made in the context of a discussion of non-actionable subsidies, and stated that:

"Countervailable subsidies

There is no consensus on the circumstances under which export incentives and other programmes of government assistance to enterprises constitute countervailable subsidies. While financial contribution by government is a necessary prerequisite, this should not imply that such contribution *per se* makes the practice a countervailable subsidy. Compensatory payments which merely offset a handicap should not be countervailable. Reimbursement of the difference between the international price and the domestic price of products and services used in the production of exported goods is an example of such compensatory payments.

Contribution by government for enabling financial institutions to extend export credit at rates different from those at which credit is made available for other purposes, should not be deemed to be a countervailable subsidy as long as the credit is given at rates equal to or above the rates prevalent in international capital markets. *On the same principle, rebate of prior stage cumulative indirect taxes should not be treated as countervailable subsidy whether or not such taxes have been levied on goods and services physically incorporated in the exported product.* Article VI of GATT states that no product can be subject to countervailing duty by reason of the exemption of such product from taxes or duties borne by the like products when destined for consumption in the country of origin. This provision clearly suggests that rebate of taxes on auxiliary material (e.g. energy, fuel, lubricants, packing, stationery), durable capital goods (e.g. machinery buildings, vehicles) and services (e.g. transport, advertising) cannot be treated as countervailable subsidies. Incentives given to enterprises to enable them to overcome locational disadvantages should also be non-countervailable. Negotiations should be held to arrive at understandings in this regard." (emphasis added)

9. Discussions on this issue continued<sup>7</sup>, and another formal proposal was made in September 1989 by Switzerland, in support of extending the scope of remission of indirect taxes to inputs

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<sup>6</sup>MTN.GNG/NG10/W/16.

<sup>7</sup>See for example, reports of the meetings of the negotiating group in MTN.GNG/NG10/12 and 13, which state that a "number of questions were raised regarding the implications of converting the illustrative list into a definitive list, rationale for singling out problems relating to paragraphs (h), (i) and (j) of this list and proposed criteria for prohibiting some other subsidies" (MTN.GNG/NG10/12); and that "some participants supported the proposal that the rules on indirect taxes and remission or drawbacks in paragraphs (h) and (i) should apply to all inputs, and not only to those physically incorporated" (MTN.GNG/NG10/W/13).

other than physically incorporated in the exported product.<sup>8</sup> The relevant part of this proposal stated that:

" Item (h) and item (i): item (h) points out to the question of the exemption, remission or deferral of prior stage cumulative indirect taxes levied on goods that are physically incorporated (making normal allowance for waste) in the exported merchandise. The same condition appears in item (i) that relates to the remission or drawback of import charges. According to the guidelines on physical incorporation (SCM/68, 24 October 1985), inputs are physically incorporated if they are used in the production process and are present in the product exported, though they need not be present in the final product in the same form in which they entered the production process. This clause is not fully compatible with the notion of net transfer of funds because all indirect taxes and import charges on services, such as transportation and communication, as well as on machinery, and on fungible inputs such as fuel and electricity used in the manufacturing process are not physically incorporated in the final product. Consequently the rules on indirect taxes and remissions or drawbacks should apply to all inputs." (emphasis in original)

10. In November 1989, India reiterated its previous proposal and presented it in greater detail<sup>9</sup>, stating that:

"A number of changes are, however, necessary in the illustrative list of export subsidies contained in the Subsidies Code. In items (h) and (i) of the illustrative list, the test of physical incorporation has been stipulated. Rebate of prior stage cumulative indirect taxes or import charges is treated as an export subsidy if such taxes or charges are levied on goods or services which are not physically incorporated in the exported product. Thus, rebate of taxes on auxiliary materials, capital goods and services employed in the production of exported goods falls under the definition of export subsidy. The physical incorporation test also applies to drawback or remission of export charges levied on imported inputs used in the exported product. The physical incorporation test is bad from the point of view of both equity and economic efficiency. It places at a disadvantage countries with multi-stage cumulative tax systems vis-à-vis those with value-added tax systems as in the latter, there is no impediment to the exporter collecting full credit for all prior stage taxes paid on inputs. If global efficiency is to be promoted, then such taxes levied not only on the final product and the raw materials, but also those levied on the inputs should be allowed to be rebated, as they also have a price-raising effect. The physical incorporation test is also not consistent with Article XI:4 of GATT as it is manifest that prior stage taxes paid on inputs, whether or not physically incorporated in the final product, are 'borne by the like product'."

11. The discussion of this issue continued, without any convergence of views. On 4 September 1990, the Chairman of the Negotiating Group presented a draft text of the

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<sup>8</sup>MTN.GNG/NG10/W/26.

<sup>9</sup>MTN.GNG/NG10/W/33.

Agreement.<sup>10</sup> The wording of items (h) and (i) of Annex I in this draft text was the same as that in the Tokyo Round Subsidies Code. Annex II in the draft text provided "Guidelines on Physical Incorporation"<sup>11</sup>, and Annex III provided "Guidelines in the Determination of Substitution Drawback Systems as Export Subsidies".<sup>12</sup> These Annexes remained unchanged in the text of the Agreement submitted in December 1990 to the Ministerial Conference held in Brussels.<sup>13</sup>

12. In 1991, the proposal for changing "goods that are physically incorporated in the exported product" in items (h) and (i) of Annex I was considered again. It was specifically taken up for discussion in October 1991 in the context of issues that were yet to be settled in the negotiations on the Agreement on Subsidies and Countervailing Measures. This discussion led to an agreement to change the text of items (h) and (i) of Annex I, by inserting "inputs that are consumed in the production of the exported product" in place of "goods that are physically incorporated in the exported product". This resulted in corresponding changes in the texts of Annexes II and III of the Agreement. Footnote 61 was added to Annex II in order to explain the coverage of "inputs consumed in the process of production" that had been agreed in the negotiations. The Draft Final Act, i.e. document MTN.TNC/W/FA (dated 20 December 1991), contained this revised text.

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<sup>10</sup>MTN/GNG/NG10/W/38/Rev.1.

<sup>11</sup>The Guidelines in Annex II had been adopted by the Tokyo Round Committee on Subsidies and Countervailing Measures at its meeting of 23-24 October 1985. See BISD 32S/156.

<sup>12</sup>The Guidelines in Annex III had been adopted by the Tokyo Round Committee on Subsidies and Countervailing Measures at its meeting of 1 November 1984. See BISD 31S/257.

<sup>13</sup>MTN.TNC/W/35/Rev.1.