THE REGULATION OF SUBSIDIES AND REGIONAL TRADE AMONG DEVELOPING COUNTRIES IN THE MULTILATERAL TRADING SYSTEM: THE CASE OF EXPORT PROCESSING ZONES IN MALAWI

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ABSTRACT

The paradigm shift engaged by countries in SADC and COMESA, such as Malawi, from the use of import substitution policies which were aimed at protecting their infant industries, to export led growth strategies, necessitated these developing countries to liberalise their economies. The liberalisation of these economies meant that, for them to attain development, they needed to trade more on the international market. However, with underdeveloped industries and a lack of local entrepreneurs who could provide export supplies to fill the void created by the liberalisation policies, developing countries had to look beyond their borders for investors. In pursuit of this objective, governments have been devising ways of attracting foreign direct investment which can stimulate export growth. One of the methods employed is the granting of investment incentives to would-be investors. Unlike developed countries who provide investment incentives in the form of financial incentives, developing countries grant fiscal incentives. These are incentives that reduce tax burdens of enterprises to induce them to invest in particular projects or sectors.

One of the mediums of providing the incentives adopted by the developing countries is the use of EPZ schemes. EPZs provide incentives such as exemptions of direct and indirect taxes to companies that operate in the zones. However, being Members of the WTO and SADC and/or COMESA, these countries are bound by obligations regulating trade and investment as found in these Agreements. The expectation is that the fiscal incentives employed in the EPZs do not grant subsidies that are prohibited under the SCM Agreement and rules regulating subsidies in SADC and COMESA. In addition, even though the use of EPZs is not expressly proscribed under the SADC Protocol on Trade, it may be against the objectives of the Protocol - one of which is the pursuance of the inter-jurisdictional goal of cooperation in attainment of free trade among its members. Therefore, this study assesses whether the use of EPZs by some countries in the two RTAs (particularly Malawi) is in tandem with the subsidies regulation as found in the multilateral trading system and at regional level. It also assesses whether, if there is a breach of the same, it might be justified as part of the special and differential treatment accorded to developing countries by developed countries under the WTO. The study further assesses whether the use of EPZs might be against the spirit and objects of FTAs such as SADC.

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ACRONYMS

CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
CU	Customs Union
EAC	East African Community
EPZ	Export Processing Zone
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GSP	Generalised System of Preferences
LDC	Least Developed Country
MFN	Most Favoured Nation Treatment
MRA	Malawi Revenue Authority
NAFTA	North American Free Trade Agreement
RTA	Regional Trade Agreement
S&DT	Special and Differential Treatment
SADC	Southern African Development Community
SCM Agreement	Agreement on Subsidies and Countervailing Measures
WTO	World Trade Organisation

LIST OF STATUTES AND INTERNATIONAL AGREEMENTS

Agreement Establishing the World Trade Organisation (Marrakesh Agreement), 1867 U.N.T.S 154

Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade (the Subsidies Code)

Agreement on Subsidies and Countervailing Measures, 1867 U.N.T.S. 14

Control of Goods Act No. 28 of 1968 (Malawi)

Customs and Excise Act No. 13 of 1969 (Malawi)

Customs and Excise Act No. 6 of 1988 (Malawi)

Export Incentives Act No. 6 of 1988 (Malawi)

Export Processing Zones Act Chapter 373 of the Laws revised edition of 2012 (Tanzania)

Export Processing Zones Act No. 11 of 1995 (Malawi)

GATT Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries

General Agreement on Tariffs and Trade (1947), 55 U.N.T.S. 183

General Agreement on Tariffs and Trade (1994), 1867 U.N.T.S. 187

Income Tax Act of 58 OF 1962 (South Africa)

International Convention on the Simplification and Harmonization of Customs Procedure

Investment and Export Promotion Act No. 11 of 2012 (Malawi)

Investment Promotion Act of 1991 Act 28 of 1991 (Malawi)

North American Free Trade Agreement 32 I.L.M 289

Protocol on the Establishment of East African Customs Union

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Taxation Act No. 46 of 1963 (Malawi).

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Vienna Convention on the Law of Treaties, 1155 U.N.T.S. 331

Southern African Development Community Protocol on Trade

Treaty of Common Market for Eastern and Southern Africa

LIST OF CASES

Appellate Body Report, *Brazil – Export Financing Programme for Aircraft* WT/DS46/AB/R (2nd August 1999).

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Appellate Body Report, *European Communities and Certain Member States-Measures Affecting Trade in Large Civil Aircraf*t WT/DS316/AB/R (18th May 2011).

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Appellate Body Report, *Turkey – Restrictions on Imports of Textile and Clothing Products* WT/DS34/AB/R (22 October 1999).

Appellate Body Report, *United States – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)* WT/DS353/AB/R (12th March 2012).

Appellate Body Report, *United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China* WT/DS379/AB/R (11th March 2011).

Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations"* WT/DS108/AB/R (24th February 2000).

Appellate Body Report, *United States -Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors* (DRAMS) from Korea WT/DS296/AB/R (27th June 2005).

Appellate Body Report, *United States-Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada* WT/DS257/AB/R (19th January 2004).
Panel Report, *Brazil – Export Financing Programme for Aircraft* WT/DS46/R (14th April 1999).

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CHAPTER 1: INTRODUCTION AND SIGNIFICANCE OF THE STUDY

1.0 Background

The integration of the world economy through measures which have been put in place by institutions such as the World Trade Organisation (WTO) that aim for trade liberalization has made developing countries adjust the way they operate their economies.[1] This has necessitated developing countries opening their economies. Countries realise that in an integrating world economy, national economic growth depends to a certain extent upon the degree to which a country trades on the international market.[2] This ideal for a new international economic order as a more favourable framework for development of developing countries' economies is intertwined with the quest for industrialisation.[3] This has led developing countries to adopt export-led growth development strategies with a view to attracting investors with an end of enhancing the competitiveness of their domestic industries and products on international markets.[4]

The adoption of these export-led growth policies has led developing countries to devise ways of attracting foreign direct investment, as most of the developing countries do not have vibrant industries that can stimulate export growth. One of the methods employed by developing countries is the granting of investment incentives to these investors. These investment incentives may be defined as "any measurable advantages accorded to specific enterprises or categories of enterprises by or at the direction of a government, in order to encourage them to behave in a certain manner."[5] The most used investment incentives around the globe are financial incentives and fiscal incentives. A financial incentive involves transfer of financial assets to investors from state funds, which could be grants, or loans at

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[1] The GATT since its establishment in 1947 has been making efforts aimed at trade liberalization, of particular importance have been its laws which are directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international trade relations. The aspirations for trade liberalization are evident from the preambles of GATT 1994 and the Agreement establishing the WTO. The WTO has numerous multilateral trade agreements that aim at ensuring that there is fair trade between members of the WTO.

[2] R Lopez-Mata "Income Taxation, International Competitiveness and the World Trade Organisation Rules on Subsidies: Lessons to the US and to the World from the FSC Dispute" (2000-2001) 54 *Tax Lawyer* 577 at 579.

[3] JD Amado "Free Industrial Zones: Law and Industrial Development in the New International Division of Labour" (1989-1990) 11 *U.PA.S.INT'L BUS.L.* 81.

[4] JP Cling and G Letilly "Export Processing Zones: A Threatened Instrument of Global Insertion" (2001) DIAL Working Paper DT/2001/17 6.

[5] United Nations Conference on Trade and Development "Tax incentives and Foreign Direct Investment a Global Survey" http://unctad.org/en/docs/iteipcmisc3_en.pdf (accessed 25th April 2016).

reduced rates or equity fusion.[6] Fiscal incentives are any incentives that reduce the tax burdens of enterprises in order to encourage them to invest in particular projects or sectors.[7] The fiscal incentives may involve reduction of corporate tax, exemption from custom duties on imported capital goods, machinery or raw materials, accelerated depreciation, among other things.[8] However, since most developing countries cannot grant financial incentives, they resort to fiscal incentives.[9] These tax incentives are intended to encourage investment in certain sectors, and hence they are rarely provided without conditions being attached to them.[10]

1.1 Malawi's Trade Policies

Malawi, being a developing country, has made strides to integrate into the world economy by, among other things, being a member of the WTO.[11] It has been a member of the General Agreement on Tariffs and Trade (GATT) since 28th August 1964 and a member of the WTO since 31st May 1995.[12] It is expected that as a member of the WTO, Malawi must ensure that its laws, regulations and administrative procedures concerning trade are in tandem with its obligations that come by virtue of membership to the WTO.[13]

One of the ways Malawi has employed to achieve these obligations has been through making policies and passing laws which aim at market liberalization. One piece of such legislation was the Investment Promotion Act[14] which was enacted in 1991 and it has since been repealed and replaced by the Investment and Export Promotion Act.[15] The Investment Promotion Act and now the Investment and Export Promotion Act aim at, among other

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[6] H Christianand AW Schulze "Free Trade Zones at the beginning of the 21st Century" (2002) 35 *CILSA* 198 at 200.

[7] United Nations Conference on Trade and Development "Tax incentives and Foreign Direct Investment a Global Survey".

[8] JS Mahand D Tamulaitis "A Note on Investment Incentives in the WTO and Transition Economies" (2000) 12(1) *Post – Communists Economies* 119 at 123.

[9] United Nations Conference on Trade and Development "Tax incentives and Foreign Direct Investment a Global Survey".

[10] *Ibid*

[11] United Nations Conference on Trade and Development "Malawi and Multilateral Trading System: The Impact of WTO Agreement, Negotiations and Implementation" (2006)http://unctad.org/en/docs/ditctncd200518_en.pdf (accessed 3rd March 2016).

[12] "Malawi and the WTO" http://www.wto.org (accessed 16th April 2016.)

[13] Article XVI (4) of the Agreement Establishing the World Trade Organisation.

[14] Act 28 of 1991.

[15] Act No. 11 of 2012. The objectives of the new Act are the same as those of the Act it has replaced, and it has retained most of the policies that were investment policies which were adopted under the old Act.

things, making provision for the promotion of investment and export. One of the guiding principles of this Act is to make sure that every public officer or authority in Malawi performing any duty connected with investment, should have recourse to Malawi's policies and business guide and must treat the policies and business guide as ranking paramount.[16]

One of the Malawian government's investment policies included in the schedule to the Act states as follows;

> "To encourage export-oriented investments, the Government will offer incentives competitive to those found in other countries. At present, these incentives include-
> (i) an income tax allowance based on export sales of non-traditional products (i.e. products other than tobacco, tea, sugar and coffee);
> (ii) rebates of import duties, surtaxes, and local taxes on most inputs used in production for export."[17]

In pursuance of the above policy, Malawi enacted statutes that provide fiscal incentives to investors as a way of attracting foreign direct investment (FDI). One such piece of legislation is the Export Processing Zones Act[18]. This Act favours investors who produce for the export market rather than domestic market by granting incentives such as tax holidays to them.

However, even though this Act is intended to attract investors, there is need to consider if it does not conflict with other investment policies and Malawi's obligations under the WTO. One such policy, also found in the Statement of Investment Policies[19] states that:

> "The thrust of the Government's efforts will be to facilitate, rather than to regulate, private investment…. Investors, both domestic and foreign, may invest in any sector of the economy, with no restriction on ownership. Further there are no restrictions on the size of investment, the source of funds or whether products are destined for export or for the domestic market. Domestic investors

[16]Section 3 of the Investment and Export Promotion Act.
[17] Paragraph 14 in the Statement of Investment Policies.
[18]Act No 11 of 1995. This Act was amended in 2013 by deleting some words and inserting some new sections in the principal Act, however the amendments did not change how the export processing zones are established, operated and the type of incentives available to the export enterprises which operate in the export processing zones.
[19] This statement of investment policies was adopted under the Investment Promotion Act of 1991 and has been retained in the Investment and Export Promotion Act of 2012 and it's included as a Schedule to the new Act.

> are encouraged to join with foreign investors to pursue investment opportunities in Malawi."[20]

The policy is in tandem with Malawi's obligations as a member of the WTO.[21] The word "restriction" used in the policy seems to mean, per the definition provided in the Black's Law Dictionary, that there is no limitation or qualification given by government as to the type of investment and investment's market targets.[22]

1.2 The Agreement on Subsidies and Countervailing Measures

One of the multilateral agreements in trade in goods in the WTO is the Agreement on Subsidies and Countervailing Measures (SCM Agreement).[23] This Agreement is there to curb protectionist tendencies that governments engage in with the purpose of limiting market access of foreign players in their territories.[24] It regulates government interventions in trade which have or might have trade distorting effects, specifically with regard to the granting by governments of subsidies to specific industries.[25] Malawi, as a member of the WTO, should not want to breach its obligations under this Agreement. However, it is possible that the provisions of the Export Processing Zones Act may amount to a form of prohibited subsidy in terms of this Agreement, and thus be in breach of Malawi's WTO obligations.

According to the SCM Agreement there will be a subsidy if there is a financial contribution by a government or any public body within the territory of a member which confers a

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[20] Paragraph 5 in the Statement of Investment Policies.

[21] Some of the obligations relating to trade and investments are found in the Trade Related Investment Measures Agreement (TRIMs Agreement). This Agreement aims at eliminating trade-distorting effects of investment measures taken by WTO Members, in particular it proscribes investment measures that infringe GATT Articles III and XI. These are measures that discriminate between imported and exported products and/or create import or export restrictions. For instance, local content requirement imposed in a non-discriminatory manner on domestic and foreign enterprises is inconstant with the TRIMs Agreement because it involves discriminatory treatment of imported products in favour of domestic products; https://www.wto.org/english/tratop_e/invest_e/invest_info_e.htm (accessed 2nd September 2017).

[22] BA Garner (ed) *Black's Law Dictionary* 9 ed (2009).

[23] This is by virtue of Article II (2) and Annex 1 of the Agreement Establishing the World Trade Organisation which provide that the Agreement on Subsidies and Countervailing Measures is one of the multilateral trade agreements which are integral parts of the agreement and are automatically binding on every member of the WTO by virtue of that membership.

[24] AO Sykes "The Questionable Case for Subsidies Regulation: A Comparative Perspective" (2010) 2(2) J*ournal of Legal Analysis 473* at 495.

[25] Panel Report *Canada – Measure Affecting the Export of Civilian Aircraft* WT/DS/70/R (14th April 1999) Para 9.119.

benefit.[26] The financial contribution must be given by a government in the sense of a body "that enjoys the effective power to regulate, control or supervise individuals or otherwise restrain their conduct through the exercise of lawful authority."[27] The financial contribution can take many forms but includes government revenue that is otherwise due but is foregone or not collected.[28] The tax that is foregone must provide a benefit to the recipient (in this case an investor) in the form of a financial contribution which puts the recipient in a "more advantageous position than would have been the case but for the financial contribution"[29] for it to be considered a subsidy for the purposes of the SCM Agreement.

Van den Bossche defines "benefit" as being present if the recipient has received a financial contribution under the terms which are more favourable than those available to the recipient in the market.[30] In other words, the transaction between the government and the investor should be on more favourable terms that those available to other investors in the market.[31]

However, the essence of the SCM Agreement in trying to regulate trade in goods is not to forbid governments from granting subsidies entirely. Only subsidies that are deemed to be specific are subject to possible condemnation under WTO law.[32] A subsidy is deemed specific if access to it is limited to certain enterprises and its application is not based on an objective criteria and neutral conditions which have a general and horizontal application.[33]

However, even though a subsidy may be specific, this on its own is not a reason enough to deem it contrary to the object and purpose of SCM Agreement. A subsidy will be proscribed only if it is within the meaning of a prohibited subsidy as provided in the SCM Agreement. Under the SCM Agreement, it is prohibited for a WTO member to offer subsidies which are contingent in law or fact whether solely or as one of the several conditions upon export

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[26]Article 1.1(a) (1) of the Agreement on Subsidies and Countervailing Measures.
[27] P van den Bossche and W Zdouc *The Law and Policy of the World Trade Organisation* 3rd ed (2013) 750.
[28] Article 1.1(a) (1) ii of the Agreement on Subsidies and Countervailing Measures.
[29]Panel Report *Canada –Aircraft* Para 9.112.
[30]Bosche and Zdouc *The Law and Policy of the World Trade Organisation* 759.
[31] P De Baere and C Du Parc *Export Promotion and the WTO: a brief guide* (2009) 5.
[32]AO Sykes "The Economics of WTO Rules on Subsidies and Countervailing Measures" (June 2003) *U Chicago Law & Economics, Onlin Working Paper No. 186* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=415780 (accessed 5th March 2016).
[33] World Trade Organisation *World Trade Report 2006*: *Exploring the Links between Subsidies, Trade and the WTO* (2006) 198.

performance.[34] It is also prohibited for a government to offer subsidies contingent whether solely or as one of the several other conditions upon the use of domestic over imported goods.[35]

The initial question to be addressed in this research, therefore, is whether Malawi's Export Processing Zones Act of 1995 could amount to a form of subsidisation which would be prohibited in terms of the SCM Agreement.

Chapter 2 of this research will consider in detail this concept of a subsidy and how fiscal incentives in the form of tax holidays and exemptions are covered under the SCM Agreement in general.

1.3 Export Processing Zones

Export processing zones (EPZs) have been one of the tools employed by developing countries to help stimulate export-led growth. Most EPZs grant incentives in the form of fiscal measures, in particular tax relief to investors operating in the zones. EPZs are known by different names depending on the terminology adopted by a particular country, some of which are the following: free trade zones, special economic zones, maquiladoras, free zones and free export zones.[36] A free zone has been defined under the International Convention on the Simplification and Harmonization of Customs Procedure to be "a part of the territory of a contracting party where any goods introduced are generally regarded in so far as import duties and taxes are concerned as being outside the customs territory."[37] In this case customs areas are any place which is licensed, appointed or approved for inspection, deposit, storage or manufacture of goods subject to customs control.[38]

This is the case as most of the export processing zones are geographically delimited areas that countries set up to woo investment in exchange for fiscal incentives.[39] EPZs are deemed to enjoy an "extraterritorial status, i.e. a juridical fiction that exempts activities held in a

[34] Article 3.1(a) of the Agreement on Subsidies and Countervailing Measures.
[35] Article 3.1(b) of the Agreement on Subsidies and Countervailing Measures.
[36] MA Almeida "Export Processing Zones and the Law of the World Trade Organization" http://www.sielnet.org/Resources/Documents/Export%20Processing%20Zones%20and%20.docx (accessed 6th April 2016).
[37] This definition is found in Specific Annex D Chapter 2 of the International Convention on the Simplification and Harmonization of Customs Procedure.
[38] Section 2(1) of Customs and Excise Act chapter 42:01 of Laws of Malawi.
[39] JJ Waters "Achieving World Trade Organization Compliance Export Processing Zones while Maintaining Economic Competitiveness for Developing Countries" (2013) 63 *Duke Law Journal* 481 at 482.

designated area from the application of the rules and regulations in force in the rest of the country."[40] The most defining factor reinforcing this notion of extraterritorial status of the EPZs are the special incentive measures offered within the zones which are unavailable to the rest of the customs area. [41]

According to Madani, some of the primary goals for an EPZ are the following:

- to provide foreign exchange earnings by promoting non-traditional exports.
- To provide jobs to alleviate unemployment or under-employment problems in the host country: assist in income creation.
- To attract foreign direct investment to the host country.[42]

Gebracht argues that in the case of a successful EPZ, FDI would be accompanied by technological transfer, knowledge spill-over and demonstration effects that would act as a catalyst for domestic entrepreneurs to engage in production of non-traditional products.[43]

1.3.1 Export Processing Zones Act 1995

In Malawi, the Export Processing Zones Act is used to establish, operate and administer export processing zones. At the core of this piece of legislation is export promotion through provision of a conducive and enabling environment to investors with an end of turning the country into a net exporter.[44] The EPZ regime was established as a response to long standing industrial inefficiencies and the concentration of exports based around a few commodities.[45] The Act grants special incentives to investors involved in manufacturing goods set for export.[46]

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[40]Amado 1989-1990 *U.PA.S.INT'L BUS.L.* 121.
[41] *Ibid*.
[42] D Madani "A Review of the Role and Impact of Export Processing Zones" http://siteresources.worldbank.org/INTRANETTRADE/Resources/MadaniEPZ.pdf (accessed 25th April 2016).
[43] BD Gebracht "Export Processing Zones and Free Trade Agreements: Lessons from North American Agreement on Labour Cooperation" 16 *Transnational Law & Contemporary Problems* 1029 at 1033.
[44] S Shadikhodjaev "International Regulation of Free Zones: An Analysis of Multilateral Customs and Trade Rules" (2011) 16 (2) *World Trade Review* 189 at 190.
[45] V Nkhoma "Export Processing Zones: is it a Regime Worth the Sacrifice?" 2007 *Integrated Framework Policy Analysis Working Paper Series No. 7* 1.
[46]WT Mughandira *Determinants of Foreign Direct Investment* (MA (economics) thesis, University of Malawi, 2007) 3.

Under the Act, the Minister of Trade and Industry has the authority to declare any area of land on which a factory is to be built or any factory to be an EPZ.[47] However, when declaring the land or factory as an EPZ, the minister must do the same with the purpose of attracting, promoting and increasing manufacture of export products or with the object of promoting economic development generally.[48] The requirement for export promotion and promotion of economic development was put in place to make sure that this regime of EPZs is used as an incentive for attracting FDI.

Section 3 of the Act establishes an Export Processing Zones Appraisal Committee. This committee is responsible for appraising and reviewing applications for the establishment and operation of export processing zones and the production or manufacture of export products. The committee then makes recommendations to the minister on whether to establish an EPZ or not. The Act mandates the committee to consider several factors before it recommends to the minister to declare a factory as an EPZ. The committee must consider the following: the utilization of local raw materials, use of advanced technology, labour intensive activities of the project, export oriented activities other than production for export of tobacco, tea, coffee and sugar, and whether there is documentary evidence of export markets for the export products.[49] If the minister is satisfied that a company or an investor meets the conditions, he issues a certificate certifying the company or investor as an export enterprise and the certificate specifies the export product. This certificate is valid for 5 years.[50]

Government provides fiscal incentives in the form of tax holidays to investors in the EPZs. Section 15B (1) of the Act states that an export enterprise is entitled to such benefits as specified in the Taxation Act, Customs and Excise Act, Value Added Tax Act, Exchange Control Act and any other written law. Section 16 of the Act is to the effect that where an export enterprise imports or purchases any dutiable goods to be used in the EPZ, no duty shall be paid on the goods if the goods are transported directly and forthwith to the EPZ. This implies that the imports are exempted from valued added tax (VAT, which is currently

[47]Section 8 of Export Processing Zones Act.
[48]Section 8 of Export Processing Zones Act.
[49]Section 7 of Export Processing Zones Act.
[50]Section 10 of Export Processing Zones Act.

at 16.5 percent)[51] customs duties (which may go as high as 30 percent), and excise tax among other taxes.

Investors in the EPZs are also exempted from paying direct taxes. Under the Taxation Act, companies are supposed to pay an income tax of 30 percent, however prior to 2011 companies in EPZs which had been granted an export enterprise by the minister were exempted from paying this income tax.[52] Companies in the EPZ currently are exempted from withholding 10 percent of the dividends which they declare to their shareholders as withholding tax. In a nutshell, investors in the EPZs enjoy the following: no withholding tax on dividends, no customs duty on capital equipment and raw materials, no excise taxes on purchases of raw materials and packaging materials made in Malawi, no value added tax on inputs and export produce and/or manufacture, and no income tax.[53]

The Act, in a way, treats EPZs as enclaves as far as matters of taxation are concerned. Therefore, for all intents and purposes the movement to and from the EPZs and other customs areas may be deemed to constitute movements between two countries.[54] This is evident from section 15A of the Act which was inserted in the 2013 amendment, which states that if goods are taken from an EPZ to a customs area for use therein, then the goods are deemed to have been imported and shall be paid in Malawi Kwacha.[55] It further states that if raw materials are taken out from any part of the customs area and brought into an EPZ, they shall be deemed to have been exported from Malawi and shall be paid for in freely convertible currency.[56]

Chapter 3 of this research will consider in detail the operations of EPZs as regulated by the Export Processing Zones Act and chapter 4 will assess whether they are in tandem with the regulations of subsidies as provided in the SCM Agreement.

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[51] Section 9 of Value Added Tax Act.
[52] Eleventh schedule of Taxation Act.
[53] Malawi Revenue Authority "*Exporters' Guide* "
http://www.mra.mw/assets/upload/downloads/EXPORTERS_GUIDE.pdf (accessed 11th April 2016).
[54] Amado 1989-1990 *U.PA.S.INT'L BUS.L.* 121.
[55] Section 15A(b) of the Export Processing Zones Act.
[56] Section 15A(a) of the Export Processing Zones Act.

1.4 Special and differential treatment under the WTO

Under the WTO, members are not always accorded equal treatment when it comes to matters dealing with sustainable development. Developing and least developed countries (LDCs) are accorded special and differential treatment under WTO Agreements.[57] This involves discrimination in favour of developing countries and LDCs through provision of differential rights and obligations mandated by the agreements themselves and differential treatment accorded to developing countries by other developed members.[58]

The SCM Agreement recognizes the developmental and financial needs of developing country members. As such, there are provisions in the Agreement which exempt application of certain obligations to developing country members. Under Article 27 of the SCM Agreement, members take cognizance of the fact that subsidies play an important role in economic development.[59] Hence the provisions of Article 3.1(a) of the SCM Agreement on prohibited export subsidies do not apply to LDCs.[60] Article 3.1(b) of the Agreement was not supposed to apply to developing members for a period of 5 years and for LDCs for 8 years from the date of entry into force of the Agreement on 1st January 1995.

A shallow consideration of Article 27 of the SCM Agreement may lead to a conclusion that Malawi may be covered and be exempted wholly as an LDC if it is found that its EPZ scheme would otherwise constitute a prohibited subsidy. However, the exemptions are twofold. The first exemption is that which allows LDCs to use subsidies contingent upon export performance.[61] This has no limitation as to the time within which the LDCs should stop using subsidies. The second one is that which allows developing countries and LDCs to use subsidies contingent on or among other factors use of domestic over imported goods. This one has a time limit factor in it. It was agreed that developing countries will stop using it on 31st December 1999 and LDCs on 31st December 2002.

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[57] The GATT 1994 has several provisions that provide special and differential treatment to developing countries such as Article XVIII which allows developing countries with balance of payment problems to apply and administer quantitative restrictions. However, it is the Decision of the GATT CONTRACTING PARTIES of 28 November 1979 on *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries*, more commonly referred to as the Enabling Clause that opened the gates for according special and differential treatment as is currently known to developing countries.

[58] AD Mitchell "A Legal Principle of Special and Differential Treatment for WTO Disputes" (2006) 5(3) *World Trade Review* 445 at 446.

[59] Article 27.1 of the Agreement on Subsidies and Countervailing Measures.

[60] Article 27.2 of the Agreement on Subsidies and Countervailing Measures.

[61] Article 27.2(a) of the Agreement on Subsidies and Countervailing Measures.

It is allowed for developing countries to ask for extension of time for the application of the exemption as far as subsidies contingent upon export performance are concerned.[62] However, this does not apply to import substitution subsidies: the grace periods for LDCs and developing countries are not extendable.[63]

If this study shows that Malawi grants incentives which are prohibited subsidies and import substitution subsidies, the conclusion will be that these incentives breach Article 3 of the SCM Agreement. However, being an LDC, Malawi passes the test on export contingent subsidy exemption, as such it will be exempted from the obligations of Article 3.1(a) of the SCM Agreement. However, Malawi cannot be exempted from its obligations under Article 3(1)(b), which concerns import substitution subsidies as the time for operation of the exemption expired.

However, even though Malawi is an LDC, it is still relevant to consider the Export Processing Zones Act in this context because Malawi may not always be considered an LDC and as such this legislation may need to change in the future. It is the expectation of both developing and developed countries that developing countries must graduate whenever their economies get stronger.[64] This is the case as special and differential treatment is but a "transitional set of measures over specifically defined time periods to allow developing countries to take on the same level of obligations as developed countries".[65]

The research in Chapter 5 will examine in detail this concept of special and differential treatment, tracing its development, scope and limitations and how it has covered under the SCM Agreement and how it applies to Malawi and the operations of EPZs.

1.5 Malawi's Regional Trade Agreements

Apart from the WTO Agreements there is also need to consider Malawi's obligations under various plurilateral treaties. Malawi is expected to execute the purposes and objects of these plurilateral treaties it is party to; hence balancing of its interest and aspirations as a

[62]Article 27.4 of the Agreement on Subsidies and Countervailing Measures.
[63]Shadikhodjaev 2011 *WTR* 206.
[64] J Whalley "Special and Differential Treatment in the Millennium Round" (1999) CSGR working paper No 30/99 http://wrap.warwick.ac.uk/2095/1/WRAP_Whalley_wp3099.pdf (accessed 12th March 2016).
[65] T Fritz "Special and differential Treatment for Developing Countries" (2005) Global Issue Paper No. 18 http://germanwatch.org/tw/sdt05e.pdf (accessed 12th March 2016).

country can no longer be subject to its unilateral considerations that would in a way alter the terms of these treaties.[66] Importantly, regional treaties such as the Treaty establishing Common Market for Eastern and Southern Africa (COMESA) and Protocol on Trade for Southern African Development Community (SADC) should be considered. What is common in these regional treaties is that they aim to establish free trade areas. They seek to eliminate tariff and non-tariff barriers to trade between member countries.[67]

In seeking to establish free trade areas, the parties to these treaties are not oblivious to the fact that there may be trade deflection of these policies to third party countries.[68] There may be situations when terms of these treaties may result in low-cost external suppliers being replaced with higher cost regional suppliers.[69] Hence mechanisms are put in place to check these deflections, one of which is the "restriction or elimination of any mechanism whereby a member of a free trade area grants preferential tariff or tax treatment to imports of extra regional inputs."[70] Therefore, most of these treaties contain provisions to the effect that parties are not allowed to grant subsidies which distort or threaten to distort trade or competition among them. These provisions are there to make sure that the inter-jurisdictional goal of cooperation in attainment of free trade among member countries is achieved.[71]

Article 19 (1) of the SADC Protocol on Trade prohibits members from granting subsidies which distort or threaten to distort competition in the Region. Article 52 of the COMESA Treaty mirrors Article 19 of the SADC Protocol on Trade as it states that, "granting of subsidies which distort or threaten to distort competition by favouring certain undertakings or the production of certain goods shall, insofar as it affects trade between the Member States, be incompatible with the treaty".[72] It can be seen that the two regional treaties to

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[66]R Dolzer and C Schreuer *Principles of International Investment Law* (2008) *23*.
[67]J Granados "Export processing Zones and other Special Regimes in the Context of Multilateral and Regional Trade Negotiations" (2003) *INTAL – ITD Occasional Paper 20* http://www20.iadb.org/intal/catalogo/PE/2007/00739.pdf (accessed 23rd March 2016).
[68]Sargent and Matthews 2001 *World Development* 1741.
[69]*Ibid*.
[70] Granados "Export processing Zones".
[71]Sykes 2010 *Journal of Legal Analysis* 498.
[72] The case is the same in other regional treaties, for example in the North American Free Trade Agreement (NAFTA), article 303 establishes restrictive disciplines with regard to imports of extra-regional goods produced under duty drawback and deferral schemes. Mexico had to change the operations of its maquiladoras to be in tandem with the said article. The case is the same with MERCOSUR (the Common Market of the South);

which Malawi is a party to limit the use of subsidies.[73] However, of particular importance is the fact that the provisos do not differentiate between developing and LDCs as is the case under the SCM Agreement.

The question that arises therefore, is whether some of these concessions and privileges such as special and differential treatment should also be acknowledged in intra-regional trade or whether Malawi as a party to these treaties must follow the treaties to the letter.[74] It is also relevant to consider these agreements in light of their possible lack of S&DT, because Malawi's breach may be justified at multilateral level but if no S&DT is allowed in terms of the FTAs it will not be exempted. Therefore, it is important to consider provisions such as Article 19(4) of the SADC Protocol on Trade which allows a member state to introduce a new subsidy but only in accordance with WTO provisions. However, the provision is very vague as it does not indicate whether this encompasses exemptions allowed to LDCs under the SCM Agreement as the Protocol does not differentiate between developing countries and LDCs. The COMESA Treaty in Articles 144 to 150 has provisions dealing with LDCs, but these provisions are vague and do not deal with the regulation of subsidies. It is therefore worthwhile to assess whether these provisions may be construed to encompass special and differential treatment as far as subsidies provided by LDCs are concerned, considering that no mention of it is made in Article 52 of the COMESA Treaty which deals with subsidies.

Considering the forgoing discussion, chapter 6 will consider the regulation of FTAs under the multilateral trading system, while chapter 7 will consider the way in which EPZs are regulated under SADC and COMESA. Thereafter, in chapter 8, an assessment will be made as to whether it is proper to have the Export Processing Zones Act amended, repealed and/or retained in the current form, regard being had to the SCM Agreement and COMESA Treaty and SADC Protocol on Trade and the bilateral treaties Malawi is party to.

Uruguay had also to change the operations of its Export Promoting Zones in line with its obligations under MERCOSUR.

[73] Article XI of Trade Agreement between the Government of the Republic of Malawi and the Government of the Republic of Republic of South Africa forbids contracting parties from granting subsidies which distort or threatens to distort competition between them. This article is replicated in article XI of the agreements between Malawi and Mozambique and Malawi and Zimbabwe.

[74] C Ng'ong'ola "Regional Integration and Trade Liberalization in the Southern African Development Community" (2000) 3(3) *Journal of International Economic Law* 485 at 501.

1.6 Goals of the Research

In light of the discussion above, it is recognised that there is a need for Malawi to put in place measures that promote and enhance investments which are focused at making the country a net exporter. It is also appreciated that Malawi as an LDC is exempted from some obligations of the WTO. However, the exemptions are not all-encompassing ones. The study will therefore seek to answer the following questions:

1. Whether the Export Process Processing Zones Act is in breach of Malawi's obligations under the WTO dealing as providing for prohibited subsidies under the SCM Agreement.
2. If it is in breach of these obligations, whether it can be exempted by the fact that it is a least developed country, and whether its graduation to developing country status would alter this position.
3. Whether the Export Processing Zones Act is in breach of Malawi's obligations under the regional trade agreements it is a party to, in particular, the SADC Protocol on Trade and COMESA Treaty.
4. Whether it is proper that Malawi retains the Export Processing Zones Act in its current form, regard being had to the results of the above discussion.

1.7 Methodology

This study will be based first and foremost on primary sources such as the SCM Agreement and its related materials together with Panel and Appellate Body decisions in terms of all of the WTO Agreements, where relevant. It will also consider the Malawian statute law, its trade policies and any other literature on the subject which will be gathered through library research, use of the internet, books, case law, journals, newspapers articles, and survey reports. The study will also consider the SADC Protocol on Trade and COMESA Treaty in its analysis of the research topic. The study will also compare what other developing countries are doing as far as modification of free trade zones and/or export processing zones statutes is concerned.

1.8 Thesis Outline

The study begins in chapter two where the legal and philosophical framework on which the study is based will be laid down. It defines concepts and principles that will form the backbone of the study. It describes how subsidies are regulated at the multilateral level and it does this by discussing the theory justifying subsidies regulation. The chapter traces the development of the subsidy regulations from the inception of the GATT to the current state under the WTO. The chapter will deal extensively with how the SCM Agreement regulates prohibited subsidies in the multilateral trading system.

Chapter three builds on the last two chapters by providing a detailed background to the EPZ regime in Malawi and it does this by explaining the different phases of trade and industrial policies that Malawi has passed through since attaining independence. This chapter explains how the policies have influenced the adoption of the EPZ scheme.

Having discussed how trade and industrial policy development influenced the adoption of EPZ regime in Malawi in chapter three, chapter four will discuss how the EPZ regime relates to the subsidy regulation under the multilateral trading system. It analyses the incentives that are provided in the Export Processing Zones Act of Malawi and determines whether the same violate subsidy regulations as provided in the SCM Agreement.

Chapter five discusses the special and differential treatment provided to developing countries in the multilateral trading system. It focuses how the SCM Agreement allows developing countries in some circumstances to grant subsidies as a tool for pursuing economic development. It then discusses how even though Malawi's EPZ regime may be found to violate Article 3.1 of the SCM Agreement by granting prohibited subsidies, some of the provisions can be justified under Article 27 of the SCM Agreement.

Since Malawi is a member of not only the WTO but also a number of Regional Trade Agreements (RTAs), chapter six goes on to discuss how the multilateral trading rules as found under the GATT 1994 regulates the formation and operations of RTAs. The chapter discusses Article XXIV of the GATT 1994 and how the Article regulates the use of trade remedy measures such as countervailing measures in RTAs.

Based on the background to RTAs set in chapter six, chapter seven discusses two RTAs that Malawi is party to; SADC and COMESA. The chapter then discusses how subsidies are regulated in the two RTAs and how the same relate to incentives that are granted in EPZs. The chapter also focuses on the use of duty drawback in EPZs and whether the same is in tandem with the spirit of the SADC Protocol on Trade.

Chapter eight offers recommendations in light of the foregoing discussion.

CHAPTER 2: CONCEPTUAL AND THEORETICAL FRAMEWORK: THE REGULATION OF SUBSIDIES IN THE MULTILATERAL TRADING SYSTEM

2.0 Introduction

This chapter will explore in general terms the regulation of subsidies in international trade law, with emphasis being placed on export and import substitution subsidies as they are the main concern of the research. It will give a background to the rules on subsidies starting with the GATT to how the rules have developed under WTO law. This chapter, however, will not deal with special and differential treatment as these are dealt with in a separate chapter.

2.1 Reasons Behind Regulation of Subsidies

Since the establishment of the GATT, the international community has been attempting to eliminate tariffs and quotas in trade which are perceived to be barriers to trade. However, it soon became apparent that some countries started adopting subsidies as a means of restoring the competitive advantage and achieving protectionism they had sacrificed in dismantling other trade distorting measures.[75] Economists over the years have persuasively demonstrated that subsidies can have considerable trade distorting effects, and this has necessitated a change of global perspective in the way subsidies have to be treated.[76] There is now a robust system that keeps in check government interventions which distort or threaten to distort world trade through the granting of subsidies. Some scholars argue that unfettered use of subsidies in international trade can lead to counter-subsidies and counter-counter subsidies in an escalating progression, all of which can seriously damage world economic welfare.[77]

There are different theories that justify why there must be legal regulation of subsidies in trade. The first theory stems from the classical comparative advantage theory. This theory posits that free trade allows each country to maximize its real income and its welfare by specializing in the production of those goods with respect to which it is relatively most efficient and exchanging these through trade for goods which it could produce at home only

[75] J Evans "Subsidies and Countervailing Duties in GATT: Present Law and Future Prospects" (1977-1978) 3 *INT'L TRADE L.J* 211 at 211.
[76] JH Jackson "Perspectives on Countervailing Duties" (1989-1990) 21 *LAW & POL'Y INT'L BUS* 739 at 742.
[77] *Ibid*.

at relatively greater cost.[78] The theory assumes that most factors of production move freely in the domestic market to locations where the highest value is placed upon them.[79] Therefore, the theory represents an adaptation to international trade of the basic notion that the value of domestic output will be maximized if resources are allocated through private market transactions.[80] According to this theory, subsidies not only reduce the total domestic output of the subsidizing country but it diverts otherwise efficiently allocated resources from competing foreign industries whose sales are captured by the subsidized imported products.[81] The net result is that consumers in importing countries who buy the subsidized product gain as they are cheaper, but they result in a decline in world welfare.[82]

Critics of this theory have argued that this theory fails to take externalities into consideration. An externality exists when an activity by one or more parties affects, for good or bad, another one or more parties who are not part of the activity.[83] Hence, subsidies correct the market failures in the form of externalities integral in the economies of all countries not accounted for under the traditional comparative advantage theory.[84]

Authors like Richard Diamond who critique the comparative advantage theory have developed an "entitlement model" as the basis for controlling subsidies. These authors argue that the objective of countervailing duty law is to insulate domestic firms from effects of certain foreign government practices upon the domestic market.[85] According to Diamond, domestic producers are entitled to whatever economic benefits they would have received had there been no government interference, regardless of whether the receipt of those benefits is consistent with efficiency or not.[86] The fundamental premise of an entitlement

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[78] JJ Barcelo "Subsidies and Countervailing Duties-Analysis and a Proposal" (1997) 9 *LAW & POL'Y INT'L BUS* 779 at 787.
[79] WF Schwartz and EW Harper "The Regulation of Subsidies Affecting International Trade" (1971-1972) 70 *MICH.L. REV* 831 at 839.
[80] *Ibid*.
[81] J Terry "Sovereignty, Subsidies and Countervailing Duties in the Context of the Canada-United States Relationship" (1988) 46 *U. TORONTO FAC.L.REV* 48 at 51.
[8282] *Ibid*.
[83] Terry 1988 *U. TORONTO FAC.L.REV* 52.
[84] *Ibid*.
[85] AO Sykes "Second-Best Countervailing Duty Policy: A Critique of the Entitlement Approach" (1989-1990) 21 *LAW & POL'Y INT'L BUS* 699 at 700.
[86] R Diamond "A Search for Economic and Financial Principles in the Administration of United States Countervailing Duty Law" (1989-1990) 21 *LAW & POL'Y INT'L BUS* 507 at 534.

model is that a subsidy consists of government action which causes the position of domestic producers in an importing nation to be changed from that to which they were entitled.[87]

However, whatever the theory that may be used as a basis for having rules in place, there are competing notions which need to be balanced as far as regulation of subsidies is concerned, the first being the fact that subsidies may cause distortions in trade. If government pays a share of a firm's costs, the firm may be able to capture sales from efficient rivals who did not receive such support.[88] The trade-distorting effects may include "overproduction, artificial competitiveness of subsidized commodities in domestic and external markets and global price suppression with adverse revenue implications for non-subsidizing countries."[89] Therefore, subsidies granted to "exporting firms can divert business from more efficient competitors, and may even trigger subsidies wars in which exporting nations waste resources competing with each other to confer competitive advantage on exporters."[90] Secondly, there may be good policy reasons which lead governments to subsidize, hence there is need to consider that subsidies, if used appropriately, may bring positive effects to countries that are still developing. Hence, subsidies in some circumstances may represent the best policy instrument in remedying trade distortions prevalent in developing countries to the degree that they operate directly on the distorted margins.[91]

2.2 The Law of Subsidies under GATT

The GATT rules that were meant to regulate governmental behaviour in the area of subsidies and countervailing duties were both incomplete and equivocal. This was mostly because there was a divided opinion on the virtues and vices of government intervention in trade through the granting of subsidies. Since there was lack of normative consensus on the issue of subsidies, the international trade laws on subsidies were full of compromise between the divergent views in the form of simple ambiguities where terms employed were less clear. This use of simple ambiguities enables groups with different interests to claim

[87] Diamond 1989-1990 *LAW & POL'Y INT'L BUS* 540.
[88] Schwartz and Harper 1971-1972 *MICH.L. REV* 834.
[89] P Kuruk "The Subsidies Issue in International Trade: Musings of the Economic Partnership Agreement Negotiations" (2012-2013) 38 *N.C.J. INT'L & COM. REG.* 327 at 332.
[90] Sykes 2010 *Journal of Legal Analysis* 475.
[91] *Ibid*.

that the law is consistent with the position each group favours.[92] This was what was prevalent in the GATT system as far as subsidies were concerned, the details of this compromise are discussed below.

This weak system had its basis in the fact that most countries saw the use of subsidies, except for certain forms of subsidies expressly designed to stimulate exports, as strictly a question of national or internal policy.[93] The drafters were persuaded that any subsidy that affects the pattern of international trade will tend to interfere with the optimum allocation of resources. On the other hand, they knew that most countries maintained a variety of domestic subsidies often for desirable social purposes, the international effects of which were negligible or virtually impossible to measure. The result was the incorporation of a single paragraph on subsidies in the original GATT in 1947.[94]

Articles VI, XVI and XXIII of the GATT were the articles that dealt with subsidies and matters relating to them. Article VI dealt with countervailing duties, while Article XVI dealt with regulations dealing with the granting of subsidies and Article XXIII dealt with settlement of disputes.

Under Article XVI:1, each contracting party was obliged to notify the contracting parties in writing regarding the nature and extent of any subsidy which it grants, and this included any form of income or price support which operated to increase directly or indirectly the exports of any product from or reduce imports of any product into its territory. In the notification, the subsidizing country was also supposed to include the estimated effect of subsidization on the quantity of the affected product or products and circumstances making the subsidization necessary. However, if a subsidy was determined to cause serious prejudice to the interest of any other contracting party or parties or threat of prejudice, the subsidizing party could be called upon request to discuss with the other contracting party or parties concerned the possibility of limiting the subsidization.

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[92] RA Cass "Trade Subsidy Law: Can a Foolish Inconsistency be Good Enough for Government Work?" (1989-1990) 21 *LAW & POL'Y INT'L BUS* 609 at 613.
[93] RR Rivers and JD Greenwald "The Negotiation of a Code on Subsidies and Countervailing Measures: Bridging Fundamental Policy Differences" (1979) 11 *LAW & POL'Y INT'L BUS* 1447 at 1449.
[94] Evans 1977-1978 *INT'L TRADE L.J* 215.

Article XVI:3 of the GATT encouraged contracting parties to avoid the use of subsidies on export of primary products. However, if a contracting party granted a subsidy to a primary product it had to make sure that the subsidy had not been applied in a manner which resulted in that contracting party having a more equitable share of the export trade in that product, account being taken of the shares the contracting party had during a previous representative period.

Under Article XVI:4 there was an obligation on all contracting parties to cease granting any form of subsidy on the export of any product other than primary products 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.

Contracting parties were allowed under Article VI of the GATT to impose countervailing duties to offset subsidies granted in exporting countries. This right could be exercised if the subsidization "is such as to cause or threaten material injury to an established domestic industry, or is such as to retard materially the establishment of a domestic industry."[95]

2.2.1 Weaknesses under GATT

The above is a brief description of what the law on subsidies used to be before the coming into force of the SCM Agreement. The provisions had many shortcomings because of the lack of consensus as to an international subsidies regime at this stage.

Firstly, in the GATT there was no definition of what was meant by subsidy. In Article VI:3 there was interchangeable use of the terms of "subsidy: and "bounty" and both these terms were not defined.[96]

The provisions had a limited reach in terms of binding obligations. The only requirement of general application concerned notification and consultation. Even after notification and it had been found that the subsidy was causing prejudice to other contracting parties, chances were slim that the subsidizing party would stop the subsidy as there was no obligation to do so. The Article provided that parties would discuss "the possibility of limiting the subsidization,"[97] meaning that chances were high that the limitation of the subsidy could

[95] Article VI: 6a of the GATT 1947.
[96] Evans 1977-1978 *INT'L TRADE L.J* 217.
[97] Article XVI:1 of GATT 1947.

not be achieved as the subsidizing party could justify the objectives of such subsidization as required under the Article. This self-notification provision had been something less than an effective brake on the use of subsidies.[98]

There was no prohibition on domestic subsidies, the only requirement was the notification obligation found in Article XVI:1. On export subsidies granted to primary products, there was no meaningful prohibition. Export subsidies were allowed as long as they did not give the subsidizing country a more than equitable share of the world market. However, there was no guidance as to what was and what was not an equitable share.[99]

The GATT prohibited subsidies on non-primary products, but only where the "subsidy result[ed] in the sale of such products for export at a price lower than comparable price charged for the like product to buyers in the domestic market."[100] This emphasis on price discrimination had been seen to confuse the evils of export subsidization with that of dumping.[101] This was also compounded by the fact that the obligation in Article XVI:4 had only been assumed by 17 countries.[102]

2.3 Tokyo Round

The GATT provisions on subsidies created interpretational and implementation problems. This was mainly because crucial terms were not defined, and this gave a chance to countries like the United States of America (USA) to use this lacuna in the law to their advantage. The United States imposed countervailing duties on imports which they defined using domestic law to have benefited from subsidies. The European Union, however, had a robust system of granting subsidies, particularly agricultural subsidies, and did not agree with the method used by the USA when it came to imposing countervailing duties. Hence the USA, when countries started negotiating in 1973, wanted stronger rules for regulating subsidies,

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[98] Rivers and Greenwald 1979 *LAW & POL'Y INT'L BUS* 1459. According to the authors of the article, this self-notification/consultation requirement had not been effective and there was no evidence according to them, during the time they were publishing the article, that any country had limited a subsidizing practice as a result of the having consultations under article XVI:1 of the GATT.

[99] Rivers and Greenwald 1979 *LAW & POL'Y INT'L BUS* 1461.

[100] Article XVI: 4 of GATT 1947.

[101] Barcelo 1997 *LAW & POL'Y INT'L BUS* 784.

[102] These countries were: Austria, Belgium, Canada, Denmark, France, the Federal Republic of Germany, Italy, Japan, Luxembourg, the Kingdom of the Netherlands, New Zealand, Norway, Southern Rhodesia, Sweden, Switzerland, the United Kingdom and the United States; Rivers & Greenwald 1979 *LAW & POL'Y INT'L BUS* 1462.

including domestic subsidies. However, most multilateral treaty negotiation participants wanted the USA to accept some form of discipline in terms of its internal regulation of subsidies of particular concern: the parties wanted the USA to accept the test of "material injury" as provided in the GATT and employ the same in its domestic countervailing duty actions.[103] Therefore, there were two blocks: on one side was the USA that wanted to strengthen the subsidies regulations, on the other side was the rest of the world which was saying that the multilateral rules regulating subsidies were already strong and what was required was for the USA to follow the regulations as already provided in the GATT. This led to one author commenting as follows: "To the United States, the code is an instrument to control subsidies. To the rest of the world, it is an instrument to control U.S. countervailing duties."[104]

Of course, in 1979 a new code was in place called the Agreement on Interpretation and Application of Articles VI, XVI and XXIII of the General Agreement on Tariffs and Trade[105] (the Subsidies Code). The major purpose of the Subsidies Code was to clarify and expand upon the then existing provisions of the GATT on subsidies and countervailing measures.[106]

The Subsidies Code recognized that governments use subsidies to promote important objectives of national policy and it also recognized that subsidies could have harmful effects on trade and production.[107] Its concern was to strike a balance on each matter. It provided certain rules for the use of subsidies and certain rules for the application of countervailing duties.[108] The signatories to the Subsidies Code agreed not to use subsidies that would cause injury to the domestic industry of another signatory.[109] It was also agreed by the

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[103] Rivers and Greenwald 1979 *LAW & POL'Y INT'L BUS* 1449.

[104] JM Finger and J Nogues "International Control of Subsidies and Countervailing Duties" (1987) 1(4) *The World Bank Review*) 707 at 713 quoting P. Messerlin "Public Subsidies to Industry and Agriculture and Countervailing Duties." (October 1986) Paper prepared for the European Meeting on the "Position of the European Community in the New GATT Round." Spain.

[105] This code came into force in 1980.

[106] CH Nam "Export Promotion Subsidies, Countervailing Threats and the General Agreement on Tariffs and Trade" (1987) Vol 1(4) *The World Bank Economic Review* 727 at 729.

[107] Preamble of the Subsidies Code.

[108] Finger and Nogues 1987 *The World Bank Review* 710.

[109] These were provided in Article 8 of the Subsidies Code which was titled general provision and it was in the following order:

> *Article 8*
> *Subsidies - General provisions*
> 1. Signatories recognize that subsidies are used by governments to promote important objectives of social and economic policy. Signatories also

signatories of the code not to grant export subsidies on primary products if this would result in a signatory having more than an equitable share of the world export trade in such a product, regard being had to the shares the signatory had during the previous representative period.[110] It was agreed that the 'previous representative period' would be defined to be the three most recent calendar years in which normal market conditions existed.[111]

On non-primary products, signatories agreed not to grant export subsidies on non-primary products meant for export. Even though export products were not defined but an illustrative list of the export products was annexed to the subsidies code.[112]

However, the Subsidies Code allowed subsidies used as important instruments for promotion of social and economic policy objectives on condition that they did not cause or threaten to cause injury to a domestic industry of another signatory or serious prejudice to

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recognize that subsidies may cause adverse effects to the interests of other signatories.
2. Signatories agree not to use export subsidies in a manner inconsistent with the provisions of this Agreement.
3. Signatories further agree that they shall seek to avoid causing, through the use of any subsidy
(a) injury to the domestic industry of another signatory[23],
(b) nullification or impairment of the benefits accruing directly or indirectly to another signatory under the General Agreement[24], or
(c) serious prejudice to the interests of another signatory.[25]

[23]Injury to the domestic industry is used here in the same sense as it is used in Part I of this Agreement.

[24]Benefits accruing directly or indirectly under the General Agreement include the benefits of tariff concessions bound under Article II of the General Agreement.

[25]Serious prejudice to the interest of another signatory is used in this Agreement in the same sense as it is used in Article XVI:1 of the General Agreement and includes threat of serious prejudice.

4. The adverse effects to the interests of another signatory required to demonstrate nullification or impairment[26] or serious prejudice may arise through
(a) the effects of the subsidized imports in the domestic market of the importing signatory,
(b) the effects of the subsidy in displacing or impeding the imports of like products into the market of the subsidizing country, or
(c) the effects of the subsidized exports in displacing[27] the exports of like products of another signatory from a third country market.

[110] Article 10 (1) of the Subsidies Code.

[111] Article 10(2) of the Subsidies Code.

[112] Article 9 of the Subsidies Code. This illustrative list was incorporated into the SCM Agreement as Annex I.

the interests of another signatory or may nullify or impair benefits accruing to another signatory under the GATT.[113] The social and economic policy objectives were such as:

> *"(a)* the elimination of industrial, economic and social disadvantages of specific regions,
> *(b)* …facilitat[ing] the restructuring, under socially acceptable conditions, of certain sectors, especially where this has become necessary by reason of changes in trade and economic policies, including international agreements resulting in lower barriers to trade,
> *(c)* …sustain[ing] employment and encourage[ing] re-training and change in employment,
> *(d)* encourag[ing] research and development programmes, especially in the field of high-technology industries,
> *(e)* the implementation of economic programmes and policies to promote the economic and social development of developing countries,
> *(f)* redeployment of industry in order to avoid congestion and environmental problems."[114]

Thus, the Subsidies Code recognized that subsidies can be an integral part of economic development programmes of developing countries. Therefore, export subsidies prohibition did not apply to developing countries. Under the Subsidies Code, developing countries could employ export subsidies as long as they did not cause serious prejudice to the trade or production of another signatory.[115]

The Code still allowed countries to impose countervailing duties, however, this could only be imposed pursuant to investigations that had been conducted in accordance with the provisions of the code as provided in Article 2. The countervailing duties were imposed to correct the injury suffered by the country imposing them, which had to be determined according to Article 6 of the Subsidies Code. This meant countries like the USA now had to show that they had suffered injury per the Code and could not impose the countervailing duties freely.

[113] Article 11(2) of the Subsidies Code.
[114] Article 11 of the Subsidies Code.
[115] Article 14 of the Subsidies Code.

The Subsidies Code, however, like the GATT provisions, provided no definition of a subsidy or even export subsidy.[116] The other weakness of the Subsidies Code was that it was not adopted by all members of the GATT. This was because during the Tokyo Round, the contracting parties were allowed to sign the Tokyo Round Non-Tariffs Barriers Codes voluntarily.[117] Only a few countries were signatories to the Subsidies Code.[118]

2.4 The SCM Agreement

The Uruguay Round of multilateral negotiations produced the SCM Agreement. The SCM Agreement builds and expands on the Tokyo Code, which only some GATT Members had signed.[119] However, the SCM Agreement applies to all the WTO members as consistent with the single undertaking[120] principle adopted during the Uruguay Round.[121] Through additional principles brought by the SCM Agreement, this Agreement now provides a much-improved discipline as far as provisions of subsidies is concerned compared to what GATT 1947 provided. The Agreement tries to address one of the fundamental issues in regulation of subsidies: distinguishing between the good and bad subsidies.[122]

2.4.1 Object of the SCM Agreement

Even though the SCM Agreement provides no object and purpose in its provisions, the Panels and Appellate Body in interpreting it have discerned its purpose as being the

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[116] Finger and Nogues 1987 *The World Bank Review* 60.

[117] JS Mah "Special and Differential Treatment of Developing Countries and Export Promotion Policies under the WTO" (2011) *The World Economy* 1999 at 2001.

[118] The Code was signed by 28 countries with we include 10 countries in the European Community (now European Union) and these countries were: Australia, Austria, Brazil, Canada, Chile, the European Community (EC, 10 Members), Finland, Hong Kong, India, Japan, South Korea, New Zealand, Norway, Pakistan, Sweden, Swirtzeland, United States, Uruguay and Yugoslavia.

[119] CD Ehlermann and M Goyette "The Interface Between EU State Aid Control and the WTO Disciplines on Subsidies" (2006*) EUR.ST.AID L.Q.* 695 at 696.

[120] "The Single Undertaking as constitutive metaphor has foundations in the texts. When signing the one-page *Final Act* of the Uruguay Round, the parties agreed 'that the WTO Agreement shall be open for acceptance as a whole . . .'. The WTO Agreement itself is... short treaty that constitutes the WTO as an international organization. The devil is in Article XIV (1), which stipulates that ratification applies to the 17 trade agreements in the annexes. It covers all of the Uruguay Round agreements, including all of the revised agreements from the Tokyo Round. Codification had caught up with experience: The Single Undertaking as constitutive metaphor symbolized a recognition that participation in the new WTO would be seamless."; R Wolfe "The WTO Single Undertaking as Negotiating Technique and Constitutive Metaphor" (2009) Vol.12(4) JIEL 835 at 843.

[121] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 696.

[122] S Lester "The Problem of Subsidies as a Means of Protectionism: Lessons from the WTO EC-Aircraft Case" (2011) 12 *MELB. J.INT'L L.* 345 at 347.

imposition of multilateral disciplines on subsidies which distort international trade.[123] It establishes multilateral disciplines "on the premise that some forms of government intervention distort international trade or have potential to distort international trade."[124] The Appellate Body in *United States - Softwood Lumber IV*[125] stated that the object and purpose of the SCM Agreement is to "strengthen and improve GATT disciplines relating to the use of both subsidies and countervailing measures, while, recognizing at the same time, the right of members to impose such measures under certain conditions."[126] It does this by providing a legally binding security of expectations to Members as far as subsidies rules are concerned. It brings certainty and predictability as regards subsidies regulation.[127] It does this by differentiating between good and bad subsidies and more importantly by providing ways in which members may deal with those subsidies which are bad and unfair to international trade.

The most basic way in which this is done is by providing a way through which a subsidy may be identified through the provision of the definition of a subsidy.

2.4.2 Definition of a subsidy

Article 1 of the SCM Agreement provides the definition of a subsidy. The Article provides as follows:

> "1.1 For the purpose of this 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 to 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 guarantees);

[123] Panel Report, *Brazil – Export Financing Programme for Aircraft* WT/DS46/R (14th April 1999) Para 7.26.
[124] Panel Report, *Canada – Measure Affecting the Export of Civilian Aircraft* WT/DS/70/R (14th April 1999) Para 9.119.
[125] Appellate Body Report, *United States-Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada* WT/DS257/AB/R (19th January 2004) Para 64.
[126] *Supra*.
[127] Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations"* (recourse to Article 21.5 of the DSU by European Communities) WT/DS 108/RW (20th August 2001) Para 8.39.

(ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)[128];

(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 GATT 1994; and

(b) a benefit is thereby conferred.

1.2 A subsidy as defined in paragraph 1 shall be subject to the provisions of Part II or shall be subject to the provisions of Part III or V only if such a subsidy is specific in accordance with the provisions of Article 2."

In short, the Article above defines a subsidy as a financial contribution or price/income support by a government or public body which confers a benefit to the recipient.[129] Hence, for there to be a subsidy there must be a 'financial contribution' and a 'benefit'.[130] These are two different elements.

2.4.3 Financial Contribution

The concept of financial contribution ensures that not all government measures that confer benefits can be deemed to be subsidies.[131] Article 1.1(a)(1) of the SCM Agreement defines and identifies government conduct that constitutes financial contribution. It does so by listing the relevant conduct, and by identifying certain entities and circumstances in which the conduct of those entities will be considered to be conduct of and therefore be

[128] "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

[129] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 696.

[130] Appellate Body Report, *Brazil – Export Financing Programme for Aircraft* WT/DS46/AB/R (2nd August 1999) Para 157.

[131] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 697.

attributed to, the relevant WTO Member.[132] It provides four types of measures which are financial contributions and these categories are exhaustive in nature:[133]

2.4.3.1 Direct transfer of funds or potential transfer of funds

The first measure that is identified as provision of financial contribution is the government practice that involves a direct transfer or potential transfer of funds or liabilities.[134] Direct transfer of funds indicates the act of conveyance of funds from government to a recipient.[135] The provision of funds includes other financial resources and financial claims and not only money.[136] There will also be financial contribution if there is potential transfer of funds or liabilities, an example being a loan guarantee.

The Panel in *United States - Large Civil Aircraft*[137] held that for there to be potential direct transfer of funds there must be a possibility that funds will transfer in future due to the uncertainty about whether the triggering event will occur, rather than uncertainty about whether the transfer of funds will follow once the predefined event has transpired. In this case, it is certain that once the triggering event occurs there will be a transfer of funds, hence what is discouraged is not the transferring of funds but rather the commitment to transfer the funds. The financial contribution must occur before the transfer of funds, before the occurrence of the triggering circumstance. The financial contribution must be found in this promise that government makes not the fulfilment of the promise. In this case, a guarantee is not a transfer of money, but the guarantee allows an entity to borrow money. It is an undertaking that government will take on the liability of the entity's debt obligation in the event of a default and It is this undertaking that helps the entity to access the loan(s). For instance, there will be a financial contribution if government undertakes to pay a loan on behalf of company 'y' that has obtained a loan from bank 'x', if company 'y' fails to repay the loan. In this instance, the financial contribution must be this 'undertaking'

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[132]Appellate Body Report, *United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China* WT/DS379/AB/R (11th March 2011) Para 284.
[133] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 697.
[134] Article 1.1(a)(1) (i) of theAgreement on Subsidies and countervailing Measures.
[135]Appellate Body Report, *United State – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)* WT/DS353/AB/R (12th March 2012) Para 614.
[136] *Supra*.
[137] Panel Report, *United State – Measures Affecting Trade in Large Civil Aircraft (Second Complaint)* WT/DS353/R (31st March 2011) Para 7.164.

by government and not the actual payment of the loan that may happen in the future should company 'y' fail to pay back the loan. A good example is what the South African government does by providing loan guarantees to South African Airways.[138]

Direct transfer of funds in some instances will not involve a reciprocal obligation on the part of the recipient as in the case of grants.[139] In other cases the recipient has an obligation to the government in exchange for funds provided, such as loans and equity infusions.[140] Thus the Appellate Body stated that the provision of funding may amount to a donation or may involve reciprocal rights and obligations.[141]

2.4.3.2 Government revenue that is otherwise due which is foregone or not collected

Article 1.1(a)(1)(ii) of the SCM Agreement provides that there can be a financial contribution through foregoing or non-collection of taxes. However, in theory a sovereign can decide which income to tax or what duties to levy on its own.[142] This is because tax policy reflects a relationship between the market, the citizen and the state which is normally dictated by a sovereign.[143] This concept of tax sovereignty means that taxation is an inherent or essential component of the sovereign status. Taxation is a crucial component in governance as it is typically the main means through which governments provide support and necessities to

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[138] In case of South African Airways, it can be argued that without the government guarantees the Airline could not access loans as currently it is not making profits as it last reported full – year profits in 2011 and it could be difficult for money lenders like banks to borrow it money. The financial guarantees that the airline has received from the government can amount to at least R14 billion: "South Africa must free itself from the burden of owning a national airline" *The Conversation* 17 August 2016 https://theconversation.com/south-africa-must-free-itself-from-the-burden-of-owning-a-national-airline-64004 (accessed 15th August 2017); "South African Airways seeks billions in long-term funding to help manage debt" *Mail & Guardian* 29 August 2017 https://mg.co.za/article/2016-08-29-south-african-airways-seeks-billions-in-long-term-funding-to-help-manage-debt/ (accessed 15th August 2017).

[139] Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation*) 752.

[140] *Ibid*.

[141] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint) para* 617.

[142] RE Lee "Dogfight: Criticizing the Agreement on Subsidies and Countervailing Measures Amidst the Largest Dispute in the World Trade Organisation History" (2006-2007) 32 *N.C.J. INT'L L. & COM. REG* 115 at 126.

[143] A Christians "Sovereignty, Taxation and Social Contract" (2008*) Legal Studies Research Paper Series Paper No. 1063* 2.

the citizenry.[144] It is also a known fact that the WTO Agreements do not impose any general obligation on members to levy taxes or duties, nor to levy them at a particular level.[145]

However, this does not mean that states can design their tax systems in a way that distorts international trade through measures like foregoing of tax as given in the SCM Agreement, because "[i]ndirect subsidies in the form of income tax relief measures are generally considered unfair trade practice, which cause disruption or distortion of international trade."[146]

For there to be foregoing or non-collection of revenue, for example in the form of fiscal incentives, the tax must be 'due'. There can only be foregoing of revenue otherwise due if less revenue has been raised by a government than would have been raised in a different situation.[147] The Appellate Body in *United States - FSC*[148] held that there will be foregoing of revenue only if government has given up its entitlement deliberately to tax that revenue. This however must not be in the abstract:[149] "[t]here must…be some defined, normative benchmark against which a comparison can be made between the revenue actually raised and the revenue that would have been raised otherwise."[150] The basis for comparison must be the rules of taxation in the country of the Member in question.[151]

The Panel in *United States - FSC*[152] held further that this comparison requires employing a 'but for' test, but the Appellate Body has rejected employing this test as a legal standard: firstly, because it's not found in the treaty language of the SCM Agreement. Secondly, because employing this test would result in limiting the ambit of Article 1.1(a)(1)(ii) of the SCM Agreement to a situation where there "actually existed an alternative measure, under

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[144] Christians (2008) *Legal Studies Research Paper Series* 6.
[145] Panel Report, *United States – Tax Treatment for "Foreign Sales Corporations"* WT/DS108/R (8th October 1999) Para 7.34.
[146] RL Mata "Income Taxation, International Competitiveness and the World Trade Organisations Rules on Subsidies: Lessons to the US and to the World from the FSC Dispute" (2000-2001) 54 *Tax Lawyer* 577 at 578.
[147] Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations"* WT/DS108/AB/R (24th February 2000) Para 90.
[148] *Supra*.
[149] *Supra*.
[150] *Supra*.
[151] *Supra*.
[152] Panel Report, *US-FSC Para 7.46.*

which revenues in question would be taxed, absent a contested measure."[153] This would result in a situation where it would be easy to circumvent such a test by designing a tax regime under which there would be no general rule that applied formally to revenues in question absent the contested measure.[154]

The Appellate Body in *United States - Large Civil Aircraft (2nd Complaint)*[155] came up with a three-step analysis in determining whether there is a foregoing of revenue otherwise due. The first step is to identify the tax treatment that applies to the income of the alleged recipient of the subsidy. This entails consideration of objective reasons behind that treatment and if it's a change of tax rules, the reasons behind the change.[156] The second step is to identify a benchmark for comparison; thus the tax treatment of comparable income of comparably situated taxpayers.[157] It involves an examination of the structure of the domestic tax regime and its organising principles.[158] The third step is to compare the reasons for the tax treatment in question with the benchmark tax treatment.[159] The comparison will help to assess whether "considering the treatment of the comparable income of comparably situated taxpayers, the government is foregoing revenue that is otherwise due in relation to the income of the recipient of the subsidy."[160]

2.4.3.3 Government provision of goods or services other than general infrastructure

There will also be financial contribution if government provides goods or services which can be valued, and which represent value to the beneficiary.[161] In this context the provision of goods or services is intended to ensure that the term financial contribution is not interpreted to mean only a money transferring action, but encompasses an in-kind transfer of resources as well, with the exception of general infrastructure.[162]

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[153] Appellate Body Report, *US-FSC* Para 91.
[154] *Supra*.
[155] Appellate Body report, *US-Large Civil Aircraft* (2nd Complaint) Para 812.
[156] *Supra*.
[157] Appellate Body report, *US-Large Civil Aircraft* (2nd Complaint) para 813.
[158] *Supra*.
[159] Appellate Body Report, *US-FSC* 814.
[160] *Supra*.
[161] Panel Report, *United States – Preliminary Determinations with Respect to Certain Softwood Lumber from Canada* WT/DS236/R (27th September 2002) para 7.24.
[162] *Supra*.

In the case of provision of goods or services, subparagraph (iii) does not specify whether the goods or services are provided gratuitously or in exchange for money or other goods or services. Thus, the provision of goods or services may include transactions in which the recipient is not required to make any form of payment, as well as transactions in which the recipient pays for the goods or services.[163] In sub paragraph (iii) the goods are provided to the government by the recipient, in contrast to the first sub clause of the paragraph, where the goods are provided by the government. In the second subclasses, the person or entity providing the goods will receive some consideration in return.[164]

The Panel and Appellate Body have interpreted 'goods' in Article 1.1(a)(1)(iii) broadly to such an extent that standing timber is a good.[165] However, if government provides general infrastructure, that will not be considered to be a financial contribution. The Panel in *European Communities - Large Civil Aircraft* interpreted 'general infrastructure' as "infrastructure that is not provided to or for the advantage of only a single entity or limited group of entities, but rather available to all or nearly all entities."[166]

There is however, no standard way of determining whether infrastructure is 'general infrastructure' as there is no general infrastructure which can be deemed in its own right to be inherently 'general' *per se*.[167] This must be assessed depending on the facts and circumstances of the matter. It has also been held that "as far as the existences of limitations on access to or use of infrastructure, whether *de jure* or *de facto*, are highly relevant in determining whether that infrastructure is 'general infrastructure', these factors are not the only legally relevant consideration which will always be determinative."[168] Other factors may be considered in determining whether infrastructure is 'general infrastructure'. These include factors surrounding the creation of the infrastructure, the conditions and

[163] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint*) Para 618.
[164] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint)* para 619.
[165] The Panel and Appellate Body in both *United States-Softwood Lumber III* and *United States-Softwood Lumber IV* held that 'goods' include property that can be severed from the land.
[166] Panel Report, *European Communities and Certain Member States - Measures Affecting Trade in Large Civil Aircraft* WT/DS316/R (30th June 2010) Para 7.1036.
[167] Panel Report, *EC - Large Civil Aircraft* Para 7.1039.
[168]Panel Report, *EC - Large Civil Aircraft* Para 7.1037.

circumstance of the provision of the infrastructure, the recipients or beneficiaries and the legal regime applicable to such infrastructure.[169]

Since no infrastructure is general *per se*, it follows that infrastructure may be general at some point in time, but not at another depending on the facts and circumstances.[170] Hence, in determining whether the provision of goods or services is other than general infrastructure, this may also include a time factor, as the government that provides the goods or services may change conditions attached to the provisions of the goods or services in question.[171]

2.4.3.4 Government use of private bodies

Article 1.1 (a)(1)(iv) of the SCM Agreement is there to avoid government circumspection of provision of financial contribution through using private bodies. Article 1.1 of the SCM Agreement identifies three possible types of actors that could provide financial contribution to a recipient; 'government', 'public bodies' and 'private bodies' that have been entrusted or directed by the government to make a financial contribution.[172] A public body within the meaning of Article 1.1 (a)(1) of the SCM Agreement is an entity that possesses, exercises or is vested with governmental authority.[173] However, "the mere fact that a government is the majority shareholder of an entity does not demonstrate that the government exercises meaningful control over the conduct of that entity, much less that the government has bestowed it with governmental authority."[174]

For there to be this practice of government acting through a private body to provide financial contribution it must be shown using probative and compelling evidence that there is a case of entrustment or direction.[175] The Panel in *United States - Export Restraints* held that action of government must contain a notion of delegation in the case of entrustment

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[169] Panel Report, *EC - Large Civil Aircraft* Para 7.1039.
[170] Panel Report, *EC - Large Civil Aircraft* Para 7.1044.
[171] *Supra.*
[172] Panel Report *United States – Definitive Anti-dumping and Countervailing Duties on Certain Products from China* WT/DS379/R (22nd October 2010) Para 8.54.
[173] Appellate Body Report, *US- Anti-Dumping China* Para 317.
[174] Appellate Body Report, *US- Anti-Dumping China* Para 318.
[175] Panel Report, *United States -Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors* (DRAMS) from Korea WT/DS296/R (21st February 2005) Para 7.35.

and command in the case of direction.[176] The Panel further held that these acts of entrusting and directing do contain three elements; (i) an explicit and affirmative action be it delegation or command (ii) addressed to a particular party, in this case a private body and (ii) the object of action which action is a particular task or duty.[177] Hence entrustment or direction is different from the situation in which the government intervenes in the market, which may or may not have a particular result simply based on the given factual circumstances and the exercise of free choice by the actors in that market.[178]

The Panel in *United States - DRAMS (Korea),*[179] while agreeing with the notion that entrustment or direction must take the form of an affirmative act, disagreed with the interpretation that this requires the act of delegation or command to be explicit. The Panel held that delegation or command can even be done through implicit or informal acts.[180] The only difference in the case of informal or implicit acts would be the evidence employed to show that there is delegation or command. There would be need for a greater degree of specificity in proving that an act of delegation or command is specifically addressed to a particular private body.[181]

The Appellate Body in *US - DRAMS (Korea)*[182] extended the meanings of 'entrusts' and 'directs'. It held that 'entrust' connotes the action of giving responsibility to someone for a task or an object.[183] In this case government gives responsibility to a private body to carry out one of the types of functions listed in paragraph (i) through (iii) of Article 1.1(a)(1) and delegation may be a means by which a government gives responsibility to a private body, usually achieved through a formal means, but it might also be informal.[184] Hence there may be other means, be they informal or formal that governments could employ for the same

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[176] Panel Report, *United States- Measures Treating Exports Restrains as Subsidies* WT/DS194/R (29th June 2001) Para 8.29.
[177] *Supra*.
[178] Panel Report, *US-Export Restraints* Para 8.31.
[179] Panel Report, *United States -Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors* (DRAMS) from Korea WT/DS296/R (21st February 2005) para 7.35.
[180] *Supra*.
[181] *Supra*.
[182] Appellate Body Report, *United States -Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors* (DRAMS) from Korea WT/DS296/AB/R (27th June 2005).
[183] Appellate Body Report, *US - DRAMS* Para 110.
[184] *Supra*.

purpose. Hence the Appellate Body held that limiting entrust to delegation is too narrow.[185] On direction, the Appellate Body opined that 'directs' involves the "act of giving authoritative instruction to something, order (a person) to do."[186] This implies that the person or entity that 'directs' has authority over the person or entity that is directed.[187] In the case of subsidies this authority is exercised by government over a private body. Therefore, a 'command' is one way in which a government can exercise authority, but governments are likely to have the other means at their disposal to exercise authority over private bodies. Some of the means may be subtler than a 'command' or may not involve the same degree of compulsion. Hence interpreting 'directs' as being limited to command (as done by the Panels) the Appellate Body held that this was too narrow.[188]

All in all, what is at the core of para (iv) are government acts done through a private body to carry out one of the types of functions in paragraph (i) through (iii), the only difference being the identity of the actor, and not the nature of the action.[189]

2.4.4 Benefit

A financial contribution granted by a government can only be a subsidy if it confers a benefit. A benefit means some form of advantage to the recipient of the financial contribution.[190] The point of focus is the recipient and not the government hence it has been ruled out to consider benefit as being cost to the government.[191] The benefit must be received and enjoyed by the beneficiary or recipient.[192] In explaining this concept of benefit, the Appellate Body stated the following:

> "we also believe that the word benefit, as used in Article 1.1 (b) implies some kind of comparison. This must be so, for there can be no 'benefit' to the recipient unless the 'financial contribution' makes the recipient 'better off' than it would otherwise have been, absent that contribution. In our view, the

[185] *Supra*.
[186] Appellate Body Report, *US-DRAMS (KOREA)* Para 111.
[187] *Supra*.
[188] *Supra*.
[189] Appellate Body Report, *US-DRAMS (KOREA)* Para 112.
[190] Panel Report, *Canada-aircraft* para 9.112.
[191] *Supra*.
[192] Appellate Body Report, *Canada-Measures Affecting the Export of Civilian Aircraft* WT/DS70/AB/R (2nd August 1999) Para 154.

> market place provides an appropriate basis for comparison in determining whether a 'benefit' has been 'conferred' because trade distorting potential of 'financial contribution' can be identified by determining whether the recipient has received a financial contribution on terms more favourable than those available to recipient in the market place."[193]

In *European Communities - Large Civil Aircraft*,[194] the Appellate Body defined a market as "an area of economic activity in which buyers and sellers come together and the forces of supply and demand affect prices."[195] This is a market in which goods and services are exchanged between willing buyers and sellers.[196]

This means that to determine benefit, the financial contribution that a recipient receives from government must be compared to what the recipient could have obtained from the market. This interpretation of benefit is in tandem with how benefit is calculated in Article 14 of the SCM Agreement where comparison is made in reference to a market. For example, a loan by a government is not considered to confer a benefit, unless there is a difference between the amount the firm receiving the loan pays on the government loan and the amount the firm would pay on a comparable commercial loan which the firm could actually obtain on the market - in which case the benefit is the difference between these two amounts.[197] This is also the reason that in finding an objective market benchmark the Appellate Body has allowed investigation authorities to use a proxy market in order to come up with a market fairly representing prevailing market conditions, not the one adulterated by trade distorting effects of a government.[198]

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[193] Appellate Body Report, *Canada-Aircraft* Para 157.
[194] Appellate Body Report, *European Communities and Certain Member States-Measures Affecting Trade in Large Civil Aircraft* WT/DS316/AB/R (18th May 2011).
[195] Appellate Body Report, *EC – Large Civil Aircraft* Para 981.
[196] *Supra*.
[197] Article 14(b) of the SCM Agreement. Accordingly, all the financial contributions illustrated in Article 1.1 (a) of the SCM Agreement will only result in a subsidy if they are granted on favourable conditions as compared to a market not distorted by government interference. In this case there is benefit through government provision of equity capital if the investment decision can be regarded as inconsistent with the usual investment practice of private investors in the territory. There will be a benefit in loan guarantee if there is a difference between the amount that the firm receiving the guarantee pays on a loan guaranteed by the government and the amount that the firm would pay on a comparable commercial loan absent the government. There will be benefit through government provision of goods or services or purchase of goods by a government if the provision is made for less than adequate remuneration, or the purchase is made for more than adequate remuneration.
[198] Appellate Body Report *US- Softwood Lumber IV* Para 99-103.

In the determination of benefit, not only is the behaviour of the grantor (government) and recipient of the alleged subsidy against the behaviour of commercial actors in the market considered, but this assessment of benefit must examine the terms and conditions of the challenged transaction at the time it is made and compare them to the terms and conditions that would have been offered in the market at that time.[199]

2.4.5 Specificity

Specificity is not *per se* a requirement for a subsidy to exist under WTO law. However, a subsidy is only subject to the provisions of parts II (prohibited subsidies), III (actionable subsidies) and V (countervailing duties) of the SCM agreement if it is specific within the jurisdiction of the granting authority.[200] A subsidy that is widely available within an economy is presumed not to distort the allocation of resources within the economy and therefore, does not fall within the scope of the SCM Agreement.[201] A subsidy can be specific to an enterprise or industry or group of enterprises or industries.[202] There will be enterprise specificity when a government targets a particular company or companies for subsidization while there will be industry specificity if a government targets a particular sector or sectors for subsidization.[203] In the specificity determination, the focus of inquiry is on the class of subsidy recipients and the manner in which eligibility to that subsidy is limited to that class.[204] The focus is not on whether a subsidy has been granted to certain enterprises, but on whether access to that subsidy has been explicitly limited.

Article 2.1 of the SCM Agreement provides principles that must be applied to determine whether a subsidy is specific or not. The principles as set out in paragraphs (a) through (c) of Article 2.1 of the SCM Agreement are to be considered "within an analytical framework that recognizes and accords appropriate weight to each principle and the application of one of the subparagraphs may not by itself be determinative in arriving at a conclusion that a

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[199] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint)* Para 636.
[200] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.*701; Article 1.2 of the Agreement on Subsidies and Countervailing Measures.
[201] Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation* 764.
[202] Article 2.1 of the Agreement on Subsidies and Countervailing Measures.
[203] Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation* 764.
[204] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint)* Para 748.

particular subsidy is or is not specific"[205]. A subsidy will be specific according to Article 2.1(a) where the granting authority or legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprise(s) or industry or industries. This means the source of any limitation is the legislation pursuant to which the granting authority operates, or the granting authority itself.[206] However, not just any limit on access to a subsidy will render it specific, but the limitation must "distinctly express all that is meant; leaving nothing merely implied or suggested."[207] The limitation must be "unambiguous and clear."[208] The unambiguousness of specificity may be expressed in legislation by which the granting authority operates or in other statements or means by which the granting authority expresses its will.[209]

However, Article 2.1 of the SCM Agreement provides that where a granting authority or legislation pursuant to which the granting authority operates establishes objective criteria or conditions governing the eligibility for and the amount of a subsidy, specificity shall not exist provided that eligibility is automatic and that such criteria and condition are strictly adhered to. These criteria and conditions must also be clearly spelled out in law, regulation or other official document so as to be capable of verification.[210] The objective criteria and conditions referred to in Article 2.1(b) of the SCM Agreement are those which are "neutral, which do not favour certain enterprises over others and which are economic in nature and horizontal in application, such as number of employees or size of enterprise."[211] This means the conditions and criteria must not be attached to the subsidy programme itself.

However, even though a subsidy may appear to be non-specific after applying the principles laid down in subparagraphs (a) and (b) of Article 2.1 of the SCM Agreement and after the granting authority or legislation deems it non-specific, a subsidy may still be specific if other factors are considered. Article 2.1 (c) of the SCM Agreement provides other factors that may be considered viz; use of subsidy programme by a limited number of certain enterprises,

[205] Appellate Body Report, *US- Anti-Dumping China Para* 366.
[206] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint)* Para 748.
[207] Panel Report, *US-Large Civil Aircraft (2nd Complaint)* Para 7.190.
[208] *Supra*.
[209] *Supra*.
[210] Article 2.1(b) of the Agreement on Subsidies and Countervailing Measures.
[211] Footnote 2 of the Agreement on Subsidies and Countervailing Measures.

predominant use by certain enterprises, the granting of disproportionately large amounts of subsidy to certain enterprises, and the manner in which discretion has been exercised by the granting authority in the decision to grant a subsidy. In terms of the manner in which discretion has been exercised, the frequency with which applications for a subsidy are refused or approved and the reasons for such decision must be considered.[212] The language of Article 2.1(c) of the SCM Agreement indicates that the application of this provision will normally follow the application of subparagraph (a) and (b) of Article 2.1.[213]

In examining *de facto* specificity, any of the four factors or indicators of specificity as provided in Article 2.1 (c) of the SCM Agreement may be considered. It is not mandatory to consider all four factors.[214] However, economic diversity of a subsidy recipient, by itself, is not sufficient to prevent a subsidy from being found *de facto* specific.[215] This is because specificity has to do with subsidies that either in law or in fact are not broadly available to different recipients in an economy.[216]

Article 2.2 of the SCM Agreement states that a subsidy which is limited to certain enterprises within a designated jurisdiction of the granting authority shall be specific. This is where government targets producers in specified parts of its territory for subsidization.[217]

2.4.6 Prohibited subsidies

Article 2.3 of the SCM Agreement states that any subsidy falling within the provisions of Article 3 shall be deemed to be specific. Article 3 deals with prohibited subsidies, and they are deemed to be specific subsidies, therefore, they are not subject to evidentiary proof of specificity.[218] Even if the prohibited subsidies are available to all enterprises, the disciplines of parts II and V will apply as they are deemed to be specific *per se*.[219]

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[212] Footnote number 3 of the Agreement on Subsidies and Countervailing Measures.
[213] Appellate Body report, *US-Large Civil Aircraft (2nd Complaint)* Para 796.
[214]Panel Report, *United States-Final Countervailing Duty Determination with Respect to Certain Softwood Lumber from Canada* WT/DS257/R (26th August 2003) Para 7.123.
[215] Panel Report, *US-Anti-Dumping (china)* Para 9.40.
[216] Panel Report, *US-Anti-Dumping (china)* Para 9.37.
[217] Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation* P 767.
[218] Kuruk 2012-2013 *N.C.J. INT'L & COM. REG.* 340.
[219] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 701.

Article 3 of the SCM Agreement provides as follows:

"3.1 Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:

(a) subsidies contingent, in law or in fact,[220] whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I;[221]

(b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods.

3.2 A Member shall neither grant nor maintain subsidies referred to in paragraph 1."

From the reading of the provision above it is clear that the Agreement prohibits subsidies that government grants with the purpose of boosting their export performance and/or shielding their domestic industries from imports. This is perhaps the reason why prohibited subsidies are deemed specific: as the design, structure and architecture of the measures show the existence of intent to have this effect on trade.[222] This differs from actionable subsidies which must be found to be specific for part II and V to apply. These types of subsidies are prohibited because they are specifically designed to affect trade.[223]

Article 3.1(a) of the SCM Agreement prohibits subsidies that are contingent in law or in fact, whether solely or as one of several conditions upon export performance. The subsidies being prohibited must be provided on condition that there will be exportation. This export contingency may be the sole condition or one of the several conditions for the granting of the subsidy.[224] The legal standard required for a subsidy to be found contingent on export performance is the same for both *de jure* and *de facto* contingency, the only difference being evidence that may be used to prove this export contingency.[225]

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[220]Footnote 4: "This standard is met when the facts demonstrate that the granting of a subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision."

[221]Footnote 5: "Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement."

[222] Lester 2011 *MELB. J.INT'L L.* 353.

[223] Panel Report, *Brazil-Aircraft* Para 7.26.

[224] Appellate Body Report, *Canada-Aircraft* Para 166.

[225] Appellate Body Report, *Canada-Aircraft* Para 167.

De jure export contingency is demonstrated on the basis of the words of the relevant legislation, regulation or other legal instrument.[226] However, the underlying law, regulation or other legal instrument does not have to provide *exprissi verbis* that the subsidy is available only upon the fulfilment of the conditions of export performance.[227] The *de jure* export contingency can also be derived by necessary implication from the words actually used in the measure.[228]

Footnote 4 to the SCM Agreement has provided for how this export contingency standard can be met by *de facto* export contingency. This is met when the facts demonstrate that the granting of the subsidy, without having been made legally contingent upon export performance, is in fact tied to actual or anticipated exportation or export earnings.[229] In *Canada - Aircraft*[230] it was held that the statement 'tied to…anticipated exportation' means that one of the conditions for the granting of the subsidy is the expectation that export will flow thereby. This involves a 'but for' test as it must be shown that the subsidy "would not have been granted but for the expectation that exports would ensue."[231] It must be shown that there is a nexus between the granting of the subsidy and the creation or generation of export sales.[232]

The export contingency as set out in footnote 4 requires proof of three different substantive elements. The first is the 'granting of a subsidy', second 'is…tied…to' and third, 'actual or anticipated exportations or export earnings'.[233] This involves showing whether the granting authority imposed a condition based on export performance in providing the subsidy.[234] It does not suffice to demonstrate solely that a government granting a subsidy anticipated that exports would result, as the prohibition in Article 3.1(a) applies to subsidies that are contingent upon export performance.[235] This test of contingency is an objective test, hence

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[226] *Supra*.
[227] Bossche and Zdouc *The Law and Policy of the World Trade Organisation* 772.
[228] *Ibid*.
[229] Footnote 4 of the Agreement on Subsidies and Countervailing Measures.
[230] Panel Report para 9.331.
[231] Panel Report, *Canada-aircraft* Para 9.331.
[232]Panel Report, *Canada-aircraft* Para 9.339.
[233] Appellate Body Report, *Canada-Aircraft* Para 169.
[234] Appellate Body Report, *Canada-Aircraft* Para 170.
[235]Appellate Body Report, *Canada-Aircraft* Para 171.

it cannot be satisfied by relying on the subjective motivation of the granting government to promote future export performance of the recipient.[236]

In *European Communities - Large Civil Aircraft*, the Appellate Body suggested a further test that can be employed, which is to ask the question; "is the granting of the subsidy geared to induce the promotion of future export performance by the recipient?"[237] The answer to this question must be inferred from the total configuration of facts constituting and surrounding the granting of the subsidy.[238] Some of the factors that may be considered include the design and structure of the measure granting the subsidy, the modalities of operation set out in such a measure and the relevant factual circumstances surrounding the granting of the subsidy that provide the context for understanding the measure's design, structure and modalities of operation.[239] However, the mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of Article 3.1(a) of the SCM Agreement.

Article 3.1(a) of the SCM Agreement provides that all the measures listed in an illustrative list in Annex I of the Agreement are prohibited subsidies. Measures meeting the criteria of an item provided on the illustrative list are deemed to be constitute prohibited subsidies.[240] It is not necessary to establish the element of benefit separately on such measures.[241] This list allows a member to directly go to the list and show that a measure is a prohibited subsidy without having first to demonstrate that the measure falls within the ambit of Article 3.1 (a) of the SCM Agreement.[242] However, the list is not exhaustive: it just contains examples of prohibited subsidies. As such, it does not preclude the existence of other such subsidies under Article 3.1(a) of the SCM Agreement.[243] Under the terms of footnote 5, measures referred to in Annex I as not constituting export subsidies shall not be prohibited

[236] Van den Bossche and Zdouc *The Law and Policy of the World Trade Organisation* 774.
[237] Appellate Body *EC-Large Civil Aircraft* Para 1044.
[238] Appellate Body Report, *Canada-Aircraft* Para 167.
[239] Appellate Body *EC-Large Civil Aircraft* Para 1046.
[240] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 700.
[241] *Ibid.*
[242] Ehlermann and Goyette 2006 *EUR.ST.AID L.Q.* 707.
[243] *Ibid.*

under the provisions of the SCM Agreement. However, this only applies where the list contains a clear indication that the measure in question is not a prohibited subsidy.[244]

Article 3.1(b) of the SCM Agreement prohibits import substitution subsidies. These are subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods. Just as with export subsidies, by their nature import substitution subsidies give an advantage to the domestic goods compared to foreign competitors.[245] Import substitution subsidies somehow overlap with the general national treatment requirements of the GATT Article III:4 as certain kinds of local content requirement violate both provisions – in other words, it could be seen to be a violation of national treatment. [246]

Article 3.2 of the SCM Agreement prohibits members of the WTO from granting or maintaining prohibited subsidies. It requires a member to withdraw the subsidies provided where they are of the kind which is prohibited. If the prohibited subsidies are being provided through legislation, this might require amending or repealing the legislation. When it comes to legislation, legislation granting a subsidy can be categorized in two ways: whether it is a mandatory or discretionary piece of legislation. It is mandatory if the legislation mandates action inconsistent with the WTO Agreement while it is discretionary legislation if it merely gives discretionary authority to the executive authority of a Member to act inconsistently with the WTO Agreement. Discretionary legislation could not be challenged as such, but only the application of such legislation contrary to WTO law could be challenged.[247]

2.5 Conclusion

This chapter has described how subsidies are regulated under the multilateral trading system. It has done this by tracing how the landscape in terms of subsidies regulation has changed. The discussion in the chapter has shown that during the formative years of the

[244] *Ibid.*
[245] Lester 2011 *MELB. J.INT'L L.* 353.
[246] *Ibid.*
[247] Panel Report, *United States-Softwood Lumber III* para 7.128 quoting Appellate Body *in United States - 1916 Act*.

GATT, contracting parties had competing interests as far as subsidies regulations were concerned. Some of the contracting parties wanted to have a robust system that would keep the use of subsidies in check while the other group of contracting parties regarded the regulation of subsidies as an internal matter for each individual country and as such not a concern of the GATT. As a compromise, the rules regulating subsidies that were included in the GATT were full of ambiguities and did not create binding obligations on the contracting parties. However, things changed after the Uruguay Round and currently we have rules that are not only clear but impose binding obligations on all Members of the WTO. Thus, certain types of subsidies that may have been acceptable under the GATT are now prohibited under the SCM Agreement. As such, WTO Members are required to bring their subsidies in line with the SCM Agreement and this would affect policies adopted or to be adopted by governments, for example Malawi.

CHAPTER 3: TRADE AND INDUSTRIALISATION POLICIES IN MALAWI

3.1 Introduction

In the introductory chapter of this thesis, the concept of EPZs was introduced and that chapter briefly started explaining the way in which they operate. This chapter will expand on that and explain in detail their operation. However, before the discussion on the operation of the EPZ schemes is commenced, this chapter will discuss major phases that Malawi trade policy has passed through since independence. These policy shifts have shaped the path of industrialisation that the country has taken and have had a major influence on trade measures that have so far been adopted. One of such measures is what is at the centre of this study: the EPZs scheme. This, chapter will also consider why EPZ schemes are now popular in developing countries. The discussion in this chapter will lay a foundation for chapter four of this study which will analyse how the operations of EPZ schemes may be contrary to the dictates of the multilateral trading system as found under the SCM Agreement.

3.2 Trade and industrialisation policy in Malawi

To fully understand why Malawi has legislation that encourages export through the EPZ scheme it will be proper to give a background to different trade and industrial policies that have been pursued by the government since independence in pursuance of economic development. However, it must be stated at the outset that the overarching goal of Malawi's trade policy is "to create a globally competitive export oriented economy that will generate higher and sustainable livelihoods through trade"[248].

Since independence in 1964, Malawi's trade and industry policy has gone through three major phases. In this chapter, when dealing with industrial policy, it means government's deliberate effort aimed at altering industrial structure to promote productivity-based growth.[249] In this case, the use of industrial policy is aimed at diversifying the nation's economy by generating new areas of comparative advantage to enhance the nation's

[248] Trade Policy Review: Report by Malawi (2016) (WT/TPR/G/335) 11.

[249] B Bora, PJ Lloyd and M Pangestu "Industrial Policy and the WTO" P*olicy Issues in International Trade and Commodities Study Series No. 6* 1.

welfare.[250] In all the three major phases of Malawi's trade and industrial policy, the government was involved in trade reform to ultimately try to find the right balance that could help the country take off on its path of economic transformation. In this case, trade reform mostly involved "dismantling of controls and rationalisation and general lowering of import tariffs."[251]

3.2.1 First Phase

The first phase is the first fifteen years after independence - that is from 1964 to 1979.[252] In this first phase the government was promoting import substitution policies and trade was more restrictive as there was little emphasis on exports.[253] The focus was on developing the manufacturing sector focused on import substitution industrialisation based on domestic demand and agricultural resources.[254] Therefore, the core of Malawi's trade were state owned agricultural companies and large public and private conglomerates which were protected by pervasive barriers to entry.[255] The strategy in this period was based on increased government involvement in the production process through acquisition of agricultural land and the establishment of state holding corporations to lead the industrialisation process.[256] The government was in the driving seat as it was controlling all the facets of the economy and almost everything that was present on the market could have its origins somehow traced to government. The result of this policy was the divorcing of domestic prices for traded goods from world levels. This led to increased trade protection in favour of the domestic manufacturers.[257]

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[250] D Rodrik "Industrial Policy for Twenty-First Century" https://myweb.rollins.edu/tlairson/pek/rodrikindpolicy.pdf (accessed 3rd May 2017).
[251] G Mulaga and J Weiss "Trade Reform and Manufacturing Performance in Malawi 1970-91" (1996) Vo24(7) *World Development* 1267 at 1267.
[252] W Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach" http://www.wadonda.com/tradepo0202.pdf (accessed 3rd May 2017).
[253] W Chirwa "Trade Policy and Poverty Reduction: The case of Malawi" in DM Melis (ed) *From Cancun to Sao Paulo: The Role of Civil Society in the International Trading System* (2004) 187.
[254] Chirwa "Trade policy and Industrialisation in Malawi: The need for a Strategic Approach".
[255] Trade Policy Review Malawi: Report by the Government (2002) (WT/TPR/G/96) 5.
[256] Chirwa "Trade policy and Industrialisation in Malawi: The need for a Strategic Approach".
[257] Mulaga and Weiss 1996 *World Development* 1268.

The basis for this import substitution policy was to substitute imports of manufactured goods by making sure that the country gets its supplies from domestic sources.[258] The proponents of import substitution believe that the size and structure of a country's industrial sector is a key determining factor of growth, hence there is need to protect domestic manufacturing industrial structure as it is this that spurs development.[259] They believe that industrial development would not occur purely through market mechanisms, like having liberalised trade which could open competition from foreign sourced goods. On the contrary, they believe that protective measures such as import substitution would ensure that growth is attained.

In this case, domestic industries were flourishing on governmental programmes of incentives while simultaneously restricting entrance of foreign products - except for imports designated as essential capital goods.[260]

The justification for government involvement in companies was that there was a lack of an indigenous entrepreneurial class.[261] This was achieved through the use of the Control of Goods Act,[262] which is the main law that regulates import and export trade in Malawi.[263] The government corporations and firms that operated at that time also enjoyed protection from foreign competition through industrial regulations under the Industrial Development Act of 1966.[264] It was during this time that 51 out of 54 large-scale manufacturing enterprises in which the government had full or partial ownership were established.[265] For instance, there was use of non-tariff barriers to trade such as import licensing as a means of protecting the domestic industry which was to lead industrialisation. There were many regulations promulgated under the Control of Goods Act: The Minister of Trade and Industry utilised section 3 of the Control of Goods Act which provides as follows:

> "(1) Whenever it appears to the Minister necessary or expedient to control—

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[258] MLK Jobim "Drawing on the Legal and Economic Arguments in Favour and Against 'Reciprocity' and 'Special and Differential Treatment' for Developing Countries within the WTO System" (2013) 6(3) *Journal of Politics and Law* 55 at 57.
[259] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach".
[260] Jobim 2013 *Journal of Politics and Law* 57.
[261] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach".
[262] Act 28 of 1968.
[263] Trade Policy Review: Report by Malawi (2016) (WT/TPR/G/335) 12.
[264] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach".
[265] *Ibid*.

(a) the import into or export from Malawi of any goods;

(b) the distribution, disposal, purchase and sale, or the wholesale or retail prices of any commodity or animal and the charges which may be made—

(i) for services relating to the distribution, disposal, purchase, and sale of the commodity or animal, as the case may be; and

(ii) for delivery of any commodity or animal, the wholesale or retail prices of which are controlled under this section, he may make such regulations as appear to him to be necessary or expedient for such purposes.

[...]

(3) Regulations made under this section may provide for empowering the Minister or such other Minister as may be specified in such regulations to make orders—

(a) for the control to such extent as may be specified in such regulations of the import into or export from Malawi of such goods or classes of goods as may be specified in such regulations;

(b) in respect of such commodities and animals as may be specified in such regulations for any of the purposes specified in subsection (1) (b).

Any orders made in terms of this subsection may contain such incidental or supplementary provisions as appear to the specified Minister to be necessary or expedient for the purpose of such orders.

(4) Regulations and orders under this section may be made so as to apply generally or to any particular trade, business, undertaking, or enterprise, or class thereof, and either to the whole or to any part of any trade, business, undertaking, or enterprise, and so as to have effect either throughout Malawi or in any particular area therein."

Therefore, using the powers under this section, regulations were made which totally banned some goods from being imported into Malawi and some which required a licence before one could import them. These regulations ensured that there was little supply of imported goods on the domestic market, and this enhanced the profitability of domestic companies plying their trade in Malawi at that time.

3.2.2 Second Phase

However, the inward-looking import substitution trade policy ended in 1980. The second phase started in 1980 and ended in 1993. The policy shift in this phase was influenced by two factors: that is, the external shocks and internal shocks which crushed the fragile economy. The first was the financial crisis of 1979 that came about because of the oil crisis in the Middle East.[266] This resulted in the rising of import prices for oil. At the time when there was this oil crisis, the country was also experiencing negative trade balance influenced by a fall in prices of traditional exports of tea and tobacco - hence the combined effect of these two produced external shocks for the economy.[267] Secondly, there were internal shocks that the economy was going through because of droughts in 1980 and 1981 which resulted in a significant drop in agricultural output and volumes, therefore crippling the economy as it relied on primary commodity products.[268]

These shocks resulted in a shortage of foreign exchange.[269] Therefore, as a solution, the government decided to abandon reliance on import substitution policies and shifted to an export-led growth and development strategy. This strategy is aimed at growing productive capacity by focusing on foreign markets.[270] It should also be noted that during the same period, the IMF and World Bank were playing a special role in spreading the agenda of export-led growth strategy. Since most developing countries such as Malawi were in dire need of financial assistance after the 1970s oil shocks, these two Bretton Woods institutions made access to this financial assistance conditional on countries embracing this paradigm shift.[271] Hence Malawi, with support of the World Bank and IMF, was one of the first countries in sub-Saharan Africa to pursue the path of structural adjustment, introducing the programme in 1981.[272]

The gist of the programme was liberalisation of the economy by creating an enabling environment to foster both domestic and foreign investment.[273] Hence, government started

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[266] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach ".
[267] Mulaga and Weiss 1996 *World Development* 1267
[268] Mulaga and Weiss 1996 *World Development* 1268.
[269] *Ibid*.
[270] TI Palley "The Rise and Fall of Export-led Growth" (2011) *Levy Economics Institute Working Paper No. 675* 3.
[271] Palley 2011 *Levy Economics Institute Working Paper No. 675* 5.
[272] Mulaga and Weiss 1996 *World Development* 1267.
[273] Trade Policy Review Malawi: Report by the Government of Malawi (2002) (WT/TPR/G/96) 6.

relaxing its control over the economy during this period. In this phase government engaged in:

> "periodic devaluations of the Malawi Kwacha, periodic adjustments in interest rates, liberalisation of industrial and input prices, abolition of exclusive monopoly rights and privatisation of state-owned enterprises, and a freeze on new industrial investments by state holding corporations."[274]

It was at this period that the Industrial Development Act was repealed and was replaced by a more progressive Investment Promotion Act[275] which promoted investment. The Act established the Malawi Investment Promotion Agency[276] which had a general objective of promoting, attracting, encouraging and facilitating local and foreign investment in Malawi.[277] The government also adopted a statement of investment policy which was scheduled to the Act. The Statement of Investment Policies is still in operation and it states in part that government encourages the private sector to assume a leading role in developing the economy.[278] The country started opening its borders and one indication of this was the signing of a trade agreement with the Republic of South Africa on the 19th day of June 1990. In this agreement, the two governments agreed, subject to meeting certain conditions, to engage in duty free trade between themselves.[279]

3.2.3 Third Phase

However, this policy reform did not perform as expected, and as compared with the first phase. The first phase was a success if we go by the GDP growth rates observed in the two phases.[280] From 1994, the government started refining the export promotion

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[274] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach "4.

[275] Act 28 of 1991, this Act was repealed in 2012 replaced with Investment and Export Promotion Act 2012, Act No. 11 of 2012.

[276] The agency now has been replaced by Malawi Trade and Investment Centre which was established under the Investment and Export Promotion Act, 2012.

[277] Section 8 of Investment Promotion Act.

[278] Statement of Investment Policies para 4.

[279] This is as stated in Articles 2 and 4 of the Agreement.

[280] In the first fifteen years after independence, which has been describe as the first phase in this study, the growth in domestic product averaged 5.3 percent per annum. When the first phase was coming to an end the economy experienced sharp reduction in economic growth, for instance in 1978 the economy grew at 8.3 percent, but this was reduced to 3.3 percent in 1979 (this might be attributed to the economic crisis in 1979) followed by negative growth rate of -4.4 percent in 1980 and -5.2 percent in 1981. The structure adjustment programs in the second phase did very little to restore growth. If we compare the contribution of

industrialisation policy that was adopted in the second phase.[281] Efforts were made to liberalise trade environment in the country and several measures were implemented geared towards opening the economy. These efforts have culminated into a state where the economy has now become more open as foreign exchange controls have been relaxed, import and export licensing have been removed, and price controls have been abolished among other measures.[282]

However, considering that the second phase was a failure, some deliberate measures were adopted to act as a catalyst to spur export growth and make the private sector the core when it came to trade. This was done through policies such as privatisation. To promote export of non-traditional export products, the Export Processing Zones Act was passed in 1995. The adoption of EPZs in Malawi came at the time when several developing countries were adopting this measure. The following paragraphs will concentrate on why the EPZ gained popularity in developing countries.

3.3 EPZ Schemes

Many scholars trace the use of the modern EPZ scheme, which is expressly created for customs-free export-oriented manufacturing, to Ireland, with the Shannon Free Trade Zone which was established in 1959 being the first of this kind.[283] However, it is believed that the use of EPZs pre-dates the First World War.[284] The popularity of the scheme is as a result of

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manufacturing sector to the gross domestic product, the rate was good in the first phase than in the second; at independence manufacturing sector accounted for only 8 percent of growth domestic product but increased to 12 percent in 1970s but there was no growth in terms of percentages during the second phase as the percentage remained stable at 12 percent even though the expectation would have been that there should have been an increase as at this time the economy adopted export led growth strategy. In the second phase, manufacturing production increased on average by 1.3 percent per annum between 1980 to 1989 and by 2.2 percent between 1990 to 1993 compared to the rate of 8.2 percent in the 1970s. Finally, manufacturing value added grew at 10.1 percent per annum in the 1970s (first phase) but only grew at 2.1 percent in the 1980-86 period and 4.8 percent in the 1987-91 Period (second phase). See Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach "

[281] Chirwa "Trade Policy and Industrialisation in Malawi: The need for a Strategic Approach ".

[282] Trade Policy Review Malawi: Report by the Government of Malawi (2002) (WT/TPR/G/96) 13.

[283] Amado 1989-1990 *U.PA.S.INT'L BUS.L.85.*

[284] Jose Daniel Amado states that the modern EPZs can be traced to a period before the 1st world war and that they are an adaptation of what were known as free ports which were areas generally encompassing an entire port and its surrounding locality where goods of foreign origin would be brought without imposition of duties or subject to a minimum tariff. He states that the oldest known free port was on the Aegean Island of Delos, and that in 1189 one of the earliest significant free port was established in the city of Hamburg where the city was exempted from paying customs duties, others were also established in harbours allocated along international trade routes such as Gibraltar (1704), Singapore (1819) and Hong Kong (1848): Amado 1989-1990 *U.PA.S.INT'L BUS.L.* 81.

seeming success in generating a significant amount of foreign investment and manufactured exports in countries like Mexico, China, Mauritius and Malaysia.[285] Since then, the use of EPZs has grown significantly, especially in developing countries.[286] The rate at which developing countries have been adopting EPZ schemes has been growing in line with the adoption of export-led growth policies, which are considered to be optimal strategies to stimulate economic growth..[287] However, even though developing countries adopted these export led growth strategies, most of them are characterised by the heavy reliance on large labour intensive industries, mainly agriculture.[288] This, compounded with a lack of capital by the entrepreneurs who were operating in these industries, made chances of developing countries undertaking industrial expansions limited.[289]

This was experienced in the second phase of trade policy reform in Malawi, in that even though many trade-related constraints were removed, local firms did not fill the gap of export supply created by the opening of the economy so that they produced goods for export. This is because indigenous firms, apart from lacking capital, had little or no export experience and hence had problems in entering the world market.[290] Thus it was believed that the coming in of foreign capital may provide a demonstration to the potential indigenous exporters of how to combine managerial, technical and marketing know-how to break into the world market.[291]

Hence even though the adoption of export-led growth is deemed to be good, it needs a country-wide structural development in terms of infrastructure to support it so that it can promote the growth of export trade.[292] This however, is expensive, and would also require

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[285] L Kinunda-Rutashobya "Exploring the Potentialities of Export Processing Free Zones (EPZs) for Economic Development in Africa: Lessons from Mauritius" (2003) 41(3) *Management Decision* 226 at 228.
[286] S Woolfrey "Industrial Development Zones in South Africa" https://www.tralac.org/discussions/article/5126-industrial-development-zones-in-south-africa.html (accessed 3rd May 2017).
[287] Cling and Letilly 2001 *DIAL Working Paper DT/2001/17* 6.
[288] M Din "Export Processing Zones and Backward Linkages" (1994) 43 *Journal of Development Economics* 368 at 369.
[289] *Ibid*.
[290] H Johansson and L Nilsson "Export Processing Zones as Catalysts" (1997) 25(12) *World Development* 2112 at 2116.
[291] *Ibid*.
[292] A Aggarwal "Special Economic Zones: Revisiting the Policy Debate" (2006) Vol. 41 No. 43/44 *Economic and Political Weekly* 4533 at 4533.

time.[293] EPZ schemes are therefore considered by developing countries as a good starting block to orient their policies towards export-looking strategies after the failure of import substitution experiments that had been carried out in the 1960s and 1970s.[294] EPZ schemes are established to act as catalysts for trade, investment and economic growth as they aim to improve competitiveness and to facilitate economic transformation of their host countries faster or more effectively.[295] In other words, they act as a bridge from import-substitution to outward looking export orientated policies. They are designed to cushion the shocks that may come with exposing infant economies to new export-led trade policies adopted in the policies. Hence "EPZs are designed not to expose local manufacturers to the vagaries of the world market, but to 'attract export oriented light manufacturing firms and to shield domestic firms from competition'."[296] By not allowing companies in the EPZs to sell into the domestic market which is mostly dominated by local producers (most of whom lack capacity), the EPZ regime shields these local producers from the stiff competition which arises if the multinational companies operating in the EPZs are allowed to sell their goods in the local customs area.

From a host developing country perspective, EPZ schemes help to persuade multinational enterprises to set up their operations in your country. The expectation is that the offering of facilities to the multinational enterprises will increase their profits, after they incorporate the costs of shifting their operations to the developing country.[297] The facilities that are offered in the EPZs are aimed at making up for the host economy's integral inefficiencies like a protected domestic market, regulatory barriers or poor infrastructure.[298]

It is expected that EPZ schemes will promote linkages with domestic economies, encourage technological transfer and promote new industrialisation strategies.[299] Therefore, from an

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[293] *Ibid*.
[294] JR McIntyre, R Narula and LJ Trevino "The Role of Export Processing Zones for Host Countries and Multinationals: A Mutually Beneficial Relationship?" (1996) Vol. X(4) *The International Trade Journal* 435 at 437.
[295] T Farole *Special Economic Zones in Africa; Comparing Performance and Learning from Global Experiences* (2011) 62.
[296] A Schrank "Export Processing Zones: Free Market Islands or Bridges to Structural Transformation?" (2001) Vol. 19(2) *Development Policy Review* 223 at 223.
[297] McIntyre, Narula and Trevino 1996 *The International Trade Journal* 438.
[298] M Engman, O Onoderaand E Pinali "Export Processing Zones: Past and Future Role in Trade Development" 2007 *OECD Trade Policy Papers, No.53* 9.
[299] K Jayanthakumaran "An Overview of Export Processing Zones: Selected Asian Countries" in N Nitungkon (ed) *An Overview of Export Processing Zones: Selected Asian Countries* (2002) 2.

economic perspective, some benefits of EPZs include foreign exchange earnings, employment generation, technological transfer and knowledge sharing. It is hoped that the strategic decisions of the foreign investors will contribute towards a fundamental change in the economic environment of the host country.[300] The expectation is that there will be an increase in foreign exchange earnings through foreign direct investment and export diversification.[301] They are also used to generate employment which in turn can help in eradicating poverty.[302] EPZs have also played a significant role in some developing countries where they have been used successfully as pressure valves from the ever growing problem of unemployment as they have been significant job creators in these countries.[303] For instance, in Hong Kong, Singapore, South Korea, Mexico and Brazil, EPZs have been deemed to have been successful in job creation.[304] Of course, EPZs have been criticised that they mostly employ unskilled labourers, but more importantly, EPZs can lead to transfer of technology from foreign companies in the zones to domestic companies.[305] This transfer of know-how has a positive effect on local suppliers and customers as well as on the competing firms which are struggling to adapt to the changes in policy where there is no longer protectionism being practised.[306]

3.4 EPZ Schemes in Malawi

Having provided a general overview of the purpose of EPZ schemes, it is worthy to remember that an EPZ "comprises of a unique configuration of individual measures and as such must be analysed at the level of these measures"[307]. Hence there is now a need to analyse the EPZ regime in Malawi in the context of its trade policy and the specific measures that are provided in the regime.

EPZs are established on recommendation (by Export Processing Zones Appraisal Committee) to the Minister after considering the following:

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[300] J Beyer ""Please Invest in our Country" How Successful were the Tax Incentives for foreign Investment in Transition Countries?" (2002) *Communist and Post-Communist Studies* 191 at 192.
[301] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 25.
[302] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 28.
[303] S Woolfrey "Industrial Development Zones in South Africa".
[304] McIntyre, Narula and Trevino 1996 *The International Trade Journal 441.*
[305] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 33.
[306] Beyer 2002 *Communist and Post-Communist Studies* 192.
[307] S Creskoff and P Walkenhorst "Implications of WTO Disciplines for Special Economic Zones in Developing Countries" (2009) *The World Bank Policy Research Working Paper 4892* 9.

"(a) labour intensive activities of the project and its propensity to contribute to employment;

(b) use of advanced technology;

(c) utilization of local raw materials;

(d) export-oriented activities other than the production for export of tobacco, tea, coffee, and sugar;

(e) the availability of sufficient warehouses for storage of raw materials and export products;

(f) documentary evidence of export markets for the export products."[308]

It is evident from the section that the EPZs scheme is there to achieve several objectives. It is there to make sure that it provides employment to the indigenous people as it requires that the companies operating in the zones must be involved in productions that are labour intensive. The only logical consequence of this requirement is that these people will be employed from the local population. It is also there to make sure that the companies should advance technology by encouraging companies in the zones to use advanced technology. However, this may at some level conflict with the first object of labour intensiveness, as advancement of technology may mean a switch to automation which requires a reduced use of human labour.

However, this use of technology is beneficial to the local industry as the expectation is that there will be a spill over effect of the same to the local industry through forward and backward linkages. One channel through which the spill over may occur is through product market linkages between EPZ firms and traders in the domestic economy.[309] For instance, backward linkages occur "when technology is transferred from a company in the zone buying an input from the local industry to a company selling the input to domestic company"[310]. It may also occur when a multinational company inside the zone subcontracts some of its production to a domestic company outside the zone depending on the regulation of the zone.[311]

[308] Section 7 (2) of Export Processing Zones Act.
[309] Farole *Special Economic Zones in Africa* 91.
[310] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 33.
[311] *Ibid*.

In the case of Malawi, the development of backward linkages is crucial to the attainment of other requirements and goals under section 7 of the Act, which is the utilisation of local raw materials. This can only happen if domestic companies are suppliers of these inputs to the companies in the EPZs.

However, the core objective of the EPZ scheme is to spur the growth of exports through promotion of exports of non-traditional export products.[312] This is evident from the emphasis that is placed on this requirement in section 7 of the Act. Apart from just requiring that the companies in the zone should focus on production for export of non-traditional products (where in this case traditional products mean tobacco, tea, coffee and sugar), the Act requires the companies intending to be in the zones to produce documentary evidence of markets for the export products even before they start producing in the zones. This becomes clearer with factors that are considered before declaring a piece of land as an EPZ enclave. Section 8 of the Export Processing Zones Act requires that when declaring a piece of land as an EPZ, the Minister of Trade and Industry must be satisfied that the company operating on the land will use the land to attract, promote or increase export products or promote economic development. In this case the issue of economic development in terms of trade can only be achieved if there is an increase in supply of export products whose attainment depends on the companies in the zones diversifying the production of exports by focusing on the production of the non-traditional export goods.

If the requirements of section 7 of the Act are satisfied, the companies operating in the zones benefit from various incentives and in this case, these are fiscal in nature. In the case of the EPZ scheme in Malawi, when it comes to fiscal measures in terms of imports and exports, the businesses in the zones are exempted from all duties. Hence where an export enterprise imports or purchases any dutiable goods to be used in an EPZ, no duty shall be paid on the goods if the goods are transported directly to the EPZ and placed there under such conditions as the Commissioner General of Malawi Revenue Authority may impose.[313] These duties are import, excise and value added tax (VAT) on capital machinery, equipment,

[312] Trade Policy Review Malawi: Report by Secretariat (2016) (WT/TPR/S/335) 39.
[313] Section 16(1) of the Export Processing Zones Act.

and raw materials directly used in the production of goods for export.[314] The EPZ companies are also exempted from paying withholding tax on dividends, value added tax and no excise taxes on purchases of raw materials and packaging materials made in Malawi is payable.[315] These incentives are meant to attract investments into the EPZs as the companies in the zones will benefit from the economies of the scale that would result from operating at a much lower cost than compared to companies operating in the customs area. This would help Malawi to pursue phase 3 trade policy goal of export promotion as more companies would invest in production of export goods.

3.5 Conclusion

This chapter has shown how Malawi trade policy has evolved to the current stage where there is liberalised trade policy being pursued. However, even though at the hub of trade policy is creation of a globally competitive export oriented economy, the local industry has failed on its own to take advantage of this policy. This has necessitated Malawi, just like so many other developing countries, to adopt measures such as EPZ schemes so that they act as a catalyst for trade, investment and wider economic growth as companies operating in the EPZs aim at improving competitiveness and facilitate economic transformation.

The chapter has also shown that in a drive to attract companies to the EPZs, different incentives are granted to companies operating in the EPZs. And in Malawi these take the form of exemption from payment of indirect taxes when the EPZs companies imports goods to be used in production of export products, exemption from paying withholding tax on dividends, exemption from paying VAT and excise tax local packaging materials. The next chapter will analyse whether the incentives granted to companies in the EPZ are in tandem with multilateral rules to trade as found in the SCM Agreement.

[314] Malawi Trade and Investment Centre *Tax incentives in Malawi* http://www.mra.mw/assets/upload/downloads/TAX_INCENTIVES_IN_MALAWI_HANDBOOK_2016.pdf (accessed 25th June 2017).

[315] Supplement to Investment and Export Promotion Act 2012.

CHAPTER 4: ASSESSING WHETHER THE EPZ REGIME IN MALAWI BREACHES THE SCM AGREEMENT

4.1 Introduction

The successful use of EPZs by Asian countries has led to many developing countries (particularly LDCs) to adopt their use - as alluded to in the preceding chapter. However, conditions in the multilateral trading system have changed and are no longer as they used to be when the Asian countries were using the schemes in the 70s to early 90s. The coming into force of the Uruguay Round Agreements means that the developing countries can no longer pick and choose what they want to be bound by. The discipline on subsidies is no longer optional, as was the case during the Tokyo Round where developing countries who did not sign the subsidies code were not bound by the code.[316] The SCM Agreement binds all WTO Members, and the regime is stricter, as shown in chapter 2.

However, neither the SCM Agreement nor any of the other WTO Agreements have specific rules dealing with EPZs.[317] Hence conformity of the EPZs cannot be analysed as a single programme but the analysis of them must be done on a case by case basis by considering the requirements, incentives and benefits which each EPZ has in place and comparing how the same compare with particular WTO rules.[318] This chapter will analyse whether the EPZ scheme in Malawi as regulated under the Export Processing Zones Act is in line with the SCM Agreement. This is crucial for Malawi's reputation at the WTO, as Malawi has been notifying the WTO that it has no programme whether on policy level or in terms of the law that grants subsidies which are contrary to the provisions of the SCM Agreement.[319]

The main benefits granted to companies operating in these zones are fiscal incentives. However, before we consider whether the incentives meet the requirements of a subsidy under the SCM Agreement I will consider that is, whether the fiscal incentives are specific in terms of the SCM Agreement.

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[316] Bora, Lloyd and Pangestu P*olicy Issues in International Trade and Commodities Study Series No. 6* 20.
[317] R Torres "Free Zones and the World Trade Organisation Agreement on Subsidies and Countervailing Measures" (2007) Vol. 2(5) *Global Trade and Customs Journal* 217 at 218.
[318] *Ibid*.
[319] New and Full Notification pursuant to Article XVI:1 of the GATT 1994 and Article 25 of the Agreement on Subsidies and Countervailing Measures: Malawi (G/SCM/N/220/MWI, G/SCM/N/253/MWI G/SCM/N/284/MWI, G/SCM/N/315/MWI).

4.2 Specificity

As discussed above, the SCM Agreement does not proscribe the granting of all subsidies but rather it proscribes or regulates the granting of subsidies which are specific. Therefore, subsidies in the EPZ regime in Malawi will only violate the SCM Agreement if the same are specific. This issue will be a straight forward one if as the name suggests, an export processing zone makes a subsidy contingent on export performance. Hence, in terms of Article 2.3 of the SCM Agreement, any subsidies falling under Article 3 of the SCM Agreement (which deals with prohibited subsidies) such as export subsidies is deemed specific.

Raul Torres notes that in EPZs, the specificity is implicitly in their requirements and conditions for establishing and operating them.[320] He notes that one of the conditions may be the requirement of a licence and he argues that in the licensing process, the government may choose industries it wants to promote (to the exclusion of others) which will be authorised to operate in the zones.[321] Secondly, he states that an explicit requirement that enterprises operating in the zones should export part of their products is another proof of specificity.[322]

In the case of the regulations in Malawi, section 10 of the Export Processing Zones Act stipulates that the Minister of Trade and Industry shall provide a certificate to companies that apply under section 8 of the Act to operate in the zones. This certificate is granted to a company which manufacturers or provides, or proposes to provide an export product. The certificate must specify among other things the export product which the export enterprise is or will be manufacturing.[323] This certificate only covers products which are designated as non-traditional export products in Malawi. Hence the certificate cannot be issued to a company that produces tobacco, sugar, coffee and tea even if these are to be exported. Without this certificate being issued, a business cannot operate in the zone. This is as stated in section 14 of the Act, which provides that:

> "No person shall carry on, in an export processing zone, any trade, business or manufacturing, unless there is in relation to such trade, business or

[320] Torres 2007 *Global Trade and Customs Journal* 218.
[321] *Ibid.*
[322] Torres 2007 *Global Trade and Customs Journal* 219.
[323] Section 10(4)(b) of the Export Processing Zones Act.

manufacturing, a certificate authorizing the carrying on of such trade, business or manufacturing."

To make sure that this is followed to the letter, there is a restriction even in terms of adding other products other than those indicated on the certificate, as section 15 of the Act provides that no export enterprise shall carry on any trade or business other than that specified on its certificate. The product(s) indicated on the certificate for an enterprise operating in the zone is called an export product(s) and this is even gazetted, meaning that as long as the certificate is valid the enterprise is supposed to only produce goods certified as export products on the certificate.[324]

The Act also requires that products produced in the zone be exported. As stated in paragraphs above, the Act requires as one condition for recommending a business to operate in the zone that it should provide documentary evidence of export market for the export products that it produces or intends to produce.[325] Since, according to the Act, it is the land on which a factory is built, the factory, or an area of land which immediately surrounds a factory that is declared an EPZ, it is not allowed to take the goods outside this area so declared as an EPZ. Goods may only be taken out when they are being exported as export products or are being moved to another area declared as an EPZ. The moving of the goods to another EPZ must happen with written authorisation of the Commissioner General of Malawi Revenue Authority.[326]

The Act also limits export products from being sold into the local customs area. Hence goods sold into the local customs area shall not exceed a percentage that the Act prescribes. Currently 10 % of goods produced in the zone can be sold locally after seeking approval from the Ministry of Trade and Industry.[327] However when selling the goods into the customs area, the goods are subject to appropriate duty and tax. The selling of goods into the customs area is treated in the same way as exporting goods from outside the EPZs, hence duty must be paid.[328] However, if goods are sold straight from the EPZ to another

[324] Section 9 of the Export Processing Zones Act.
[325] Section 7 (2)(f) of the Export Processing Zones Act.
[326] Section 17 of the Export Processing Zones Act
[327] Malawi Trade and Investment Centre *Tax incentives in Malawi*.
[328] Section 15C of the Export Processing Zones Act.

country there is no payment of duty. This means the rules are there to make sure that no goods produced in the zones are sold into the domestic market.

Therefore, from the discussion above it is clear that the EPZ regime provides fiscal incentives that are specific, in that the incentives are only granted to specific industries (those that produce Malawi's non-traditional export products) with a specific purpose, namely exports. If these incentives are found to be subsidies, they would be prohibited subsidies as provided under Article 3.1 of the SCM Agreement.

4.3 Whether the EPZ schemes in Malawi grant subsidies to export enterprises?

When assessing subsidies in the EPZs in developing countries, most of them provide subsidies in terms of foregoing of revenue otherwise due. They provide these through granting tax holidays and exemption from payment of taxes to companies operating in these zones. In Malawi these take the form of exemption from payment of indirect taxes when the EPZs companies imports goods to be used in production of export products, exemption from paying withholding tax on dividends, exemption from paying VAT and excise tax local packaging materials. However, as it was explained in chapter 2 of this study, a sovereign has the discretion to decide which income to tax and what duties to levy on its own. Hence, when assessing whether the EPZ scheme in Malawi grants subsidies in the form of foregoing of revenue, this is taken into consideration. For there to be financial contribution through the fiscal incentives there is need to demonstrate that the fiscal incentives given to companies operating in the EPZs is a tax that is "due". It was held by the Appellate Body in *United States – FSC* that there will be foregoing of revenue only if government has given up its entitlement deliberately to tax the revenue that is 'due'.[329] The only way of showing this deliberateness is by comparing the situation that exists after the government has given up its entitlement with that which would have existed had government not deliberately given up its entitlement to raise this revenue which was due.

It has also been held by the Appellate Body that, when assessing foregoing of revenue otherwise due, there must be some defined benchmark against which a comparison can be

[329] Appellate Body Report, *United States – Tax Treatment for "Foreign Sales Corporations"* WT/DS108/AB/R (24th February 2000) Para 90.

made between the revenue that would have been raised if the subsidising measure was not there.[330] This means that in assessing the revenue foregone in the EPZs we must compare the revenue being collected with the revenue government could have collected from these companies had it been that this EPZ scheme was not there. Thus, the benchmark would be the tax they would have paid had it been that they were operating in the customs area, outside of the EPZs.

When doing the analysis in this chapter, I will follow the three-steps that the Appellate Body held must be followed in the case of *United States-Large Civil Aircraft (2nd Complainant).* The first step is to identify the tax treatment that applies to the income of the alleged recipient of the subsidy, which involves consideration of objective reasons behind that treatment and if it's a change of tax rules, the reasons behind the change.[331] The second one is to identify a benchmark for comparison; thus the tax treatment of comparable income of comparably situated taxpayers.[332] Finally, the third step is to compare the reasons for treatment in question with the benchmark tax treatment. The comparison will help to assess whether "considering the treatment of the comparable income of comparably situated taxpayers, the government is foregoing revenue that is otherwise due in relation to the income of the recipient of the subsidy."[333]

However, in terms of the SCM Agreement there is a difference between direct and indirect taxes, in that the exemption of other forms of indirect taxes is not deemed to be a subsidy. This discussion will first deal with how the indirect taxes are treated in the EPZ schemes.

4.3.1 Indirect taxes on input products

Footnote 1 and Annexes I to III to the SCM Agreement identify situations when foregoing of revenue will not confer a benefit and thereby result in subsidisation.[334] Footnote number 1 provides as follows:

> "In accordance with the provisions of Article XVI of GATT 1994 (Note to Article XVI) and the provisions of Annexes I through III of this Agreement, the exemption of an exported product from duties or taxes borne by the like product when destined for

[330] *Supra*.
[331] Appellate Body Report, *Unite States-Large Civil Aircraft (2nd Complaint)* Para 812.
[332] Appellate Body Report, *United States- FSC* para 91.
[333] *Supra*.
[334] PC Mavroidis *Trade in Goods* 2nd ed (2013) 535.

domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy."

The provisions of the above-quoted footnote (which just rephrases what is stated in Ad Article XVI of GATT 1994) are clarified in the Annexes I-III to the SCM Agreement. Annex I is an Illustrated List of Export Subsidies. Once a measure meets the requirement of the measures described in the Illustrative List, then that is conclusive that the measure is a prohibited subsidy under the Article 3.1(a) of the SCM Agreement. Hence, prohibited export subsidies are also subject to the Illustrative List of Export Subsidies in the Annex I of the SCM Agreement.[335]

According to the Illustrative List of Export Subsidies, the exemption or remission of indirect taxes, through for example, duty drawbacks, is not regarded as a subsidy.[336] However, these indirect tax exemptions become an export subsidy only if it involves exemption or remission in excess of those levied on the product destined for domestic consumption.[337]

In this case paragraph (h) of the illustrative list is relevant when it comes to EPZ schemes. Paragraph (h) states as follows:

"The exemption, remission or deferral of prior-stage cumulative indirect taxes 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). This item shall be interpreted in accordance with the guidelines on consumption of inputs in the production process contained in Annex II"

[335] S Laird "Export Policy and the WTO" (1999) Vol.8(1) *The Journal of International Trade and Development* 73 at 76.
[336] Mah 2011 *The World Economy* 2000.
[337] A Hoda and R Ahuja "Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement" 2003 *India Council for Research on International Economic Relations Working Paper No 101 5.*

In this case import charges have been interpreted as "tariffs, duties and other fiscal charges…that are levied on imports"[338] while indirect taxes mean "sales, excise, turnover, value added, franchise, stamp, transfer, inventory and equipment taxes, border taxes, all taxes other than direct and import charges".[339]

Annex II of the SCM Agreement provides guidelines for interpreting item (h) of the Illustrative list relating to indirect tax.[340] Paragraph 2 of Annex II interprets what it means by the term "inputs that are consumed in the production of the exported products" by stating that the drawback schemes can constitute an export subsidy to the extent that they result in the remission or drawbacks of import charges in excess of those actually levied on inputs that are consumed in the production of the exported product. This of course considers normal allowance for waste.

When it comes to situations where investigations are being conducted to determine the amount of countervailing duty to levy on a product which has been deemed to have breached the exemption found in footnote 1 of the SCM Agreement. Paragraph 1 of part II of Annex II of the SCM Agreement advises that the investigating authority should first determine whether the country of the exporting Member has in place and applies a system or procedure which confirms inputs that are consumed in the production of the exported product and in what amounts. If the investigators are satisfied with the system used by the exporting country and are convinced that the same is reasonable, they can use that system to determine the amount of breach. This supports the point that the exemption is only accorded to taxes consumed in the production process and not otherwise. Therefore, duty free import of raw materials and intermediate inputs used in the production of goods for export and the drawback schemes of similar nature are exempted from the subsidy definition.[341]

[338] Footnote 58 of the Agreement on Subsidies and Countervailing Measures.
[339] Footnote 58 of the Agreement on Subsidies and Countervailing Measures.
[340] Hoda and Ahuja 2003 *India Council for Research on International Economic Relations Working Paper No 101* 5.
[341] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 45.

Section 16 (1) of the Export Processing Zones Act provides that when a company operating in the zones imports goods to be used in the zones and the goods are transferred to the zones, the goods are exempted from paying imports duties and taxes. It is clear from this provision that the arrangement under the Act as far as goods used in the zone for production of exports is in line with what footnote 1 of the SCM Agreement provides. Therefore, as far as the treatment of imports of inputs used for production in zones are concerned, the Act is in tandem with the SCM Agreement.

To make sure that the goods that are imported duty and tax free are indeed those that are to be consumed in the production of the export product, the export enterprises are required to keep day to day records of goods released for consumption, sale or manufacture within the EPZ. They are also supposed to keep records of waste stocks, and its manner of disposal, balances of all goods stocked at the place or premises where the EPZ activities are carried out.[342] These records are supposed to be sent on a monthly basis to the Commissioner General of the Malawi Revenue Authority and principal secretary to the Ministry of Trade and Industry and can only be destroyed if the same is approved by the Minister of Trade and Industry who gets recommendation for the approval from the Commissioner General of MRA.[343]

In addition to this requirement of keeping records of the materials used in the EPZ, it is also not allowed to remove inputs from the EPZ to local customs areas.[344] If it happens that raw materials are taken from the EPZ into the customs area for use in the customs area, they are deemed to have been exported to the customs area and hence all the duty that was exempted is supposed to be paid on these transferred goods.[345] Where the commissioner general of MRA is satisfied that there is a deficiency in the quantity of dutiable goods for use in the EPZ which were exempted from the payment of duty without any reasonable justification, the export enterprise involved is liable to pay to the Commissioner a general duty leviable on the goods not accounted for.[346]

[342] Regulation 13(1) of the Export Processing Zones Regulations.
[343] Regulation 13(2) and 14 of the Export Processing Zones Regulations.
[344] Section 17 of the Export Processing Zones Act.
[345] Section 15A (1) of the Export Processing Zones Act.
[346] Section 18 of the Export Processing Zones Act.

Therefore, the above explanation regarding exemption of indirect taxes as provided in footnote 1 of the SCM Agreement means that Section 16(1) of the Export Processing Zones Act is not in violation of the SCM Agreement by exempting imported goods to be used in the zones. This is because Section 16(1) of the Export Processing Zones Act, exempts export enterprises from paying indirect taxes on imported goods if the goods are to be consumed in production of export products as allowed in footnote 1 of the SCM Agreement.

4.3.2 Indirect tax on capital goods

The treatment of import duties and taxes imposed on inputs used in production of export goods discussed above does not extend to capital goods. According to some authors[347] capital goods are not the same as inputs that are consumed in the production of the export goods such that the exemption in footnote 1 of the SCM Agreement should be extended to them. It must be acknowledged that this matter has not been adjudicated by the dispute settlement body of the WTO hence as of now, there is no report of the panel or the Appellate Body of the WTO interpreting whether capital goods can be exempted from indirect taxes. According to these authors, duty free treatment of capital goods and machinery used in the production of an export product do not meet the requirements of footnote 1 as these are not deemed to have been consumed in the production of the export product.[348]

The authors' interpretation is in line with footnote 61 of the SCM Agreement which does not include capital goods in its clarification of what it means by "inputs consumed in production". However, footnote 61 includes catalysts and fuel in its definition. The footnote provides that "[i]nputs 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." Annex II of the SCM

[347] Some of the articles that have argued this include: M Engman, O Onodera and E Pinali "Export Processing Zones: Past and Future Role in Trade Development" 2007 *OECD Trade Policy Papers, No.53;* A Hoda and R Ahuja "Agreement on Subsidies and Countervailing Measures: Need for Clarification and Improvement" (2005) 39(6) *Journal of World Trade* 1009; R Torres "Free Zones and the World Trade Organisation Agreement on Subsidies and Countervailing Measures" (2007) Vol. 2(5) *Global Trade and Customs Journal* 217.

[348] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 46.

Agreement further states that the inputs need to be physically present in the export product. The Annex states that:

> "[i]nvestigating authorities should treat inputs as physically incorporated if such inputs are used in the production process and are physically present in the product exported. The Members note that an input need not be present in the final product in the same form in which it entered the production process."[349]

The exemption of indirect taxes granted to an imported input will be deemed a subsidy not only if the inputs are used in the production process but if they are physically present in the exported product, albeit not necessarily in the same form.[350] Therefore, capital goods are not considered as being used in the production process even in the case of their depreciation.[351]

Even though, as alluded to above, this issue has not been adjudicated upon by the WTO's dispute settlement body, it has been referred to the Committee on Subsidies and Countervailing Measures (SCM Committee). During the SCM Committee's deliberation, a proposal was made to include capital goods in the exemption of footnote 1 by including it as part of goods consumed in the production process in footnote 61 of the SCM Agreement.[352] However, Members did not agree with the proposal and some even suggested then that this could be included in the Doha Round of negotiations.[353] However, even though there were divergent opinions, it was noted by some members that "footnote 61 was specifically negotiated to exclude capital goods and therefore could not lend itself to interpretation as including such goods."[354]

Hence, the members of the SCM Committee could not even agree with the reasoning of India in its proposal to include capital goods in footnote 61 because the footnote includes catalysts. This study will deal with the possibility of including capital goods in footnote 61 in the recommendation chapter: chapter 8 of the study. Therefore, some Members to the

[349] Paragraph 3 in part II of Annex II of the Agreement on Subsidies and Countervailing Measures.
[350] S Shadikhodjaev "Duty Drawbacks and Regional Trade Agreements: Foes or Friends?" 16(3) *JIEL* 587 at 594.
[351] Mah 2011 *The World Economy* 2003.
[352] This was proposed by Colombia and India.
[353] Chairman's Report on the Implementation-Related Issues Referred to the Committee on Subsidies and Countervailing Measures in the 15 December 2000 Decision of the General Council G/SCM/34 (3 August 2001) 2.
[354] *Ibid*.

WTO have indicated that the language of the footnote is clear and that the absence of reference to capital goods is a deliberate result of explicit negotiations on the subject and not an oversight by negotiators. These Members have also stated that they will not forgo their right to pursue either dispute settlement action or countervailing action in case there is a breach to footnote 61 by extending the exemption to capital goods.[355] It is indeed true that countries have been subjecting each other to countervailing actions if a Member breaches this footnote. For example India's Export Promotion Capital Goods (EPCG) scheme has been countervailed by USA, Canada and European Communities (EC).[356] Under this scheme India allowed import of new capital goods at 5 percent customs duty subject to the importer undertaking an export obligation equivalent to five times of the Cost, Insurance and Freight (CIF) value of the capital goods to be fulfilled over a period of eight years from the date of issuance of the licence.[357] This programme has been found to be an actionable subsidy as the government provided a financial contribution by partially exempting the duty and benefit arose from the use of the capital goods for the production of exported products.[358]

Thus, as per the explanation above, it would appear that a tariff exemption for capital goods which is contingent on exports would be an export subsidy as defined by Article 1 as read with Article 3 of the SCM Agreement and would not be covered by this exemption.[359]

If we consider the treatment of imports in terms of the Export Processing Zones Act, there is no distinction between general inputs and capital goods used in the production of the exports as the exemption from paying import duties and other taxes is provided to both. Section 16 of the Act states that if an "export enterprise imports or purchases *any dutiable* goods to be used in … export processing zone, no duty shall be paid on the goods…". The use

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[355] *Ibid.*

[356] The US Department of Commerce countervailed against the Scheme In the final Countervailing Duty (CVD) determinations in Certain Cut-to-Length Carbon Steel Plate from India (1999) and Certain Hot-Rolled Carbon Steel Flat Products from India (2001); The EC countervailed against the Scheme in their CVD investigations relating to Certain Broad Spectrum Antibiotics (1998), PET Film (1999), Certain Flat-Rolled Products of Iron or Non-alloy Steel (2000), and Certain Polyethylene Terephthalate (2000); Canada also countervailed against the EPCG scheme in the final CVD determination against Certain Stainless Steel Round Bars exported from India (2000): Hoda and Ahuja 2005 *Journal of World Trade* 1038, 1039, 1040.

[357] Hoda and Ahuja 2005 *Journal of World Trade* 1039.

[358] Hoda and Ahuja 2005 *Journal of World Trade* 1040.

[359] Engman, Onoderaand Pinali 2007 *OECD Trade Policy Papers, No.53* 46.

of "any" in the Act means that the Act does not distinguish general inputs from capital goods. This is contrary to the dictates of the SCM Agreement. This therefore means that the Export Processing Zones Act provides for an export subsidy which is in the form of foregone revenue otherwise due by exempting export enterprises from paying import duties and other taxes due when the enterprises are importing the capital goods. This is because without this scheme the export enterprises would have paid import taxes and customs duties when importing the capital goods just as other businesses that operate in the customs area.

4.3.3 Direct taxes

Just like with capital goods, the SCM Agreement also treats direct taxes differently. These taxes are not given the exemption enjoyed by indirect taxes. Perhaps this is because "it came to be recognized over the years in GATT 1947 that indirect taxes were borne by the product whereas direct taxes were not"[360]. Paragraph (e) of the Illustrative List of Export Subsidies stipulates that it is prohibited to grant "the full or partial exemption remission, or deferral specifically related to exports, of direct taxes or social welfare charges paid or payable by industrial or commercial enterprises." In this case direct taxes have been interpreted to mean "taxes on wages, profits, interests, rents, royalties, and all other forms of income and taxes on the ownership of real property."[361]

In terms of income tax, the relevant benchmark for taxation of EPZ businesses in Malawi is found in the Taxation Act.[362] Under the eleventh schedule of the Taxation Act, companies are supposed to pay 30 percent of their taxable income as corporate tax. In terms of companies operating in EPZs, prior to 2011, these companies were granted 100 percent exemption from paying corporate tax.[363] This was provided in paragraph c (1) of the Eleventh schedule to the Taxation Act. This means in terms of the corporate tax before 2011 the EPZ Act was granting to these export enterprises an export subsidy by foregoing this tax which would otherwise be due as all companies operating in Malawi were supposed to pay this tax.

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[360] Hoda and Ahuja 2003 *India Council for Research on International Economic Relations Working Paper No 101* 5.

[361] Footnote 58 of the Agreement on Subsidies and Countervailing Measures.

[362] Act No. 46 of 1963.

[363] Trade Policy Review: Report Malawi (2016) (WT/TPR/G/335) 29.

However, this policy changed in 2011. The change in policy, did not come as a move toward compliance with the SCM Agreement, however. It was done because the government wanted to expand the sources of domestic revenue to finance its operations. This is acknowledged in the National Industrial Policy of Malawi.[364] In the policy, it is stated that the fiscal pressures arising from rapidly increasing funding conditionality by development partners have made the tax policy over the years to increasingly be aligned towards meeting short term revenue collection needs at the expense of promotion of overall economic development.[365] For instance this change came at the time when donors[366] were pulling out of Malawi.

However, even though there was a change in administration of corporate tax for whatever purpose, the Export Processing Zones Act still grants a subsidy in the form of foregone revenue when it comes to other direct taxes, such as withholding tax. Under the Taxation Act, the benchmark is that every company incorporated in Malawi is mandated on distribution of any dividend to withhold 10 per cent of such dividend and remit the amount to the Malawi Revenue Authority.[367] What this means is that every company that was incorporated and operates within the borders of Malawi is mandated to pay this withholding tax.

However, under the EPZ regime, companies that are operating in the EPZ are exempted from paying this withholding tax on dividends.[368] This means that had these companies which are in operation in the EPZs been operating in the customs area, they would have been expected to pay this tax as the rest of the companies in the customs are. They are being shielded from paying this tax because of where they are operating their businesses in the EPZs. It means that their status of trading in EPZs is what confers these companies this benefit of being

[364] Ministry of Industry, Trade and Tourism *National Industrial Policy* (2016) http://www.malawitradeportal.gov.mw/kcfinder/upload/files/National%20Industrial%20policy.pdf (15th May 2017).
[365] Ministry of Industry, Trade and Tourism *National Industrial Policy*.
[366] Some donors such as Germany, United Kingdom, Norway, USA and World Bank who are members of Common Approach to Budget Support(CABS) in Malawi, stopped giving direct budget support Malawi government as such government had to come up with means of sourcing funds to cover the budget deficit.
[367] Section 70A (1) of Taxation Act.
[368] Trade Policy Review Malawi: Report by Secretariat (2016) (WT/TPR/S/335) 39; Supplement to Investment and Export Promotion Act 2012.

exempted from withholding tax on dividends. The main objective for giving the companies in the zones this benefit is because government wants these companies to produce goods meant for export, and not any goods but only goods which are non-traditional export products. This is why companies producing for export traditional products such as sugar, coffee, tea and tobacco are not exempted from this tax.

Therefore, this means that the EPZ Act provides a subsidy in terms of withholding tax exemption to export enterprises operating within EPZs as defined under Article 1 of the SCM Agreement. Furthermore, the fact that these companies are granted this exemption for operating within the EPZ, because of the purpose of the EPZ being the increase of exports, this subsidy is contingent on export performance. It would thus amount to a prohibited subsidy in terms of the SCM Agreement.

4.3.4 Import substitution subsidy

There is not much academic discussion on import-substitution subsidies as is the case with export subsidies, but such subsidies can also be found in EPZ schemes. An example would be the case where some benefits are provided to companies located in the zones contingent upon the use of domestic over imported goods.[369] For instance, it has been found that an EPZ program could violate Article 3.1(b) of the SCM Agreement if there was a condition of value addition and the value added must use at least some domestic goods to meet the content requirement.[370]

One of the benefits of the EPZ scheme in Malawi is that export enterprises are exempted from paying taxes such as excise, surtax and VAT on purchases of raw materials and packaging materials made in Malawi.[371] This benefit is there to encourage export enterprises to use locally made raw materials and goods as compared to imported ones in line with section 7 of the Export Processing Zones Act requirements.

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[369] Engman, Onodera and Pinali 2007 *OECD Trade Policy Papers, No.53* 46.
[370] GA Horlick and PA Clarke "WTO Subsidies Discipline During and After the Crisis" 13(3) *JIEL* 859 at 864.
[371] Trade Policy Review Malawi: Report by Secretariat (2016) (WT/TPR/S/335) 39.

If this incentive is considered on face value, the logical conclusion would be that it is an import-substitution subsidy as provided under Article 3.1 (b) of the SCM Agreement. However, this must be considered in the light of the exemption that is accorded to indirect taxes in footnote number 1 of the SCM Agreement. In this case we will have to consider whether it is captured under the exemption accorded to drawbacks. Paragraph (i) of the Illustrative List of Export Subsidies is relevant in this case and it provides as follows:

> "The remission or drawback of import charges 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."

In paragraph 2 of part I of Annex II it has been stated that this exemption will only be extended to inputs consumed in the production of the export product. Annex III is crucial when it comes to the issue of using local materials as substitutes to imported inputs. It provides as follows:

> "I
>
> Drawback systems can allow for the refund or drawback of import charges on inputs which are consumed in the production process of another product and where the export of this latter product contains domestic inputs having the same quality and characteristics as those substituted for the imported inputs. [...]
>
> II
>
> In examining any substitution drawback system as part of a countervailing duty investigation pursuant to this Agreement, investigating authorities should proceed on the following basis: 1. Paragraph (i) of the Illustrative List stipulates that home market inputs may be substituted for imported inputs in the production of a product for export provided such inputs are equal in quantity to, and have the same quality and characteristics as, the imported inputs being substituted."

It is clear from the above quoted provisions that for the local materials to be used as substitutes of the imported inputs (which are not considered a subsidy under footnote 1 of the SCM Agreement) they must be of the same quality and quantity.

In this scenario, what must be answered is whether these local raw materials and packaging materials are being used as substitutes that are of the same quality and are in the same quantity. As discussed above, the exemption of indirect taxes borne by imported inputs used in the production of an export product is not a subsidy. It can just be assumed for argument's sake that if the local materials and imported inputs are used to produce the same export product, then they must be substitutes.

However, this does not resolve the issue to finality. The other issue that must be considered is whether the substitutes are being consumed in the actual production process of the export product since the exemption of indirect taxes will only be granted if the inputs are consumed in the actual production of the export product. In this case there is need to determine whether the local raw materials are indeed used in the production process. If they are being consumed in the production process, then they will be exempted from indirect taxes as allowed under footnote 1 of the SCM Agreement.

4.3.5 Packaging materials

The EPZ regime in Malawi provides that companies in the EPZ are not to pay excise taxes (and VAT) on purchases of raw materials and packaging materials made in Malawi.[372] When assessing the treatment of local raw materials in terms of whether their treatment accords a subsidy or not to export enterprises, it seems it is straightforward (as discussed above) but the same is not the case when it comes to packaging materials. This can be answered by considering the term "consume" as has been used in the SCM Agreement when dealing with inputs used to produce export products. An item is said to have been consumed if it is physically incorporated in the production process of the export product. This is as given in footnote 61 and Annex II to the SCM Agreement. In this case it means that the input must undergo a substantial change in substance and form to produce the final product. It means

[372] Supplement to Investment and Export Promotion Act 2012; Nkhoma 2007 *Integrated Framework Policy Analysis Working Paper Series No. 7.* 5.

that it must be incorporated in the production process of the export good. If we consider this, then packaging materials do not meet the requirement. The packaging materials come into play after the fact, after the export product has already been produced.

It would also be proper when considering packaging materials to remember that capital goods, such as machinery which are used in the production of export products are not considered to be consumed in the production of the export product. Hence if the machinery involved in the process is not deemed to be consumed in the production process, then the packages that are used after the production process has finished cannot be deemed to have been consumed in the production of the export product.[373] It would also be proper to reflect on how these packaging materials are considered in the provisions that deal with drawbacks in Malawi. Section 97 of the Customs and Excise Act[374] states that a drawback may be granted on any such goods and materials used in the production of the exported product. In terms of export products, Section 15 of the Export Incentives Act[375] states that export products from Malawi shall be entitled to drawback of duty under section 97 of the Customs and Excise Act on "… such products raw materials, *including packaging materials* on which duty was paid…" (emphasis added) used in the production process. The inclusion of packaging materials in the wording of the section seems to indicate an addition. It means packaging materials are not considered to be raw materials or inputs in the normal course of the words. Hence, they are not regarded as raw materials normally consumed during production of export product.

This therefore, means packaging materials are not part of inputs consumed in the production process, and hence cannot be included in the exemption granted under footnote 1 of the SCM Agreement. Since they are not covered by footnote 1, they may be deemed to be an import substitution subsidy as provided under Article 3.1(b) of the SCM Agreement. This Article is in the following order:

[373] Footnote 61 of the Agreement on Subsidies and Countervailing Measures; Annex II to the Agreement on Subsidies and Countervailing Measures.
[374] Act No. 6 of 1988.
[375] Act No. 6 of 1988.

> "Except as provided in the Agreement on Agriculture, the following subsidies, within the meaning of Article 1, shall be prohibited:
> [...]
> (b) subsidies contingent, whether solely or as one of several other conditions, upon the use of domestic over imported goods."

The Appellate Body in the case of *Canada - Certain Measures Affecting the Automotive Industry* held that "contingent in law" means that the subsidy is conditional or dependent for its existence on something else.[376] This can be demonstrated based on the words of the relevant legislation, regulation or the legal instrument. Hence the conditionality can be derived by necessary implication from the actual words used in the measure.[377] In the case at hand, the exemption of taxes such as excise and VAT to an export enterprise operating in the zone in terms of packaging materials will only apply if the same are made in Malawi. This exemption is not available when they buy packaging materials which are not made in Malawi. However, it should be remembered that under section 15A of the Export Processing Zones Act, if goods are taken from the customs area and brought into the EPZ, they are considered to have been imported and they are supposed to be paid freely in convertible currency and taxes must also be paid. This is not the case with packaging materials which are made in Malawi as they are treated differently from packaging materials made anywhere else.

Therefore, it would appear that the Export Processing Zones Act provides prohibited import substitution subsidies in exempting indirect taxes when it comes to packaging materials made from Malawi.

4.4 Conclusion

This chapter has shown that, even though the EPZ schemes in Malawi may contribute greatly towards spurring export growth, it has some measures which are contrary to regulations regulating trade in the multilateral trading system to which Malawi is a party to. It has been shown in the chapter how some benefits under the scheme are contrary to Article 3.1 of the

[376] Appellate Body Report, *Canada-Certain Measures Affecting the Automotive Industry* WT/DS139/AB/R, WT/DS142/AB/R (adopted 31st May 2000) Para 123.
[377] *Supra*.

SCM Agreement. These include exemption of imports of capital goods from paying duties and taxes, exempting companies in EPZs from paying withholding tax on dividends and exempting EPZs companies form paying VAT and excise tax if they buy locally made packaging materials. However, Malawi is a developing nation and as such, under the multilateral trading system it may be allowed to breach certain rules that are not allowed to be breached by developed nations in pursuance of its national development. It will be relevant for this research to consider if Malawi may be allowed to breach the stated articles using its status as an LDC. Chapter 5 will consider this in detail.

CHAPTER 5: PREFERENTIAL AND DIFFERENTIAL TREATMENT

5.1 Introduction

The discussion in the preceding two chapters looked at subsidies and EPZs without considering the special and differential treatment (S&DT) that the multilateral trading system accords to developing countries and LDCs. This chapter will discuss the S&DT accorded to developing countries with the focus being on the SCM Agreement and how this relates to EPZ schemes. The first part of this chapter will dwell on the evolution of the S&DT principle in the GATT and the second part will discuss how this principle is currently applied in the WTO Agreements and how this impacts the operations of the EPZ schemes.

5.2 Evolution of S&DT under GATT

The inception of the GATT 1947 was premised on equal treatment of contracting parties to the Agreement. The equality of contracting parties meant that rights and obligations applied uniformly to all contracting parties[378]. This is evident from the preamble of the Agreement which stresses the importance of non-discrimination and reciprocity. The preamble in part states that:

> "[…] Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce"

Therefore, in the founding years of GATT, the strategy that was being pursued by the contracting parties was reciprocal trade liberalisation based on equality of nations. According to the preamble of the GATT, the attainment of trade liberalisation in the multilateral trading system was possible if all parties engaged in reduction of tariffs and other barriers to trade.[379] Hence, the founding contracting parties attempted to enjoin governments in this common goal of liberalisation, as liberalisation was believed to be the best approach to the realization of economic success.[380] It is of course agreed as a fact by

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[378] C Michalopoulos "The Role of Special and Differential Treatment for Developing Countries in GATT and the World Trade Organisation" (2000) *World Bank Policy Research Working Paper No. 2388* 2.

[379] A Jayagovind "Special and Differential Treatment in International Trade: A Developing Country Perspective" (2008) 20 *Nat'l L. Sch. India Rev.*95 at 97.

[380] AM Brennan "The Special and Differential Treatment Mechanism and the WTO: Cultivating Trade Inequality for Developing Countries?" (2011) 14 *Trinity College Law Rev.* 143 at 144.

members of the multilateral trading system that pursuance of liberalisation through the MFN principle is the first-best approach for the world as a whole.[381]

In addition, when the GATT was being conceived by the founding contracting parties, it was designed as a trade policy forum to facilitate the reduction of barriers to trade and not a forum to deal with typical developmental issues - such as the development concerns of developing countries.[382] In other words, the Agreement was based on a pure "principle of mercantilism where the 'governments gain' by getting access to other markets for their exports for which they 'pay' by giving trade access to exports to other countries."[383] Therefore, even though not all founding contracting parties were developed countries, all were treated as equals and had to enjoy the same rights and fulfil the same obligations.[384]

However, from the 1950s to 1980s, there was a wave of change as far as obligations of developing countries in the GATT were concerned. This was because it now became apparent to the parties that developing country Members had different needs than developed members and that it was necessary to modify GATT disciplines to reflect this reality.[385] It was clear that the pursuit of trade based on reciprocity was not producing the expected results, as developing countries' exports were not growing as had been hoped.[386] The contracting parties realised that without rectifying this problem the developing contracting parties were bound to suffer long-term economic difficulties and this would in the long run affect enforcement of developing countries' obligations.[387]

Therefore, progressively, the contracting parties in the GATT started extending S&DT to developing parties. In this case, S&DT refers "to a set of trade policies pursued in the multilateral trading system to address the complex challenges of development and respond

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[381] B Hoekman "Operationalizing the Concept of Policy Space in WTO: Beyond Special and Differential Treatment"8(2) *JIEL* 402 at 408.
[382] U Ewelukwa "Special and Differential Treatment in International Trade Law: A Concept in Search of Content" (2003) 79 *North Dakota Law Rev.* 831 at 844.
[383] RE Hudec "GATT and the Developing Countries" (1992) 67 *Colum. Bus. L. Rev.* 67 at 69.
[384] M Pangestu "Special and Differential Treatment in the Millennium: Special for Whom and How Different?" https://www.researchgate.net/publication/4792232_Special_and_Differential_Treatment_in_the_Millennium_Special_for_Whom_and_How_Different (accessed 1st September 2016).
[385] AD Mitchell and T Voon "Operationalizing Special and Differential Treatment in the World Trade Organisation: Game Over?" (2009) 15 *Global Governance* 343 at 345.
[386] Hudec 1992 *Colum. Bus. L. Rev.* 69
[387] *Ibid*.

to the inequitable distribution of wealth among participants in the system."[388] The terms of S&DT during GATT years leaned towards three areas: improving market access for developing country exports into developed countries, non-reciprocity in trade relations between developing and developed countries and flexibility in the application by developing country Members of GATT disciplines.[389] The provisions which were introduced in GATT were meant to rearrange the formal equality rules in the GATT and allow extensive positive discrimination.[390] This was necessary as the formal guarantees of equality present in the GATT had failed to achieve the objective of growing trade among the parties, particularly developing country parties.[391]

One of the earlier amendments in the GATT was to do with how developing countries could use trade measures to protect their infant industries from foreign competition.[392] It can be recalled in chapter 3, there was a discussion of how import substitution measures were employed by developing countries to protect their industries. This was a result of the amendments that were made to Article XVIII of the GATT. Article XVIII of the GATT applied to all contracting parties and it provided for when to apply measures such as quantitative restrictions. The amendment introduced at the time, made it flexible for the developing

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[388] Ewelukwa 2003 *North Dakota Law Rev.* 883-884.
[389] Michalopoulos 2000 *World Bank Policy Research Working Paper No. 2388* 3.
[390] Brennan 2011 *Trinity College Law Rev.* 147.
[391] Brennan 2011 *Trinity College Law Rev* 152.
[392] The adoption of sections C and D to Article XVIII made it possible for developing countries to adopt measures that were specifically aimed at protecting their infant industries from competing with imports from developed countries. Some of the paragraphs in section C of the Article which allowed this provide as follows:

> "13. If a contracting party coming within the scope of paragraph 4 (*a*) of this Article finds that governmental assistance is required to promote the establishment of a particular industry* with a view to raising the general standard of living of its people, but that no measure consistent with the other provisions of this Agreement is practicable to achieve that objective, it may have recourse to the provisions and procedures set out in this Section.
>
> 14. The contracting party concerned shall notify the CONTRACTING PARTIES of the special difficulties which it meets in the achievement of the objective outlined in paragraph 13 of this Article and shall indicate the specific measure affecting imports which it proposes to introduce in order to remedy these difficulties. It shall not introduce that measure before the expiration of the time-limit laid down in paragraph 15 or 17, as the case may be, or if the measure affects imports of a product which is the subject of a concession included in the appropriate Schedule annexed to this Agreement, unless it has secured the concurrence of the CONTRACTING PARTIES in accordance with provisions of paragraph 18; *Provided* that, if the industry receiving assistance has already started production, the contracting party may, after informing the CONTRACTING PARTIES, take such measures as may be necessary to prevent, during that period, imports of the product or products concerned from increasing substantially above a normal level."

countries to adopt measures dealing with quantitative restrictions. The amendment extended the possibility of maintaining sufficient flexibility in tariff structure of developing countries enabling them to establish their industries and apply quantitative restrictions to achieve equilibrium in their balance of payments.[393] This amendment to Article XVIII was entitled 'Governmental Assistance to Economic Development."[394] Article XVIII was amended by adding sections B, C, and D to the Article. The added provisions allowed developing countries to apply more liberally quantitative restrictions than developed countries and they were liberally used by most developing countries and practically these provisions exempted developing countries from free trade obligations during the GATT period.[395]

This was in essence an acknowledgement that developing countries faced serious balance of payment problems as compared to developed ones, and that protection of infant industry was needed to address these problems.[396] Of course, the words used to describe developing countries was not developing countries but "economies which can only support low standards of living and 'are in early stages of development."[397] However, the amendment did not address criteria used to determine that a country is a developing or developed country, and today it remains a self-selection process.[398]

During this period, GATT contracting parties also adopted Part IV to the GATT 1947. This Part IV, entitled "Trade and Development", emphasized the need for according preferential market access to goods from developing countries by the developed countries.[399]

Part IV of the GATT approved principles and objectives for granting trade preferences to products from developing countries.[400] These principles included increasing export earning, promoting industrialisation and accelerating economic growth of developing countries.[401] However, whilst Part IV adopted promotion of development, it has been criticised that it

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[393] Jobim 2013 *Journal of Politics and Law* 57.
[394] Ewelukwa 2003 *North Dakota Law Rev* 844.
[395] Jayagovind 2008 *Nat'l L. Sch. India Rev.* 98.
[396] Ewelukwa 2003 *North Dakota Law Rev* 844.
[397] Article XVIII:4 of GATT 1947.
[398] Pangestu "Special and Differential Treatment in the Millennium: Special for Whom and How Different?".
[399] Ewelukwa 2003 *North Dakota Law Rev* 846.
[400] *Ibid.*
[401] *Ibid.*

was never more than a set of 'best endeavour' undertakings which had no legal force.[402] It did not contain binding obligations, therefore, it could not be enforced upon the developed countries. S&DT provisions under WTO law are identified as mandatory in nature if in their language they use the word "shall" rather than "should".[403] However, it is also true that some S&DT provisions which are mandatory in the strict legal sense are nevertheless characterised by a considerable flexibility of obligations laid out in them which make them not necessarily effective.[404] This was the case in Part IV of GATT 1947, hence, even though there was continued use of the word "shall", this was qualified by phrases such as "to the…extent possible" and "give active consideration", which watered down the effectiveness of the provisions. The provisions were hortatory in nature, as even though they created an obligation of result, which required developed contracting parties to achieve a certain outcome, they left them free to choose appropriate way of achieving that result. In the end Part IV created no right which developing countries could enforce. A good example is Article XXXVII:1 of GATT 1947 which provided as follows;

> "1. The developed contracting parties shall to the fullest extent possible - that is, except when compelling reasons, which may include legal reasons, make it impossible - give effect to the following provisions:
>
> *(a)* accord high priority to the reduction and elimination of barriers to products currently or potentially of particular export interest to less-developed contracting parties, including customs duties and other restrictions which differentiate unreasonably between such products in their primary and in their processed forms;
>
> *(b)* refrain from introducing, or increasing the incidence of, customs duties or non-tariff import barriers on products currently or potentially of particular export interest to less-developed contracting parties; and
>
> *(c)* (i) refrain from imposing new fiscal measures, and
>
> (ii) in any adjustments of fiscal policy accord high priority to the reduction and elimination of fiscal measures, which would hamper, or which hamper, significantly the growth of consumption of primary products, in raw or

[402] A Keck and P Low "Special and Differential Treatment in the WTO: Why, When and How?" (2004) *WTO Staff Working Paper ERSD-2004-03* 4.
[403] Implementation of Special and Differential Treatment Provisions in the WTO Agreements and Decisions; A Review of Mandatory S&DT Provisions WT/COMTD/W/77/Rev.1/add.2 (21 December 2001) 4.
[404] Non-Mandatory S&DT Provisions in WTO Agreements and Decisions WT/COMTD/W/77/Rev.1/add.3 (4th February 2002) 2.

processed form, wholly or mainly produced in the territories of less-developed contracting parties, and which are applied specifically to those products."

However, one significant feature of this part was provided in Article XXXVI:8 of GATT which provides that: "the developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to the trade of less-developed contracting parties." This non-reciprocity principle meant that developing countries would not be expected in the course of trade negotiations to make contributions inconsistent with their individual development, financial and trade needs.[405] This principle paved the way for the Generalised System of Preferences (GSP).

A waiver pursuant to Article XXV of the GATT was created in 1971 to allow developed countries to provide preferential market access to developing countries under the GSP.[406] The GSP represented a series of unilateral concessional measures extended to developing countries by the developed countries.[407] However, just like with the other S&DT measures, these are not binding on the developed countries in the GATT - they run at the pleasure of the developed countries and can be withdrawn at any time.[408] Hence under this measure, developed countries would not impose tariffs on imports from developing countries or they would impose reduced tariffs. The arrangement was supposed to be a temporary one, to operate for 10 years. However, in 1979 the contracting parties adopted the Enabling Clause.[409]

5.3 The Enabling Clause

Unlike the temporary relief under the Article XXV GATT waivers, the Enabling Clause provides a permanent legal authority to employ various types of discrimination in favour of developing countries.[410] The aim of the Enabling Clause is to allow preferential

[405] Keck and Low (2004) *WTO Staff Working Paper ERSD-2004-03* 4.
[406] Jobim 2013 *Journal of Politics and Law* 58.
[407] J Whalley "Non-Discriminatory Discrimination: Special and Differential Treatment Under the GATT for Developing Countries" (1990) 100(403) *The Economic Journal* 1318 at 1322.
[408] *Ibid*.
[409] The Decision of the GATT CONTRACTING PARTIES of 28 November 1979 on *Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries* provides for S&DT; this is more commonly referred to as the Enabling Clause.
[410] Hudec 1992 *Colum. Bus. L. Rev.*73.

arrangements among developing country Members; it is, per *EC — Tariff Preferences*, an exception to the MFN principle enshrined in Article I:1 of the GATT 1994.[411] The Enabling Clause permits Members to provide "differential and more favourable treatment" to developing countries 'despite' the MFN obligation of Article I:1. Such treatment would otherwise be inconsistent with Article I:1 because that treatment is not extended to all Members of the WTO "immediately and unconditionally."[412] The Appellate Body in *EC — Tariff Preferences*, when discussing the place of S&DT provisions, stated that in the case of dispute between the two, the Enabling Clause shall triumph over the general MFN principle. The Appellate Body stated, "the Enabling Clause, as the more specific rule, prevails over Article I:1."[413] S&DT can therefore overcome the MFN principle. This is, of course, only if the S&DT satisfies the requirements of the Enabling Clause.

According to paragraph 2 of the Enabling Clause, some of the instances covered by the clause are where preferential tariff treatment is accorded by developed contracting parties to products originating in developing countries in accordance with the GSP, and also where there is differential and more favourable treatment with respect to the provisions of the General Agreement concerning non-tariff measures governed by the provisions of instruments multilaterally negotiated under the auspices of the GATT and now WTO. Paragraph 3 of the Enabling Clause sets out the substantive requirements for its application and these are:

- the measure shall be aimed at promoting trade in developing countries, and not at creating barriers or undue difficulties for other Members' trade interests.
- the measure shall not constitute an impediment to the reduction or elimination of tariffs and other restrictions to trade on a MFN basis.
- the measure shall respond positively to the development, financial and trade needs of developing countries.

One important element in the Enabling Clause was the fact that it was the first time that the LDCs were recognised as a separate class of category in need of more favourable S&DT than

[411] Appellate Body Report, *EC — Tariff Preferences* Para.99; this is clear in paragraph 1 on the Enabling Clause.
[412] Appellate Body Report, *EC - Tariff Preferences* Para. 90.
[413] Appellate Body Report, *EC — Tariff Preferences* Para 101.

other developing countries.[414] The use of the S&DT provision allowed the developing countries using their status not to adopt some agreements during the Tokyo Round - for instance the Subsidies Code. However, the Enabling Clause also contained a clause dealing with graduation. This is a recognition that as developing country economies grow strong they would participate more fully in the GATT. This was a seed for policy change.[415]

5.4 S&DT under the WTO

Under the WTO, the developing countries and LDCs are still granted S&DT. This however, is not at the same level as it used to be under the GATT. This is because S&DT provisions that were introduced during the Uruguay Round significantly diminished the favourable treatment accorded to the developing countries.[416] In the case of LDCs, even though international trade law still grants them most of the rights as LDCs when it comes to S&DT, the law still brought them back under the core trade law discipline and obligation. This is because S&DT is but for a limited time to help gain the necessary capacity to adapt to WTO disciplines.[417]

This change in policy was influenced by several factors. First, some developing countries such as Asian countries and some in Latin America, had enjoyed rapid growth and had succeeded in diversifying their economies. Therefore, they were better equipped to participate more fully in the trading system, and hence they were not interested in policies which promoted import substitution anymore.[418] These emerging economies were pursuing export led trade strategies and as such, they were now interested in addressing a range of issues affecting market access for their goods and not only the preferential arrangement which was previously dictated by developed countries.[419] These countries were now ready to take up obligations that were attendant to their needs, and this divided developing country members' interests in the negotiations.

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[414] Whalley 1990 *The Economic Journal* 1321.
[415] Hudec 1992 *Colum. Bus. L. Rev.*73.
[416] Brennan 2011 *Trinity College Law Rev.* 148.
[417] *Ibid.*
[418] Keckand Low *2004 WTO Staff Working Paper ERSD-2004-03* 5.
[419] Pangestu "Special and Differential Treatment in the Millennium: Special for Whom and How Different?".

Secondly, during this period there was a rethinking of development strategy based on import substitution and promotion of infant industry.[420] Countries realised that these policies were no longer effective, and there were limitations in terms of the domestic market which could be used to implement these policies to consume the produced goods.[421] This was true for most developing countries who were confronted with debt crises, pressures from international lending agencies and economic stagnation, and thus they started removing trade barriers and moved towards more modern market oriented economic policy.[422] Therefore, with the help of the IMF and World Bank, these developing countries were implementing radical changes to their trade policies aimed at liberalising their industries. This was compounded by the popularity of the idea that developing countries had to assume higher levels of obligations within the multilateral trading system.[423]

It should also be appreciated that the import substitution policies meant that the developing countries were in a way closing their borders to imports. During the Uruguay Round, the trading system was trying to confront the challenge brought up by these protection provisions, which came with the increased use of voluntary export restraint arrangements.[424] It should also be appreciated that at that time, major economic players like the USA were militating against government intervention and emphasized the role of markets in pursuing development goals.[425]

However, despite this, the WTO still maintained S&DT provisions. This is evident from the preamble of the Marrakesh Agreement Establishing the World Trade Organisation which states that the parties:

> "[recognise] further that there is need for positive efforts designed to ensure that developing countries, and especially the least developed among them, secure a share in the growth in international trade commensurate with the needs of their economic development".

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[420] *Ibid.*
[421] *Ibid.*
[422] Hudec 1992 *Colum. Bus. L. Rev* 74.
[423] Keckand Low *2004 WTO Staff Working Paper ERSD-2004-03* 5.
[424] *Ibid.*
[425] Keckand Low *2004 WTO Staff Working Paper ERSD-2004-03* 5.

The revised provisions in favour of developing countries can be characterised into three categories: firstly, S&DT provisions which deferred but did not deflect the full obligations of trade liberalisation for developing countries.[426] This comes in the form of extended transition time for developing countries from implementing obligations found in WTO Agreements. Secondly, S&DT provisions which authorise individual accommodation in the requirements of developing countries under the multilateral trading system.[427] Thirdly, the S&DT provisions which encourage developed Members to recognise and accommodate the interests of developing countries to increase developing countries' trade opportunities and their capacity to utilise those opportunities.[428]

Hence, it is clear from the provisions in the WTO that S&DT is not regarded as a permanent solution for developing countries, but it is there to give them extended time to adapt to WTO disciplines.[429] The justification for the extensions relates to the weakness in institutional capacity of developing countries and LDCs.[430] For instance, in the case of subsidies, the object of granting extended time is to allow countries to develop the institutions and policies to implement alternative means of support which are acceptable under the SCM Agreement.[431]

5.5 S&DT and the SCM Agreement

In the Tokyo Round, there was a 'code approach' which was used during negotiation. This allowed agreements to apply only to signatories and this led to many developing countries refraining from signing the Subsidies Code, among other measures.[432] However, the 'single undertaking' of the Uruguay Round meant that all WTO Members had to accept all Agreements, including those which could be said not to accommodate the developing countries' needs. Hence, the SCM Agreement applies to all Members with the only exemptions being those permitted in the Agreement. Article 27 of the SCM Agreement provides S&DT to developing countries. Article 27.1 of the SCM Agreement states that Members recognise that subsidies may play an important role in the economic development

[426] Brennan 2011 *Trinity College Law Rev* 148.
[427] Brennan 2011 *Trinity College Law Rev* 148.
[428] *Ibid.*
[429] Mitchell and Voon 2009 *Global Governance* 436.
[430] Michalopoulos 2000 *World Bank Policy Research Working Paper No. 2388* 22.
[431] *Ibid.*
[432] Keck and Low *2004 WTO Staff Working Paper ERSD-2004-03* 5.

of developing countries. Paragraphs 2 and 3 of Article 27 of the SCM Agreement go further to exempt developing countries from some provisions of the SCM Agreement. The paragraphs provide as follows:

> "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.
>
> 27.3 The prohibition of paragraph 1(b) of Article 3 shall not apply to developing country Members for a period of five years, and shall not apply to least developed country Members for a period of eight years, from the date of entry into force of the WTO Agreement."

The Panel in *Canada - Aircraft Credits and Guarantees* held that Article 27 "accords developing country Members special and differential treatment in respect of all export subsidies whatever form they take."[433] This means, as far as export subsidies are concerned, there is total exemption for some developing countries, and they can be used as a development tool by those developing country Members. Therefore, LDCs are covered from the general prohibitions of the use of export subsidies for industrial goods while other developing countries they were granted a limited time to make use of the export subsidies.[434]

Annex VII provides for countries that are to benefit under Article 27. Thus, LDCs and transition countries listed in the Annex whose per capita income is $1000 or less are exempted from Article 3.1 (a) of the SCM Agreement. The dollar value that is used to determine this GNP of $1000 is the constant dollar value of 1990. In terms of other developing countries, Article 27.2(b) provides that they were supposed to phase out the subsidies in 8 years from the inception of the Agreement, subject to meeting requirements under paragraph 4 of Article 27. Paragraph 4 states that these developing countries may not increase their subsidies during the transition period and had to reduce the subsidies in a progressive manner. They would also be allowed to maintain their subsidies only if it was shown that the subsidies were consistent with their development needs.

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[433] Panel Report *Canada – Aircraft Credits and Loan Guarantees for Regional Aircraft* WT/DS222/R (adopted 28th June 2002) Para 7.179.

[434] Laird 1999 *The Journal of International Trade & Development* 77.

The Appellate Body in *Brazil - Aircraft* agreed with the Panel that exemption for developing country Members other than those in the Annex VII from the application of Article 3.1(a) of the SCM Agreement is conditional on compliance with the provisions of paragraph 4 of the SCM Agreement. Hence, "when a developing country Member complies with the conditions in Article 27.4, a claim of violation of Article 3.1(a) cannot be entertained during the transitional period, because the export subsidy prohibition in Article 3 simply does not apply to that developing country Member."[435] The Panel further held that it is the developing country Member itself which is best positioned to identify its development needs and to assess whether its export subsidies are consistent with those needs.[436] When it comes to applying Article 27.4 of the SCM Agreement, substantial deference should be given to the views of the developing country Member in question on the issue of its development needs.[437] Furthermore, the time limits in Article 27.2(b) of the SCM Agreement have been extended on several occasions but the last date for these *ad hoc* extensions was 31st December 2013 and the extended programs were supposed to come to an end on 31st December 2015.[438]

Regarding import substitution subsidies, the time for exemptions has lapsed and all Members of the WTO are subject to the provisions of Article 3.1(b) of the SCM Agreement, including LDCs such as Malawi.

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[435] Appellate Body Report, *Brazil-aircraft* para 139.
[436] Panel Report, *Brazil-Aircraft* para 7.89.
[437] *Ibid*.
[438] Basing on the economic, financial and development needs of a developing country Article 27.4 of the SCM Agreement allowed transition countries referred to in Article 27.2(b) of the SCM Agreement to extend their subsidies programmes. However, in 2007 a decision of the SCM Committee was adopted by the General Council, in which it was agreed that the "last authorised period" referred in last sentence of Article 27.4 of the SCM Agreement shall not extend beyond 31st December 2013 and that the final two year phase out period provided for in the last sentence of Article 27.4 of the SCM Agreement shall end not later than 31st December 2015; WTO General Council Article 27.4 of the Agreement on Subsidies and Countervailing measures Decision of 27 July 2007 WT/L/691 (July 27, 2007. P2. In the period beginning 2009 to 2013 transition period, Antigua and Barbados, Belize, Costa Rica, Dominica, the Dominican Republic, El Salvador, Fiji, Grenada, Guatemala, Jamaica, Jordan, Mauritius, Panama, Papua New Guinea, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines and Uruguay applied for extension and more than 40 export programmes from these countries were granted extensions; Office of the U.S. Trade Representative & U.S. Department of Commerce *"Subsidies Enforcement Annual Report to the Congress"* 25 (2010) http://ia.ita.doc.gov/esel/reports/seo2010/seo-annual-report-2010.pdf (accessed 18th August 2017). The programmes that were granted extension are listed in an Annex to WTO General Council Decision of 27th July 2007 (WT/L/691) and most of them deal with EPZ Schemes or programmes akin to that.

5.6 S&DT provisions and Malawi's EPZ scheme

Article 27 of the SCM Agreement has impacted on the EPZ scheme in Malawi. This is because Malawi, being an LDC, is exempted from Article 3.1(a) of the SCM Agreement. It means that all the financial contributions that the scheme provides to export enterprises in the EPZs regarding export subsidies are exempted from Article 3.1(a). Therefore, it is not contrary to the SCM Agreement to offer indirect tax exemption to capital goods imports used in the EPZ and the withholding tax exemption so long as Malawi remains an LDC. It also means that even if the EPZ companies were to continue being exempted from corporate tax as was the case prior to 2011, it would be covered by Article 27.2(a) of the SCM Agreement. This simply means the amendment to the Taxation Act in 2011 regarding corporate tax exemption of the export enterprises was not done in compliance with the SCM Agreement but for revenue purposes. However, it must be remembered that even though during the period for which prohibition does not apply, these subsidies can be the subject of multilateral challenge as actionable subsidies and be countervailed upon.[439] Nevertheless, it must be remembered that in case of actionable subsidies, Article 27.9 of the SCM Agreement provides that action under Article 7 of the SCM Agreement (request for consultations or taking a matter before the Dispute Settlement Body) can only be taken if;

> "nullification or impairment of tariff concessions or other obligations under GATT 1994 is found to exist as a result of such a subsidy, in such a way as to displace or impede imports of a like product of another Member into the market of the subsidizing developing country Member or unless injury to a domestic industry in the market of an importing Member occurs"

In interpreting Article 27.9 of the SCM Agreement the Panel in *Indonesia — Autos* described this provision as follows:

> "Article 27.9 provides that, in the usual case, developing country Members may not be subject to a claim that their actionable subsidies have caused serious prejudice to the interests of another Member. Rather, a Member may only bring a claim that benefits under GATT have been nullified or impaired by a developing country Member's subsidies or that subsidized imports into the complaining Member have caused injury to a domestic industry." [440]

[439] Laird 1999 *The Journal of International Trade & Development* 77.
[440] Panel Report, *Indonesia – Autos* Para. 14.156.

Furthermore, no action can be taken against a developing country Member if the subsidy programme under consideration concerns direct forgiveness of debts, covers social costs in whatever form including relinquishment of government revenue and other transfer of liabilities if such subsidies are granted within or directly linked to a privatisation programmes of a developing country Member concerned provided the subsidy is granted for a limited time and ultimately the programme results in the privatisation of the enterprise.[441]

However, the exemption from Article 3.1 (b) of the SCM Agreement was temporary and it expired on 31st December 2002, thus 8 years after the coming into force of the SCM Agreement. Hence, the exemption regarding packaging materials and raw materials made in Malawi breaches Article 3.1 (b) of the SCM Agreement and is not saved by Malawi's status as an LDC. It is therefore in need of rectification to be in tandem with the SCM Agreement.

5.7 Conclusion

This chapter has shown that the multilateral trading system does not regard all countries as equals. Even though the non-discrimination principle is at the core of the multilateral trading system, positive discrimination is allowed when dealing with developing countries and LDCs. This is one way of making sure that there is equity and fairness among Members of the WTO so that the goal of trade and development can be attained at all levels. The SCM Agreement also provides S&DT to developing countries. As a result, some benefits provided to export companies in the zones by some of the developing countries and LDCs, even though they are prohibited subsidies, are exempted. In Malawi, all export subsidies are exempted by the country's status as an LDC, these include exemption of imports of capital goods from paying duties and taxes, exempting companies in EPZs from paying withholding tax on dividends. However, this does not extend to import substitution subsidies such as exempting EPZ companies from payment of VAT and excise tax if they buy packaging materials and raw materials made in Malawi. Furthermore, should the country no longer be an LDC it will no longer benefit from the exemption provided for export subsidies either.

It should also be remembered that Malawi, apart from being a Member of the WTO, is also party to regional trade agreements. These regional trade agreements come with their own regulations on the conduct of trade among Members and with third parties. The following

[441] Article 27.13 of the SCM Agreement.

two chapters will elaborate on whether the EPZ scheme is in tandem with the trade obligations that Malawi has as a party to these regional trade agreements.

CHAPTER 6: THE REGULATION OF REGIONAL TRADE AGREEMENTS UNDER THE MULTILATERAL TRADING SYSTEM

6.1 Introduction

The assessment of the use of EPZs cannot be complete if this research only considers their compliance with multilateral rules under the WTO as there is also a need to further assess their compliance with the rules regulating trade at the regional level. Since the inception of GATT in 1947, regional trade agreements (RTAs) have risen in number and reach over the years, and currently all WTO Members belong to at least one RTA in force.[442] Malawi belongs to several preferential trade agreements and in all these agreements there is an expectation that it will comply with them in good faith. However, the RTAs that are formed by Members of the WTO are required to comply with rules set by the WTO for the formation and operations of the same. This is because RTAs operate as subsets to the WTO by modifying multilateral rules set by the WTO when they operate amongst Members of the RTA. However, it is required that the RTA's operations must abide by the rules set by the WTO, for their formation and operation is on condition that they further the WTO's goal of trade liberalisation. This means the assessment of the operations of RTAs such as SADC and COMESA in the following chapters cannot be complete unless one is aware of the requirements set by the WTO for their formation and operation.

This chapter therefore provides a background to the assessment of SADC and COMESA (as the two most significant RTAs to which Malawi is a party) in chapter 7 by dealing with how the multilateral trading system regulates the formation and operation of RTAs to make sure that the RTAs operate in consonant with the WTO in pursuance of the overall goal of attaining global trade liberalisation. This chapter will therefore explain the regulation of RTAs under the WTO and it will do this by looking at the purpose, types, formation and limits of these RTAs. The chapter will also discuss how trade remedy measures such as rules regulating subsidies should be handled in the RTAs. This is crucial as chapter 7 assesses how the subsidy regulations as provided in SADC Protocol on Trade and COMESA Treaty affect the operations of EPZ schemes in Members States of the two RTAs.

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[442] It is reported that Mongolia was the country remaining that did not belong to a regional trade agreement, but it has recently negotiated an agreement with Japan which was notified to the WTO in June 2016. https://www.wto.org/english/tratop_e/region_e.htm accessed on 7 April 2017.

6.2 Regulation of Regional Trade Agreements under the WTO

One of the fundamental principles of international trade law is the principle of non-discrimination which is known as Most Favoured Nation Treatment (MFN). It is a core concept both under the GATT and the WTO. Article I:1 of the GATT, the MFN clause, states that:

> "with respect to customs duties and charges of any kind imposed on or in connection with importation or exportation … any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."[443]

This provision is crucial as far as market access is concerned. However, there are some exceptions under the GATT that allow for discrimination or granting of preferential rights when countries are trading. An example of such an exception is the discrimination that is allowed among members of RTAs. RTAs are reciprocal preferential trade arrangements between two or more partners that favour their members by reducing trade barriers below the level of reduction under the multilateral system.[444]

One of the rules that permits the formation of RTAs is Article XXIV of the GATT. This Article recognises that subject to meeting certain conditions, customs unions and free-trade areas between and among WTO members are desirable.[445] The Article acknowledges that the desire for rapid commercial expansion often produces an incentive for formation of preferential regional alliances (as was the case prior to the formation of GATT where countries were trading in blocs) which purport to serve the exclusive interests of the selected participants.[446] Hence, WTO members who have the desire to increase freedom of trade by the development of closer integration between their economies are allowed to voluntarily form such trade agreements.[447]

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[443] Article 1.1 of General Agreement on Tariff and Trade(GATT) 1994.
[444] MF Nsour "Regional Trade Agreements in era of Globalization: A Legal Analysis" (2007-2008) 33 *NC.J. Int'l L. & Com. Reg.* 359 at 360.
[445] Panel Report, *Turkey-Restrictions on imports of textile and clothing products* WT/DS34/R (31st May 1999) Para 9.63.
[446] S Cho "Breaking the Barriers Between Regionalism and Multilateralism: A New Perspective on Trade Regionalism" (2000) 42 *Harv. Int'l L. J.* 419 at 419.
[447] Article XXIV:4 of the GATT 1994.

At the centre of Article XXIV of the GATT 1994 is the desire contracting parties have of increasing freedom of trade.[448] At the time of adoption of this Article, contracting parties hoped that genuine RTAs that promote trade liberalisation among the countries in the RTA could be congruent with the overriding object of the multilateral trading system of pursuing trade liberalisation, hence they could contribute to the development of global trade.[449] In other words, the purpose of RTAs is to achieve integration at regional level which should complement the multilateral trading system and not threaten it. The framers of Article XXIV of the GATT believed that the co-existence of regional and multilateral tracks for trade liberation was positive in international trade.[450]

There is a debate as to whether this has been achieved as some argue that regionalism is halting the efforts of trade liberalisation based on the MFN principle. Some scholars argue that the GATT/WTO system allows the Article XXIV exception because it is believed that the trade creation effects of RTAs which have complied with requirements as laid out in the GATT 1994 would outweigh any trade diversionary effects.[451] In this case, trade creation means a shift of imports from an inefficient source, which in this case are third parties to an RTA, to an efficient source that is within the RTA.[452] Trade diversion means a shift of imports from an efficient source, being third parties, to an inefficient source that is within the RTA.[453]

However other scholars such as Jagdish Bhagwati argue that the analysis of whether an RTA is trade creating or diverting is not a deciding factor when considering the welfare outcome of an RTA.[454] Bhagwati argues that RTAs must be conceptualised as to whether they are "stumbling blocks" or "building blocks" to the accomplishment of broader goals of the multilateral trading system.[455] They will be a "building block" if they contribute to multilateral freeing of trade by either progressively adding new members down the path to

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[448] *Ibid*.
[449] Y Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* (PHD Thesis, The University of Edinburgh 2012) 22.
[450] *Ibid*
[451] M Schaefer "Ensuring that Regional Trade Agreements Compliment the WTO System: US Unilateralism a Supplement to WTO Initiatives?" 10(3) *JIEL* 585 at 587.
[452] J Bhagwati and A Panagariya "Preferential Trading Areas and Multilateralism: Strangers, Friends or Foes?" (1996) *Discussion Paper Series No. 9596-04* 3.
[453] *Ibid*.
[454] Bhagwati and Panagariya 1996 *Discussion paper series no. 9596-04* 5.
[455] Cho 2001 *Harv. Int'l L.J.* 429.

the creation of worldwide free trade or by promoting accelerated multilateral trade negotiations and they are "stumbling blocks" if they do the opposite.[456] These authors have concluded therefore, that "regional alignments have led to fears of fragmentation of the world economy into trading blocs in antithesis to [WTO-wide] multilateral free trade."[457] The fragmentation that has resulted from RTAs has caused a phenomenon called the "spaghetti bowl" which comprises numerous criss-crossings of RTAs and applicable tariff rates that depend on "arbitrarily-determined and often a multiplicity of sources of origin [rules]"[458]. As a result, the RTAs have caused a reduction in global welfare because the RTAs compete not only with third parties but also with other RTAs to shift the terms of trade in the bloc's favour by raising tariffs against other blocs.[459] This, they argue, has resulted in a world which is ridden with preferences and protectionism[460]. That said, this study will no longer indulge itself in this debate as that is beyond the scope of this paper.

Even though the effectiveness of regionalism in furthering the goals of the GATT and now the WTO is in doubt, the current trend is that RTAs are being formed at an increasing rate as compared to the time when Article XXIV of the GATT was adopted.[461] There are various reasons for this phenomenon. Apart from economic integration, countries join RTAs for political strategies and other non-economic reasons.[462] Countries also join RTAs because there is this common belief that RTAs are easier to negotiate than under the multilateral system.[463] This may be true if we take into consideration the period that has taken to finish the first trade negotiation round under the WTO, the Doha Round which was launched in 2001 but to date it has not been completed.[464] Some authors argue that since regionalism

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[456] Bhagwati and Panagariya 1996 *Discussion paper series no. 9596-04* 3.
[457] J Bhagwati "Departures from Multilateralism: Regionalism and Aggressive Unilateralism" (1990) 100(403) *The Economic Journal* 1304 at 1305.
[458] J Bhagwati, D Greenway and A Panagariya "Trading Preferentially: Theory and Policy" (1998) 108(449) *The Economic Journal* 1128 at 1139.
[459] Cho 2001 *Harv. Int'l L.J* 430.
[460] Bhagwati, Greenway and Panagariya 1998 *The Economic Journal* 1139.
[461]The WTO in its report of 2011 noted that as of 1st November 2010 479 RTAs of both goods and services had been notified to the GATT/WTO and out of these 288 were in force at the time; World Trade Organisation *World Trade Report 2011: The WTO and Preferential Trade Agreements; From Co-existence to Coherence* (2011) 185.
[462] MK Lewis "The Prisoners' Dilemma Posed by Free Trade Agreements: Can Open Access Provisions Provide an Escape?" (2010-2011) 11 *Chi. J. Int'l L.* 631 at 642.
[463] YN Hodu "Regionalism in the WTO and the Legal Status of Development Agenda in the EU/ACP Economic Partnership Agreement" (2009) 78 *Nordic Journal of International Law* 225 at 226.
[464] YS Lee "Regional Trade Agreements in the WTO System: Potential Issues and Solutions" (2015) 8 *J.E.Asia & Int'l L.* 353 at 366.

allows like-minded states or states with similar concerns to pursue their common interests, it is easy for this to happen.[465] The other reason that has also led to RTAs being attractive is the fact that countries can design RTAs to cover issues that go beyond what is covered under the WTO, such as investment and competition law and can also make more specific rules on issues already being covered by the WTO.[466] However, regional integration initiatives have also influenced the multilateral systems in a number of ways, for example it has influenced the establishment of rules in new areas. For instance, some authors have said that the development of rules regulating trade in services at the WTO level were influenced by progress in NAFTA and the European Union.[467]

6.3 Types of RTAs

Article XXIV of GATT defines three types of RTAs, these are; Free Trade Agreements (FTAs), Customs Unions (CUs) and an interim agreement necessary for the formation of CUs or FTAs. Article XXIV:8a of the GATT 1994 defines CUs as the substitution of a single customs territory for two or more customs territories where duties and other restrictive regulations of commerce are eliminated with respect to substantially all the trade between the constituent territories of the union (or at least with respect to substantially all the trade in products originating in such territories) and where substantially the same duties and other regulations of commerce are applied by each of the members of the union to the trade of territories not included in the union. This means countries in a CU have a Common External Tariff (CET) which they apply when they trade with third party countries. Article XXIV describes an interim agreement for the formation of an FTA or CU as a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time.[468]

An FTA is defined as a "group of two or more customs territories in which the duties and other restrictive regulations of commerce are eliminated on substantially all the trade between the constituent territories in products originating in such territories."[469] Countries

[465] Hodu 2009 *Nordic Journal of International Law* 228.
[466] A Lavi "Preferential Trade Agreements and the Law and Politics of the GATT Article XXIV" (2010) Vol. 1 No. 1 *Beijing Law Review* 7 at 8.
[467] L Cernat and S Laird "North, South, East, West: What's Best? Modern RTA's and their Implications for the Stability of Trade Policy" *Credit Research Paper NO. 03/11* 6.
[468] Article XXIV:5(c) of the GATT 1994.
[469] Article XXIV: 8(b) of the GATT 1994.

in an FTA maintain autonomous foreign economic policies vis-à-vis third countries.[470] The biggest advantage of a CU is that because members have a CET, it allows a deeper integration and allows the members to have a simplified internal border procedure (and sometimes none at all) as compared to an FTA which leaves external trade policy to individual governments and faces a problem known as trade deflection[471] or transhipment.[472] This issue of trade deflection will be dealt with in detail in chapter 7 when I will be discussing how rules of origins are used in RTAs, particularly in FTAs such as SADC to curb trade deflection.

At the core of the formation of a RTA is facilitation of trade between the constituent territories by, among other things, the reduction of barriers to the trade among contracting parties. This is in line with the global objective of both GATT 1994 and WTO which is to "increase trade by reducing (making less restrictive) tariffs and lowering of non-tariff barriers."[473] In order to satisfy Article XXIV of the GATT 1994, parties to an FTA must satisfy some conditions: among them being the elimination of duties and other restrictive regulations on substantially all trade between constituent territories originating in those territories.[474] They must also not raise duties or other restrictive regulations against non-members upon formation of the FTA.[475] Parties must agree to achieve these objectives within a reasonable time.[476] There is a further requirement of notification, where parties must notify the formation of the RTA to the WTO's Committee on Regional Trade Agreements.

6.4 Formation of RTAs

It has been explained in the introductory paragraph of this chapter that RTA members can accord preferences amongst themselves which are exclusive to the participating countries.

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[470] Z Hafez "Weak Discipline: GATT Article XXIV and the Emerging WTO Jurisprudence on RTAs" (2003) 79 *N.D.L. Rev.*879 at 886.

[471] Trade deflection or transhipment occurs when non-regional goods enter into an RTA through a member country with the lowest tariffs, undergo minor processing then are exported to other country members, thereby evading the higher duties in the other importing members.

[472] Hafez 2003 *N.D.L. Rev.* 887.

[473] Panel Report, *Turkey - Textiles* Para 9.159: This has always been goal and aspirations of the multilateral trade system, and the preamble of GATT 1947 is proof of the fact that even in the formative years of GATT it was the aspirations of the countries that were involved in its formation to reduce barriers to trade on multilateral level.

[474]CO Taylor "Of Free Trade Agreements and Models" (2009) *Ind. Int'l & Comp. L. Rev."* 569 at 578-579.

[475] Taylor 2009 *Ind. Int'l & Comp. L. Rev* 579.

[476] *Ibid*.

This exclusivity is inherently inconsistent with the MFN principle which is one of the core principles under WTO law.[477] However, it is a fact that this inconsistency is sanctioned by Article XXIV of the GATT 1994. However, to safeguard against RTAs being adopted willy-nilly by countries, the GATT requires that certain rules must be followed before an RTA can be said to be WTO consistent.

These rules regulating the formation of RTAs are found in Article XXIV of the GATT 1994 and the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994 (the 1994 Understanding). It has been stated that

> "the objective of GATT Article XXIV is to assume the role of overriding, constitutional disciplines which structure the shape and contents of the preferential agreements- all with the view to support regional integration and liberalisation while at the same time avoiding unnecessary trade distortions".[478]

It must also be acknowledged that several scholars have labelled these rules to be rather weak, and as a result not effective in regulating the operation of the RTAs. This paper will not indulge in the debate on the effectiveness of these rules as that is beyond its scope.

In general terms, as explained by the Panel in *Turkey – Textiles*, "Article XXIV recognises that, subject to certain conditions, customs unions and free-trade areas between WTO members are desirable."[479] Article XXIV:4 of the GATT 1994 sets forth the overriding and pervasive purpose for formation of RTAs which is to increase trade integration on a regional level on condition that the formation of FTAs and CUs, do not raise barriers to the trade of other contracting parties with such territories.[480] This implies that the object of RTAs is to complement the multilateral trading system by increasing trade by allowing the smooth flow of trade among the parties to the RTAs while at the same time not raising barriers to trade as a shield against other GATT/WTO prohibitions.[481]

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[477] Lee 2015 *J.E.Asia & Int'l L.* 356.
[478] Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 33.
[479] Panel Report, *Turkey — Textiles* Para 9.98.
[480] Article XXIV:4 of GATT 1994; Appellate Body Report, *Turkey – Restrictions on Imports of Textile and Clothing Products* WT/DS34/AB/R (22 October 1999) Para 57.
[481] Hafez 2003 *N.D.L. Rev.* 890.

6.4.1 External requirements of an RTA

Article XXIV:5 of the GATT 1994 provides as follows:

> "5. Accordingly, the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area or the adoption of an interim agreement necessary for the formation of a customs union or of a free-trade area; Provided that:
>
> (*a*) with respect to a customs union, or an interim agreement leading to a formation of a customs union, the duties and other regulations of commerce imposed at the institution of any such union or interim agreement in respect of trade with contracting parties not parties to such union or agreement shall not on the whole be higher or more restrictive than the general incidence of the duties and regulations of commerce applicable in the constituent territories prior to the formation of such union or the adoption of such interim agreement, as the case may be;
>
> (*b*) with respect to a free-trade area, or an interim agreement leading to the formation of a free-trade area, the duties and other regulations of commerce maintained in each of the constituent territories and applicable at the formation of such free-trade area or the adoption of such interim agreement to the trade of contracting parties not included in such area or not parties to such agreement shall not be higher or more restrictive than the corresponding duties and other regulations of commerce existing in the same constituent territories prior to the formation of the free-trade area, or interim agreement as the case may be; and
>
> (*c*) any interim agreement referred to in subparagraphs (*a*) and (*b*) shall include a plan and schedule for the formation of such a customs union or of such a free-trade area within a reasonable length of time."

The Appellate Body in *Turkey - Textiles* held that the words "shall not prevent" in the first sentence of Article XXIV:5 of the GATT 1995 means that the provisions of the GATT 1994

shall not make impossible the formation of a CU or FTA.[482] This Article justifies the adoption in the RTAs of measures that may be perceived to be contrary to the provisions of the GATT 1994.

Article XXIV: 5(a) and (b) mandates CUs and FTAs to make sure that their coming into force should not make trade with third parties more onerous compared to what it was prior to their existence. It requires that, in the case of CUs, duties and other regulations of commerce imposed after the formation of the CU should not be on the whole higher or more restrictive than the general incidence of the duties and regulation of commerce applicable in their constituent territories prior to the formation of such a union. The 1994 Understanding in interpreting Article XXIV:5a stated that the comparison of duties and other regulations of commerce applicable before and after the formation of the CU shall be based on overall assessment of weighted tariffs and rates and customs duties collected. In making the comparative analysis, the 1994 Understanding requires that this should be based on applied rates of duties and not bound ones.[483] When considering the CUs' trade with third parties, the members are considered collectively as they have a common external tariff and common trade policies in their trade with third parties.

Article XXIV:5b of the GATT 1994 relates to FTAs. Since FTA parties have no obligation to adopt CET the comparison is made on individual party basis. It requires that parties to the FTA must not, after the formation of the FTA, apply higher duties or other regulation of commerce when they are trading with third parties as compared to the situation existing prior to the formation of the FTA. This is to make sure that parties to an FTA are not using the formation of an FTA as a disguise to increase the burden of regulations to commerce they impose when trading with third parties.[484]

Article XXIV:5c provides that as contracting parties before formation of FTAs and CUs may adopt interim agreements which lead to FTAs and CUs, such an interim agreement must

[482]NJS Lockhartand AD Mitchell "Regional Trade Agreements Under GATT 1994: An Exception and its Limits" https://papers.ssrn.com/abstract=747984 (accessed 6th March 2017).
[483] Para 2 of the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994.
[484] Lockhart and Mitchell "Regional Trade Agreements Under GATT 1994: An Exception and its Limits"

include a plan and schedule for the formation of such an RTA and it must be formed within reasonable time. The 1994 Understanding, in interpreting this 'reasonable time', states that it should exceed 10 years only in exceptional cases, and where parties to the interim agreement believe that the 10 years would be insufficient for the coming into force of an RTA, then the parties to the interim agreement must provide a full explanation to the Council for Trade in Goods of the need for a longer period.[485] Therefore, in line with the overriding purpose for the formation of RTAs set out in paragraph 4 of Article XXIV, the requirement not to raise the CU's and FTA's external tariffs set out in paragraph 5 can be interpreted as a precaution against trade diversion and harm to third party countries.[486] Paragraph 5 seeks to minimise as much as possible the incidence of trade diversion.[487]

6.4.2 Internal requirements of an FTA

Article XXIV:8 of the GATT 1994 further clarifies the requirements for establishment of RTAs. This Article provides as follows:

> "8.For the purposes of this Agreement:
>
> > (*a*) A customs union shall be understood to mean the substitution of a single customs territory for two or more customs territories, so that
> >
> > (i) duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated with respect to substantially all the trade between the constituent territories of the union or at least with respect to substantially all the trade in products originating in such territories, and,
> >
> > (ii) subject to the provisions of paragraph 9, substantially the same duties and other regulations of commerce are applied

[485] Para 3 of the Understanding on the Interpretation of Article XXIV of the General Agreement on Tariffs and Trade 1994.
[486] J Bhagwati "Regionalism vs Multilateralism" (1992) 15(5) *The World Economy* 535 at 543.
[487] Bhagwati 1992 *The World Economy* 546.

by each of the members of the union to the trade of territories not included in the union;

(*b*) A free-trade area shall be understood to mean a group of two or more customs territories in which the duties and other restrictive regulations of commerce (except, where necessary, those permitted under Articles XI, XII, XIII, XIV, XV and XX) are eliminated on substantially all the trade between the constituent territories in products originating in such territories."

Article XXIV:8a of the GATT 1994 requires countries in a CU to form one customs territory, hence they have the same regulations regulating trade internally and with third parties. It means all these countries will have to adopt and apply the same regulations, duties and charges when they trade with other third countries. In other words, CUs are required to have common external tariff (CET) to be applied to all goods imported into the CU.[488]

Unlike CUs, FTAs as given in Article XXIV:8b of the GATT 1994, can maintain their original tariff rate for non-member inputs or to introduce new ones so long as they are not higher than prior to the coming into force of the FTA.[489]

6.4.2.1 "Substantially all trade"

What is common between CUs and FTAs is the requirement that both must make sure that duties and other restrictive regulations of commerce are eliminated on substantially all trade between the constituent territories in products originating in such territories.[490]

There has been much debate as to what this phrase means, and it has been subject to several interpretations that have been proposed by contracting parties and scholars. However, contracting parties have not reached a conclusive agreement as to what this phrase means. Suffice to say, this phrase dictates how much trade must be liberalised

[488]Nsour 2007-2008 *NC.J. Int'l L. & Com. Reg.* 368.
[489] *Ibid.*
[490] Article XXIV:8a & b of GATT 1994.

within an RTA setting.[491] Hence the controversy is based on how to assess the extent of this liberalisation.

The first school of thought proposes that the right approach is a quantitative one which favours employing a statistical benchmark. This approach proposes quantifying the amount of trade in a percentage that parties to an RTA must meet as a threshold for them to be deemed to have satisfied the substantially all trade requirement.[492] The other school of thought advocates for a qualitative approach which requires that "no sector (or at least no major sector) be excluded from intra-RTA trade".[493] Even though there is this difference in terms of methodology in assessing liberalisation, it is evident that the phrase seeks to "protect RTA members themselves from other members' exclusion of trade from the agreement and to protect other WTO members from claiming an exception from the MFN principle for agreements that are not really FTAs and CUs".[494]

The 1994 Understanding, in its preamble, states that members of the WTO/GATT recognise that CUs and FTAs' contribution to expansion of trade is "increased if the elimination between the constituent territories of duties and other restrictive regulations to commerce extends to all trade, and is diminished if any major sector of trade is excluded". The Appellate Body, while it did not come up with a definitive interpretation of this phrase's meaning, held that "it is clear, though, that 'substantially all the trade' is not the same as *all* the trade, and also that 'substantially all the trade' is something considerably more than merely *some* of the trade."[495] The Appellate Body agreed with the Panel's determination that this phrase includes both qualitative and quantitative approaches. The Appellate Body stated as follows:

> "We agree with the Panel that:
>
> > [t]he ordinary meaning of the term "substantially" in the context of subparagraph 8(a) appears to provide for both qualitative and quantitative

[491] Lockhart and Mitchell "Regional Trade Agreements Under GATT 1994: An Exception and its Limits".
[492] F Frost "Reconciling Regional Trade Agreements with The Most Favoured Nation Principle in WTO-GATT" (2008) 5 *Macquire J. Bus. L.* 43 at 61.
[493] *Ibid.*
[494] Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 191.
[495] Appellate Body Report, *Turkey — Textiles* Para 48.

> components. The expression "substantially the same duties and other regulations of commerce are applied by each of the Members of the [customs] union" would appear to encompass both quantitative and qualitative elements, the quantitative aspect more emphasized in relation to duties."[496]

The Appellate Body also held that since the phrase "substantially all trade" does not mean 'all trade', members of an RTA have some flexibility: they can still maintain some restrictions when it comes to internal trade in the customs union. Even though in this case they were dealing with CUs, this interpretation can also be extended to FTAs. Hence a member of an FTA still has discretion to impose some trade restrictions to goods from members of the FTA. However, the Appellate Body cautioned that the degree of "flexibility" allowed by Article XXIV:8 of the GATT 1994 is limited by the requirement that "duties and other restrictive regulations of commerce" be "eliminated with respect to substantially all" internal trade.[497] Therefore, considering the limit of the flexibility allowed under Article XXIV: 8 of the GATT, it is necessary in this study to consider whether it is relevant to regulate EPZs in SADC and COMESA or leave their operations to individual Members. This will be considered in chapter 7 and the recommendations on the same will be made in 8.

6.4.3 Necessity test

The Appellate Body in *Turkey – Textiles,*[498] however, added that for a provision to be said to have been adopted pursuant to Article XXIV of the GATT in an RTA (hence labelled as a justified Article I of the GATT inconsistency), two things must also be proved. First it must be shown that the measure was adopted at the formation of the RTA and secondly it must be shown that the measure was a necessary condition to the formation of the RTA. In other words, it was a prerequisite to the formation of the RTA without which the RTA could not be formed. This was expressed in the following terms:

> "However, in a case involving the formation of a customs union, this "defence" is available only when two conditions are fulfilled. First, the party claiming the benefit of this defence must demonstrate that the measure at issue is introduced upon the formation of a customs union that fully meets the requirements of sub-paragraphs

[496] Appellate Body Report, *Turkey — Textiles* Para 49.
[497] Appellate Body Report, *Turkey — Textiles* Para 48.
[498] Appellate Body Report, *Turkey — Textiles* Para 58.

8(a) and 5(a) of Article XXIV. And, second, that party must demonstrate that the formation of that customs union would be prevented if it were not allowed to introduce the measure at issue. Again, *both* these conditions must be met to have the benefit of the defence under Article XXIV."[499]

6.5 Limits of an RTA

Since RTAs are an exception to the MFN principle, it is necessary to investigate the limits of this exception. As alluded to above, most crucial terms in Article XXIV are not clear as they are prone to different interpretations. The Article has been criticized for being vague and being extremely elastic to such an extent that it can be stretched to undesirable limits.[500] This may result from the fact that countries seek to make the best of both worlds (multilateralism and regionalism), knowing that the WTO grants regionalism exemptions from fulfilling some rules regulating trade at multilateral level.[501]

At the centre of it all is the question as to what the limits of Article XXIV of the GATT 1994 are as far as regionalism and multilateralism are concerned. There are two divergent perspectives on the relationship between Article XXIV and the other WTO provisions. One view holds that Article XXIV should be considered as a derogation only from Article I of the GATT 1994 and that parties to the RTA must abide by all other WTO provisions.[502] The other view holds that Article XXIV of the GATT should be considered as an exception from all provisions of the WTO and not just the MFN principle.[503]

However, the opening statement of Article XXIV of the GATT 1994 gives a guide as to what its limits are. It states that the "the provisions of the agreement" shall not prevent countries from concluding RTAs. In this statement, the agreement being referred to is the GATT 1994 as a whole and not in particular Article I of the GATT 1994. Hence, the first view on the limits

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[499] *Supra*.
[500] A Saurombe "The Southern African Development Community Trade Legal Instruments Compliance with certain criteria of GATT Article XXIV" (2011) 14 *Potchefstroom Elec. L.J.* 286 http://dx.doi.org/10.4314/pelj.v14i4.10 (accessed 6th March 2017).
[501] M Oduor "Resolving Trade Disputes in Africa: Choosing between Multilateralism and Regionalism: the Case of COMESA and WTO" (2005) 13 *Tul.J.Inti'l & Comp. L.* 177 at 181.
[502] R Lear-Arcas "Proliferation of Regional Trade Agreements: Complementing or Supplanting Multilateralism?" (2010-2011) 11 *Chi. J. Int'l L.* 597 at 605.
[503] *Ibid*.

of Article XXIV cannot on that basis be in tandem with what the contracting parties, when they were framing this Article, envisaged its limits to be.

What remains to be considered is whether this Article, apart from allowing deviation from all the provisions of the GATT 1994, also allows deviations from other obligations found in other Agreements of the WTO. In other words, the question is "to what extent can WTO member states pre-emptively 'contract out' of their WTO legal obligations by making side agreements…that change the terms of their legal obligation?"[504] In this study this pertains to trade remedies, in particular subsidies and countervailing measures, and the question to be answered is, whether through the RTAs WTO members can contract out of their obligation to impose countervailing measures on each other while imposing the same on third parties. In the same way it is also crucial to assess whether the RTAs can maintain the rules regulating subsidies and countervailing measures but exclude the application of S&DT provisions within the RTAs, as would be the case for Malawi where it has entered into RTAs with other developing countries.

It is difficult to answer with certainty what is or is not feasible. This is compounded by the fact that apart from being vague, this Article since its adoption has not undergone thorough interpretation before the GATT or the WTO's dispute settlement body apart from the *Turkey - Textiles* case. The difficulty is furthered by the fact that the coming into force of the WTO brought with it several new Agreements as found in Annex I of the WTO Agreement, hence it is questionable whether Article XXIV can also modify these obligations. The 1994 Understanding did not do justice to this Article as it did not clarify or interpret the controversial parts of the Article.

However, it is crucial to consider whether the Article can be used to deviate from the WTO Agreements. This is necessary as under international law on multilateral treaties it is allowed for some parties to a multilateral agreement to form a subsequent agreement between the subset of the membership of the wider agreement in which they vary their rights and

[504] J Langile "Neither Constitution nor Contract: Understanding the WTO by Examining the Legal Limits on Contracting Out through Regional Trade Agreements" (2011) 86 *N.Y.U L. Rev.* 1482 at 1484.

obligations amongst themselves.[505] The only condition required for this to happen is that the sub-treaty parties must make sure not to abridge the rights of third parties who are parties in the principal agreement. The Vienna Convention on the Law of Treaties in Article 41 provides as follows:

> "1. Two or more of the parties to a multilateral treaty may conclude an agreement to modify the treaty as between themselves alone if:
> (a) The possibility of such a modification is provided for by the treaty; or
> *(b)* The modification in question is not prohibited by the treaty and:
> (i) Does not affect the enjoyment by the other parties of their rights under the treaty or the performance of their obligations;
> (ii) Does not relate to a provision, derogation from which is incompatible with the effective execution of the object and purpose of the treaty as a whole.
> 2. Unless in a case falling under paragraph l(a) the treaty otherwise provides, the parties in question shall notify the other parties of their intention to conclude the agreement and of the modification to the treaty for which it provides."

However, in the only case so far dealing with Article XXIV, the Appellate Body held that the chapeau of Article XXIV:5 refers only to the provisions of GATT 1994.[506] Hence under Article XXIV:5 the extension of the exception to provisions of the other WTO Agreements will depend on whether there are 'close interrelations' between the provisions and GATT 1994.[507] This is what the Appellate Body stated in its footnote 13 of the *Turkey - Textile* case:

> "We note that legal scholars have long considered Article XXIV to be an "exception" or a possible "defence" to claims of violation of GATT provisions. An early treatise on GATT law stated: "[Article XXIV] establishes an *exception to GATT obligations* for regional arrangements that meet a series of detailed and complex criteria." (emphasis added)
> [...]
> We note also the following statement in the unadopted panel report in *EEC – Member States' Import Regimes for Bananas*, DS32/R, 3 June 1993, para. 358: "The Panel noted that Article XXIV:5 to 8 permitted the contracting parties to *deviate from their obligations under other provisions of the General Agreement* for the purpose of forming a customs union ...". (emphasis added)

[505] Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 174.
[506] Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 176.
[507] Lockhart and Mitchell "Regional Trade Agreements Under GATT 1994: An Exception and its Limits".

> The chapeau of paragraph 5 refers only to the provisions of the GATT 1994. It does not refer to the provisions of the *ATC*. However, Article 2.4 of the *ATC* provides that "[n]o new restrictions... shall be introduced *except under* the provisions of this Agreement or *relevant GATT 1994 provisions*." (emphasis added)
> In this way, Article XXIV of the GATT 1994 is incorporated in the *ATC* and may be invoked as a defence to a claim of inconsistency with Article 2.4 of the *ATC*, provided that the conditions set forth in Article XXIV for the availability of this defence are met.'

The reasoning of the Appellate Body found in footnote 13 in *Turkey – Textiles* suggests that the exception does not extend automatically to all WTO provisions. In the *Turkey-Textiles* case, the extension was because Article 2.4 of the Agreement on Textiles and Clothing specifically referred to the GATT 1994.[508] Voon argues that this exception can also be applied to the Agreement on Safeguards. She argues that footnote 1 of the Agreement on Safeguards which expressly refers to Article XXIV:8 of the GATT 1994 provides an exception to the non-discrimination requirement provided in Article 2.2 of the Agreement on Safeguards, as such an RTA cannot impose Safeguard measures to Members within the RTA.[509] This does not apply to the SCM Agreement and the Anti-Dumping Agreement as both agreements do not contain provisions that expressly refer to the GATT 1994 to justify parties to an RTA to contract out of the two agreements. Therefore, this means that RTAs must contain provisions regulating subsidies and countervailing measures as provided in the SCM Agreement, and the same is true for SADC and COMESA.

The application of Article XXIV of the GATT 1994 in the way that has been interpreted by the Appellate Body would lead one to perceive this application of the provision as following some hierarchy of norms among the good obligations, with some being subject but others not.[510] However, it is a fact that in international law there is no hierarchy to be followed among treaties, except for the supremacy of the charter of the United Nations over any other international agreements.[511] Saurombe argues that RTAs are agreements that modify

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[508] Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 176.
[509] T Voon "Eliminating Trade Remedies from the WTO: Lessons from Regional Trade Agreements" (2010) 59 *Int'l & Comp. L. Q.* 625 at 658.
[510] Lockhartand Mitchell "Regional Trade Agreements Under GATT 1994: An Exception and its Limits".

[511] Saurombe "The Southern African Development Community Trade Legal Instruments Compliance with certain criteria of GATT Article XXIV"; Article 103 of the UN Charter grants supremacy to the Charter of any other Treaty it provides as follows; "In the event of a conflict between the obligations of the Members of the

the GATT 1994/WTO law. Hence, by virtue of Article 41(1) of the Vienna Convention on the Law of Treaties (the VCLT), they can only modify the GATT/WTO law to the extent permitted by the GATT/WTO. Therefore, Article 41(1) of the VCLT implies that the WTO rules are inherently higher in rank than RTAs provisions.[512]

If indeed Article XXIV of the GATT 1994 is limited in its reach, what happens in practice is contrary to the above stated theories, as there are several RTAs that have adopted provisions which deviate obligations which may not be derogated from under WTO law.[513] What is also interesting is that to date, RTAs which may be deemed to go over the board and have over stretched the application of Article XXIV of the GATT 1994 have not been dealt with by WTO Members to require their modification or been brought before the DSB for assessment of their compliance with Article XXIV[514]. Does this silence mean that the WTO has allowed them even though Article 41(1) of the VCLT provides otherwise?

6.6 Conclusion

This chapter has shown that even though the multilateral trading system is based on MFN principles, the WTO allows its members to grant preferential treatment to each other contrary to the MFN principle through the formation of RTAs. The breach of the MFN

United Nations under the present Charter and their obligations under any other international agreement, their obligations under the present Charter shall prevail."

[512] Saurombe "The Southern African Development Community Trade Legal Instruments Compliance with certain criteria of GATT Article XXIV".

[513] Some RTAs have abolished the use of countervailing duties within the RTAs, such RTAs include the Closer Economic Partnership Arrangement between China-Hong Kong (China-Hong Kong CEPA), China-Macao (China-Macao CEPA), European Communities, European Free Trade Association (EFTA), the European Economic Area (EEA); R The, TJ Prusaand M Budtta "Trade Remedy Provisions in Regional Trade Agreement" (2007*) WTO Staff Working Paper*. The same applies to anti-dumping even though the administration of the anti-measures are required to be on MFN basis per Article 9.2 of the ADA some RTAs have opted to abolish them in their RTAs, this is the case in the EFTA, EEA, EFTA-Albania FTA, EFTA-Singapore FTA, EFTA-Chile FTA, Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), Canada-Chile Free Trade Agreement (CCFTA), China-Hong Kong CEPA and China-Macao CEPA; Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 120.

[514] The expectation was that through the working parties review process under the GATT and now the notification process to the Committee on Regional Trade Agreements of WTO some of the RTAs not complying with this requirement could not be allowed to be operate without making the needed amendments and adjustments to the provisions of the RTAs. However, to date the review mechanism of the RTA both under GATT and WTO has failed to reach a consensus as to the consistency of the RTA with the provisions of Article XXIV of the GATT. Among all the RTAs notified under GATT 1947, only one case received a "clear-cut assessment of fill consistency with the rules." This was the CU formed between the Czech Republic and the Slovak Republic: Cho 2001 *Harv. Int'l L.J* 437.

principle through RTAs is allowed only if the RTAs will achieve integration at regional level which complements the multilateral trading system goal of pursuing trade liberalisation. However, the chapter has also shown that, even though RTA Members can extend preferential treatment to each other, there are limits to this as there are other trade measures that are supposed to be maintained even when trading within the RTAs. One of the measures that has to be maintained includes regulations dealing with subsidies and countervailing measures. Thus, the RTAs to which Malawi is party must contain regulations dealing with subsidies, and these regulations should pursue the goal of trade liberalisation in the region.

The following chapter will build on the foundation laid in this chapter by looking at two RTAs: SADC and COMESA, both of which Malawi is party to. The chapter will assess whether the use of EPZ schemes by Member States of the two RTAs are in tandem with the goal of attaining regional integration as set in Article XXIV:4 of the GATT 1994.

CHAPTER 7: EXPORT PROCESSING ZONES AND THE REGULATION OF SUBSIDIES IN REGIONAL TRADE AGREEMENTS: THE CASE OF SADC PROTOCOL ON TRADE & COMESA TREATY

7.1 Introduction

This chapter will consider two RTAs that Malawi is party to, SADC and COMESA, and it will assess Malawi's compliance with these preferential trade agreements. The focus of the chapter will be on the practices such as the use of EPZ schemes that some Member States of these two RTAs have adopted and assess whether this is in line with rules regulating subsidies in the RTAs. It will also determine whether the use of EPZs is in tandem with the spirit and objectives of the SADC FTA, in light of the discussion in Chapter 6 regarding FTAs at the WTO. In doing this assessment, the discussion will not only assess the EPZs against the spirit of the SADC Protocol on trade but will also determine how the same might be against some provisions of the Protocol itself.

7.2 SADC Protocol on Trade

The SADC Protocol on Trade came into effect pursuant to Article 22 of the Treaty of SADC which calls for member states to conclude protocols that may be necessary to further cooperation among the Members. The SADC Protocol on Trade, like most of the RTAs has a basic goal of reducing and eventually eliminating tariffs and non-tariff barriers to trade of goods among member states.[515]

The protocol envisages that the establishment of an FTA would be a gradual process and "would start with the suspension, followed by the prohibition, elimination or reduction of the trade barriers".[516] Hence the Protocol has provisions that provide for elimination of import and export duties, non-tariff barriers to trade and elimination of quantitative restrictions.[517] The Protocol includes a timeframe for the elimination of the barriers to trade and it is indicated that the elimination of barriers to trade had to be achieved within a time

[515] Sargent and Matthews 2001 *World Development* 1739.
[516] Ng'ong'ola 2000 *JIEL* 497.
[517] These are provided in Articles 4, 5, 6, 7 and 8 of the SADC Protocol on Trade.

frame of eight years from entry into force of this Protocol.[518] It came into force in 2000 and the SADC region was declared to be a free trade area on 17th day of August 2008.[519]

The objectives of the Protocol *inter alia* include: to liberalize intra-regional trade in goods and services on the basis of fair, mutually equitable and beneficial trade arrangements, to enhance the economic development, diversification and industrialization of the Region and most importantly, to establish a free trade area in the SADC Region.[520] The aspirations of the Protocol are that through the elimination and/or reduction of barriers to trade between the member countries of the Protocol, trade and economic well-being of the region would be enhanced. This would be the result as high cost producers within individual member states will be replaced by less expensive and more efficient producers that will be found in other member states within the trading block.[521] In furtherance of the objectives of the Protocol, SADC Member States are called upon to adopt policies and implement measures which promote an open cross-border investment regime and prohibit unfair business practices and promote competition.[522]

7.3 COMESA

COMESA was established on the 5th day of November 1993 by a treaty concluded at Kampala, Uganda.[523] Article 3 of the Treaty contains objectives of the common market. The Article provides as follows:

> "The aims and objectives of the Common Market shall be:
> (a) to attain sustainable growth and development of the Member States by promoting a more balanced and harmonious development of its production and marketing structures;

[518] Article 3(1)(b) of the SADC Protocol on Trade.
[519] M Dube *Liberalisation and Regulation of Trade in the Southern African Development Community (SADC): A Critical Analysis of the SADC Trade Protocol's Provisions and its Implementation* (LLM thesis, Rhodes University, 2008) 2.
[520] Article 2 of the SADC Protocol on Trade.
[521] "Globalisation, free trade zones and international economic insertion: Development Challenges for Latin America and the Caribbean" http://www.sela.org/media/264970/t023600005859-0-di_12-02_zonas_francas.pdf (accessed 11th September 2016).
[522] Ng'ong'ola 2000 *JIEL* 496.
[523] KK Mwenda "Legal Aspects of Regional Integration: COMESA And SADC on the Regulation of Foreign Investment in Southern and Eastern Africa" (1997) 9 *Afr.J. Int'l & Comp. L.* 324 at 352.

(b) to promote joint development in all fields of economic activity and the joint adoption of macro-economic policies and programmes to raise the standard of living of its peoples and to foster closer relations among its Member States;
(c) to co-operate in the creation of an enabling environment for foreign, cross border and domestic investment including the joint promotion of research and adaptation of science and technology for development;
(d) to co-operate in the promotion of peace, security and stability among the Member
States in order to enhance economic development in the region;
(e) to co-operate in strengthening the relations between the Common Market and the
rest of the world and the adoption of common positions in international fora; and
(f) to contribute towards the establishment, progress and the realisation of the objectives of the African Economic Community."

It can be seen from Article 3 of the COMESA Treaty that as with most African RTAs it is not merely centred around a vision of market-led integration, but it is also designed as a forum for a variety of other goals and initiatives.[524] To achieve the objectives in Article 3 of the Treaty, Article 4 of the COMESA Treaty requires member countries to fulfil several undertakings among which are undertakings dealing with trade liberalisation and customs co-operation. In terms of trade liberalisation, one of the undertakings by member states is to "establish a customs union, abolish all non-tariff barriers to trade among themselves; establish a common external tariff; co-operate in customs procedures and activities."[525] It is evident from this undertaking that, unlike SADC which is an FTA, COMESA operates like a CU.

7.4 Some Export Processing Zones legislation in SADC and COMESA Member States

EPZs have been used for quite a long time in trade. However, a majority of African countries adopted the use of EPZs in late 1990s or in 2000, and this was in part because of the success that the use of EPZs had brought to countries like Mauritius and other developing countries, particularly in Southeast Asia and Central America.[526] This, as discussed in chapter 3, was in part because African countries, like other developing nations, were embracing the change of

[524] JT Gathii "African Regional Trade Agreements as flexible Legal Regimes" (2009-2010) 35 *N.C.J. Int'l L. & Com. Reg* 571 at 593.
[525] Article 4 (1) of COMESA Treaty.
[526] S Woolfrey "Special Economic Zones and Regional Integration in Africa".

shifting from using import substitution growth strategy to export-led growth strategy.[527] African countries were adopting legislation regulating EPZs. These statutes are used to establish, operate and administer EPZs. At the core of these pieces of legislation is export promotion through provision of a conducive and enabling environment to investors with an end of turning these countries into net exporters.[528] In fact, developing countries adopt these EPZ regimes as a response to long-standing industrial inefficiencies and the concentration of their export base around a few commodities.[529] The different rules applied in these zones usually concern investment conditions, taxation and international trade and are typically intended to ensure that "the business environment in the zones is more liberal from a policy perspective and more efficient from an administrative perspective than that prevailing in the rest of the domestic economy."[530]

Most of the SADC and COMESA Member States have adopted the use of EPZs even though what differs is the nomenclature employed to describe these EPZs.[531] The operations of companies in the zones differs from the rest of the customs area in these countries and the companies found in these zones are considered to be outside the customs area. As such, the rules employed in most of these EPZs in the form of taxes and other regulations also differ as compared to those found in the rest of the areas of these countries.

However, of interest to the discussion in this chapter are the benefits/incentives which companies operating in the zones are accorded and how the goods produced in these zones are treated. As already stated above, the EPZs are established to fulfil certain policy goals of the countries, but one of the most important factors is export growth. Goods produced in these zones are intended for export. In fact, goods produced from the EPZs are most of the time not allowed to be sold in the domestic market of the country. For example, the Export Processing Zones Act for Tanzania[532] states in section 4 that one of the objects of the establishment of an EPZ is to attract and promote investment industrialization with the view

[527] Woolfrey "Special Economic Zones and Regional Integration in Africa".
[528] S Shadikhodjaev "International Regulation of Free Zones: An Analysis of Multilateral Customs and Trade Rules" (2011) 16 (2) *World Trade Review* 189 at 190.
[529] Nkhoma 2007 *Integrated Framework Policy Analysis Working Paper Series No. 7* 1.
[530] Woolfrey "Special Economic Zones and Regional Integration in Africa"
[531] While most countries use Export processing zones some countries like South Africa use the term Special Export Zones.
[532] Chapter 373 of the Laws revised edition of 2012.

to diversifying and facilitating promotion of international competitiveness.[533] This is also true for Malawi, Zimbabwe, and Kenya. It is evident from these pieces of legislation that the aim is export growth.

To attract companies to invest in these EPZs, countries, as shown in Chapter 3 in the case of Malawi, provide different concessions and privileges as incentives to these companies. The most used incentives concern taxes in the form of exemption from income tax, such as, corporate tax and withholding tax, exemptions from payment of indirect taxes such as custom duties, import duties, export duties, value added taxes among other benefits – much the same as the EPZ scheme in Malawi. As explained in chapter 3, EPZ schemes allow companies to source raw material/inputs from anywhere in the world so long as they are meant to be used in the production of export products. This means that even if these companies that operate in EPZs such as those in Malawi, source their raw materials/inputs from within SADC FTA or COMESA CU, the raw materials/inputs so imported will also be exempted from import duties and taxes. This chapter will assess whether the tax incentives in these EPZs comply with the object and purposes of COMESA and SADC.

Since most of these EPZs are established to spur growth of non-traditional export trade in these countries, some countries go even further to limit the type of goods that can be produced in these zones. For instance, in the case of Malawi the focus is on non-traditional export products. Hence, you cannot establish an EPZ that will focus on Malawi's traditional products.[534] It is normal that raw materials used in these zones are imported from other countries. Most countries in the COMESA and SADC region, except for South Africa,[535] have

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[533] Section 4 (a) of Export Processing Zones Act of Tanzania.

[534] Section 7 of Export Processing Zones Act of Malawi: EPZ firms in Malawi are not allowed to produce tobacco, tea, coffee and sugar as these are Malawi's traditional export products.

[535] Section 24 of the Special Economic Zones Act, Act No. 16 of 2014 which gives discretion to the Minister to designate any area as a special economic zone does not provide details of the benefits that are accorded to firms operating in the special economic zones suffice to say that some categories of the special economic zones are accorded the benefit of import goods duty free. Section 24(5) of Special Economic Zones defines different categories of the zones and it is from the definitions that one may construe in general the benefits. The subsection in in following terms:

> "(5) For the purposes of this section—
> *(a)* **"free port"** means a duty free area adjacent to a port of entry where imported goods may be unloaded for value-adding activities within the Special Economic Zone for storage, repackaging or processing, subject to customs procedures;
> *(b)* **"free trade zone"** means a duty free area offering storage and distribution

in their legislation provisions that explicitly exempt payment of taxes when these companies import raw materials to use in the zones. For instance, the Export Processing Zones Act of Tanzania exempts companies in the EPZ from paying customs duty, value added tax and other taxes charged on raw materials and goods of capital nature related to production in the export processing zones.[536] They are also exempted from payment of all taxes and levies imposed by local government authorities for products produced in the zones for a period of ten years.[537] These companies are further exempted from pre-shipment or destination inspection requirements.[538] Goods destined for the EPZ zones are also treated as transit cargo.[539] In Malawi, companies in EPZs as shown in chapter 3 of this study, are exempted from paying customs duty, value added tax, and other taxes on capital equipment and raw materials imported for use in the EPZ. They are also exempted from paying value added tax and excise tax on purchases of raw materials and packaging materials made in Malawi and they are exempted from paying value added tax on export produce and/or manufacture.[540]

The treatment of companies in the EPZs is different from those that operate outside the zones, as companies outside the zones when they import goods they have to pay customs, import duties and valued added tax at MFN rates and must comply with all the regulations if the goods they are purchasing are coming from third party countries. It has been shown in chapter 4 that some of the incentives in the form of tax exemptions granted to companies operating in these zones qualify as prohibited export subsidies in breach of Article 3 of the SCM Agreement. For instance, Malawi breaches Article 3.1(a) of the SCM Agreement by exempting companies in the EPZs from paying customs duties and taxes when importing capital goods to be used in the zones, and by exempting companies from paying withholding tax on dividends. Tanzania similarly breaches the Article by exempting the companies from

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facilities for value-adding activities within the Special Economic Zone for subsequent export;
(c) **"port of entry"** means a place designated as a place of entry for the control of vessels, aircraft, trains, vehicles, goods and persons entering the Republic; and
(d) **"sector development zone"** means a zone focused on the development of a specific sector or industry through the facilitation of general or specific industrial infrastructure, incentives, technical and business services primarily for the export market."

[536] Section 21(1)(b) of Export Processing Zones Act of Tanzania.
[537] Section 21(1) (e) of Export Processing Zones Act of Tanzania.
[538] Section 21(1) (f) of Export Processing Zones Act of Tanzania.
[539] Section 21(1)(j) of Export Processing Zones Act of Tanzania.
[540] Section 15(B)(1) of the Export Processing Zones Act MW: Section 9 of Value Added Tax of Malawi.

paying customs duties and taxes on importation of capital goods and machinery used in the Zones and also it exempts the companies from paying corporate tax and withholding tax on dividends for a period of 10 years.[541] Kenya also breaches Article 3.1(a) of the SCM Agreement by exempting the companies from paying customs duties and taxes on importation of capital goods, machinery, office equipment and building materials used in the Zones and also it exempts the companies from paying corporate tax and withholding tax on dividends for a period of 10 years.[542] In terms of South Africa, the companies operating in Industrial Development Zones (IDZs) established under the Special Economic Zones Act of 2014, from 1st March 2016 started paying corporate tax at a reduced rate of 15 percent instead of the 28 percent that applies to other companies.[543] However, even though some of the countries in SADC and COMESA may be deemed to be breaching the SCM Agreement, we need to consider if the rules regulating trade on a regional level allow these countries to adopt measures like EPZs which grant these incentives as is currently the case.

7.5 The EPZs and the objects of the SADC Protocol on Trade and the COMESA Treaty

7.5.1 Can EPZs be justified in SADC because of its status of being an FTA?

Chapter 4 of this study has shown that the SCM Agreement does not proscribe the use of duty drawbacks, however, the drawbacks will only become an issue if the goods exempted from paying indirect taxes exceed those that are required to be used in production of export product. In other words, the exemption is extended to imported inputs that are used in the manufacture of export products. This means that the drawbacks used in EPZs are not a problem *per se*. However, this raises some issues as to whether the EPZs are contrary to the spirit of the SADC Protocol on Trade and COMESA Treaty. To address how the use of

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[541] Section 21(1) of the Export Processing Zones Act of Tanzania.

[542] http://www.epzakenya.com/index.php/investment-information/incentives.html (accessed on 25th July 2017).

[543] South Africa Revenue Service "External Guide: Comprehensive Guide to the Income Tax Returns for Companies (ITR14)" http://www.sars.gov.za/AllDocs/OpsDocs/Guides/IT-GEN-04-G01%20-%20Comprehensive%20guide%20to%20the%20ITR14%20return%20for%20companies%20-%20External%20Guide.pdf (accessed on 6th September 2017): According to section 12R of the Income Tax Act of South Africa, the reduced corporate tax only applies to companies that were incorporated in South Africa and have their effective management in South Africa, the companies should be carrying their businesses in the special economic zones designated by Minister of Trade and Industry and 90 percent of the companies income must be derived from carrying business within the special economic zones . The companies must also make sure that not more than 20 percent of expenses incurred, or income received or accrued do not arise from transactions with any resident connected person in relation to the companies or any non-resident connected person where those transactions are attributable to a permanent establishment of that connected person(s) in South Africa.

drawbacks can affect the object of RTAs, in particular an FTA such as SADC, there is need to first address the issue of trade deflection or transhipment.

7.5.2 Trade deflection and rules of origin

As alluded in chapter 6, at the core of the establishment of an FTA is the granting of preferential rights among and between members of an FTA with the view to boosting trade and development in the trading block.[544] In theory, it is believed that the granting of preferential treatment would induce trade creation in the trading block by shifting of production from inefficient domestic producers to efficient RTA producers.[545] This would happen as countries in the FTA would capitalise on their "comparative advantage" by producing certain products more efficiently than the other countries who do not have comparative advantage on the said products and provide those products to the needy countries in exchange for a different set of products that the needy countries have comparative advantage on.[546] This system of exchange of products through trade is designed to increase prosperity in each of the Member State and increase competition within the FTA.[547] Therefore, the FTA ensures that there is free trade being practiced between members of the FTA and the economic concerns of third parties are usually not on the primary agenda of any FTA.[548] However, there is a caveat in Article XXIV:4 of GATT that requires members of an FTA to make sure that they do not raise tariff barriers when they trade with third countries.

In the case of SADC, the goal is to remove all the barriers in terms of tariffs and non-tariff barriers to trade so that goods can move from one country to another without paying duties - particularly import duties. In this case, the result would be increased intra-SADC trade as the removal of tariffs and non-tariff barriers will act as an incentive to the member states to do more trade with each other as the goods from the trading block will be less expensive, hence increasing efficiency among the member countries. However, unlike in customs unions where members have a common external tariff that they use when trading with third

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[544] Article XXIV: 4 of the GATT.
[545] Freund and Ornelus "Regional Trade Agreements" 2.
[546] BH Malkawi "Rules of Origin Under U.S. Trade Agreements with Arab Countries: Are they Helping and Hindering Free Trade?" (2010) 51(4) *Acta Juridica Hungarica* 273.
[547] Malkawi 2010 *Acta Juridica Hungarica 274.*
[548] MDR Islam "Hark! Are PTAs Swallowing up the WTO and Global Economic Welfare? A Legal and Political Economy Critique of PTAs" (2008) 12 *S.Y.B.I.L* 133 at 144.

parties, in an FTA the members are not obligated to harmonize their trade regulations with third parties. Hence countries in an FTA retain separate trade policies with third parties. This includes different MFN rates which countries use when trading with third parties. This might mean that MFN rates applied by members when they are trading with third countries may differ, with some having lower rates and some having higher rates.

Since the MFN rates differ among countries in an FTA, another problem may crop up which is known as trade deflection. This is the situation which occurs when non-regional goods enter an FTA through a member country with the lowest tariffs, undergo minor processing then are exported to other member states, thereby evading the higher duties in the importing member.[549] For instance, let's assume there is an import duty of 30 percent on product X in country A, and in country B the import duty on the same product is 10 percent. Both countries A and B are members of the same FTA, it means that if country B imports product X and then exports it to country A, product X will be sold free of import duty if sold between the two countries since both countries are members of the same FTA. However, in this case it also means that the importer of X in country A will have bought the product at a much lower cost than the cost he could have paid had he bought the raw material directly from the third party because there is a higher import duty in country A as compared to country B, all things being equal. This in a way would mean that an FTA has allowed the circumvention of MFN rates that country A charges when it trades with third parties. This is called direct deflection.[550]

There may also be cases where goods from third parties would be imported by a low tariff country then undergo a minimal transformation for example repackaging and then be sold duty free to another member of an FTA with the higher MFN rates. This is called indirect deflection. Trade deflection would happen if third parties are the reliable sources of the raw material and product in question. However, since an FTA does not exist to prevent trade with external suppliers but to encourage and boost trade among members, a high rate of trade deflection might in a way defeat the object of an FTA.

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[549] R Abbott "The Caribbean Free Trade" (1969) 1 *LAW. AM* 24 at 32.

[550] A Rogmann "The Trans-Tasman Single Economic Market: Best Practice for Regional Integration?" (2013) 16 *Int'l Trade & Bus. L. Rev* 1 at 77.

7.5.3 Rules of Origin

To eliminate trade distortion that comes through trade deflection, non-regional inputs or products must be subjected to external tariffs using MFN rates before they are processed and turned into regional goods under the terms of an FTA.[551] One way of curbing this practice of trade deflection is through the use of rules of origin. Rules of origin are used to stipulate whether a good is deemed to originate in an FTA partner country and consequently eligible for preferential treatment.[552] The purpose of the rules is to prevent unwittingly extending to non-members tariff benefits accorded to members in an FTA.[553] The theoretical understanding is that the rules of origin would promote regional development by urging producers in the FTA to source inputs from within the region.[554]

The rules of origin are a major factor in determining whether preferential trade agreements achieve their objectives. The SADC Protocol on Trade has rules of origin annexed to the Protocol that distinguish between goods that are produced within the SADC Member States and are entitled to preferential tariff treatment and those that are considered to have been produced outside the SADC region that attract full import duties when traded. These rules are vital as they ensure that only goods originating in participating countries enjoy such preferences.[555] The rules specify the necessary conditions for goods to be considered to have been originating in a qualifying member country.[556] The rules of origin do not prohibit members from importing raw materials from third parties, but they require that the importing country should transform the raw materials so imported in order for them to be deemed products originating from SADC and hence enjoy the preferential tariff rates which apply to products from SADC Member States.

However, since members in an FTA can maintain their own trade policies there might be a danger that an FTA might adopt rules of origin that go beyond their objective of making sure that trade deflection does not occur. It has been increasingly argued that rules of origin can be and are often employed to achieve objectives other than identifying the nationality of a

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[551] Sargent and Matthews 2001 *World Development* 1741.
[552] H Mabrouk "Rules of Origin as International Trade Hindrances" (2010) 5 *Entrepreneurial Bus. L.J.* 97 at 102.
[553] Abbot 1969 *The Caribbean Free Trade* 30.
[554] E Mukucha *The Regulation and Impact of Non-Tariff Barriers to Trade in SADC Free Trade Area* (LLM thesis University of Pretoria 2011) 25.
[555] P Brenton, F Flatters and P Kalenga "Rules of Origin and SADC: The Case for Change in the Mid Term Review of the Trade Protocol" (2005) *Africa Region Working Paper Series No. 83* 1.
[556] Brenton, Flatters and Kalenga 2005 *Africa Region Working Paper Series No. 83* 2.

product.[557] Restrictive rules of origin might be used as a tool for furthering protectionist agendas which might be contrary to the goal of GATT and the WTO in allowing countries to form the RTAs. However, it is also a fact that if lax rules of origin are imposed in an FTA, trade deflection could occur.[558]

Nonetheless, the objectives of an FTA will not be achieved by only having the rules of origin in place, but rather it will only be achieved if the rules are dutifully implemented by the customs officials in the Member countries.[559] This requires that the rules should be clear, simple and unambiguous and easy to enforce. These rules should not be infested with undue regard to technicalities which might also increase the burden on the customs officials and increase costs to the traders.

There are different ways in which a product is determined to be a product from the SADC region per the rules of origin. A good will be deemed to have originated in SADC if the good has been consigned directly from a Member state to a consignee in another Member State and the good meets the criteria provided in Rule 2 SADC Rules of Origin. In this case the good must, be wholly produced or obtained from a Member State. However, even if the good is not wholly obtained in SADC it will be deemed as originating in SADC if the non-originating materials used to produce the product have undergone sufficient working or process in one or more Member States such that they have been transformed. There will also be transformation and hence a good will be accepted as originating in SADC if there has been a change in the tariff heading of a product arising from processing carried out on the non- originating materials. This means the final tariff heading of the product made from the non-originating materials will be different from the tariff heading the materials themselves had when they were being imported from a third country.

However, even though the SADC Protocol on Trade contains these rules of origin, there are trade practices which member states have adopted in the region which might in a way also encourage trade deflection and increase the failure of achieving the object behind the formation of the SADC free trade area, for instance, the duty drawbacks in EPZ schemes.

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[557] Brenton, Flatters and Kalenga "Rules of Origin and SADC" 1.
[558] H Mabrouk *Would Harmonizing Preferential Rules of Origin Aid Trade Liberalization?* (LLM thesis University of Dundee 2014) 19.
[559] *Ibid*.

7.6 EPZs and their compatibility with RTAs

Even though both aim at growth of trade, EPZs and RTAs may be driven by somewhat inconsistent economic rationales.[560] At the core of an RTA is the granting of preferential rights to member countries that are part of the RTA. EPZs on the other hand are outward looking as they focus on exports and the firms import production inputs are duty free from any part of the world. Therefore, it is necessary to analyse whether this near universal EPZ benefit can be used as a tool enabling firms to avoid paying duties on their non-regional imports contrary to the purpose of the RTAs.[561]

Since SADC is an FTA which leaves it to each country to adopt its own trade regulation with third countries, it can be argued that there is no problem with having Member States adopting the use of EPZs in trying to attract investors who will focus on products meant for export. But the same cannot be said of COMESA which requires the CU to have a CET and in the case of duty drawbacks it can be argued that the COMESA Treaty has already provided a way to curb their use. Article 59 of the COMESA Treaty provides that Member states may refuse to accept eligible goods which have benefited from duty drawback schemes. This Article provides as follows:

> "The Member States may, at the end of the ten years specified in Article 45 of this Treaty, refuse to accept as eligible for Common Market tariff treatment goods in relation to which drawback is claimed or made use of in connection with their exportation from the Member States in the territory of which the goods have undergone the last process of production."

However, even though COMESA has this provision, (which does not impose an obligation on the member states) there is need to consider the spirit and object of the two RTAs and the rules regulating trade to conclude that indeed the EPZs are in tandem with their goal.

7.7 EPZs incentives and spirit of SADC Protocol on Trade

Article 28 of the SADC Protocol on Trade allows member states to grant or maintain preferential trade arrangements with third countries, provided such trade arrangement do not impede or frustrate the objectives of the Protocol.[562] Even though this article states that

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[560] Sargent and Matthews 2001 *World Development* 1739.
[561] *Ibid.*
[562] Article 28(2) of the SADC Protocol on Trade.

it is permissible to maintain preferential trade with third countries, the same cannot be done willy-nilly. Each country granting preferential rights to third countries has an obligation of making sure that this does not impede the attainment of the objectives of the protocol. Hence member states cannot grant preferential treatment to third countries at the expense of the FTA as that would be contrary to the object of the Protocol - part of which is the pursuance of inter-jurisdictional goal of cooperation in attainment of free trade among its members.

It would be better to investigate whether the duty-free importation enjoyed by companies in the EPZs would pass the standard that is required in Article 28(2) of the Protocol. This practice of granting duty deferrals/ drawbacks to EPZ firms cannot pass the test of Article 28(2) of the SADC Protocol on Trade as they frustrate what is at the core of the formation of a free trade area. Article XXIV of the GATT 1994 proscribes coming up with restrictive regulations to commerce when trading with third parties after coming into force of the FTA. However, it does not require the FTA to grant preferential treatment to third parties. This is why Article XXIV of the GATT allows countries to breach the MFN principle with the aim of achieving regional integration which may also mean allowing countries in an FTA to come up with restrictive rules of origin as the success of an FTA hinges on the discrimination which is manifested through the lowering of tariffs and non-tariff barriers to trade to only countries in an FTA.[563] The duty drawback provided in EPZ schemes allows imports from third parties to be treated preferentially similar to imports from Members of the FTA as there is no payment of duties and taxes. If the purpose of the FTA is to increase trade among the Members and one of the incentives (in a way it is a sacrifice as most of the developing countries depend on taxes) is the non-payment of customs tariffs and taxes, it is not logical to have the same treatment apply to imports from third parties as there will be no need to source them from among the FTA members.

It should be remembered that goods that are imported from third parties to customs areas of the SADC Member States having EPZ schemes are subjected to normal treatment which includes payment of duties and taxes at MFN rates. These goods that are imported into the customs area are subjected to rules of origin imposed by the SADC Protocol on Trade if

[563]KL McCall "What is Asia Afraid of? The Diversionary Effect of NAFTA's Rules of Origin on Trade Between the United States and Asia" (1994-1995) 25 *Cal. W. Inti'l L.J. 389 at 391.*

traded in the FTA. It would be difficult to justify why countries which have chosen to be in an FTA, in this case SADC, should accord preferential treatment like the ones granted among themselves to third countries at the expense of the dictates of both the FTA and the multilateral trading system.

Basically, if trade between members of SADC is preferential trade, the expectation would be that the trade between non-members and a member of SADC should be conducted on MFN principles which would also include the imposition of import and export duties. This is the simple interpretation of the concept of free trade. The free trade is among members and not between members and non-members. This is also the situation that persists if we consider how companies outside the EPZs in the SADC member states conduct trade with third countries.

It cannot be argued that the effects of the EPZs can be cured using rules of origin as even though there are rules of origin, these rules do not achieve total elimination of trade deflection. This is because, unlike CUs and FTAs that require goods to be originating to be accorded preferential treatment, EPZs only require that the goods being imported be used in production of export products before the goods can be exempted from indirect duties and taxes on their importation. This means that, goods even though not originating, can still be accorded preferential treatment like the one extended to originating goods in a CU or FTA through EPZs. For instance, Rule 3 of SADC Rules of Origin provides that some processes such as mere packing, repacking, including bottling, placing in flasks, bags, cases and boxes, fixing on cards or boards and all other simple packing operations are insufficient to support a claim that goods originate in a Member State.[564]

However, the operations of the EPZs schemes may compromise the effect of Rule 3 of SADC Rules of Origin, since the incentives that are granted to imported goods are granted solely on one condition; whether the goods will be used in the production process of export product. For instance, assuming there is a company in country A, which is a Member State of SADC FTA, that has capacity to import chemicals in bulk from Europe at a lower cost than they can be manufactured in SADC region, this company then supplies these chemicals to other companies who use them in their industries. Let us further assume that one of the

[564] Rule 3 (1) of SADC Rules of Origin.

companies that buys these chemicals from this big company is found in country B, which is also a member of SADC FTA. All things being equal, the company in country B is supposed to pay duties and taxes (indirect taxes) when importing the chemicals from country A, as what the big company in country A does, is to re-package the chemicals into small units/amounts and that does not suffice to designate the chemicals as originating. However, if the importing company in country B is an EPZ company and it is importing the chemicals for its use in production of export products in the EPZ, it will be exempted from paying the import duties and taxes. In this scenario, the chemicals will be accorded similar treatment befitting an originating good from the FTA even though it is not. This means the operation of the EPZs has allowed the importing company to defeat the purpose of having Rule 3 of SADC Rules of Origin. This would be even worse if the company that imports the chemicals form Europe in country A is also operating in an EPZ and imports the chemicals to be used for production of export products as it will mean that the chemicals would be imported free of duty from Europe.

This also mean that EPZ firms can import non-regional inputs and use them to produce products that have sufficient regional content to qualify under SADC rules of origin and no duties will be collected on non-regional inputs if the produced goods are sold in the SADC regional market. This is even worse because unlike the situation where these non-regional inputs have been bought on a lower MFN rate as is usually the case with the rest of the customs area, EPZ firms will import them with zero customs and import duty. Furthermore, when it comes to EPZs, the use of imported raw materials will likely be preferred as these would not be bound by the same rules of origin as regionally-produced materials. It follows therefore, that when tariff barriers are reduced or eliminated as in the case of RTAs such as the SADC FTA, some concomitant elimination of duty drawbacks as provided in the EPZs schemes is required as their continuation would distort trade and affect attainment of the objects of the FTA.[565]

7.8 How strict Rules of Origin affect preferential trade

The use of these EPZs complicates the fight against trade deflection and makes the smooth movement of goods among member countries come at a high cost as exporters and

[565] D Stevens "The Canada – United States Free Trade Agreement: An Analysis of its main Provisions" (1989) Int'Bus. *L.J.* 918 at 928.

importers must meet stringent rules of origin for their goods to qualify as originating in the Area. In a way, the application of stringent rules of origin may frustrate the achievement of the goals of the FTA as too many bottlenecks would make traders prefer to pay MFN tariffs than trade preferentially because of the work and cost associated to meet the standards of the rules of origin. If this happens, the trade agreement becomes a trade barrier as exporters and importers decide to forgo the benefit associated with the agreement to avoid incurring costly administrative requirements.[566]

There is also need that we consider the EPZs in terms of the kind of rules of origin that are found in SADC. Studies that have so far been conducted by different authors and researchers have shown that by international standards the SADC rules of origin are relatively complex and restrictive.[567] The studies have also shown that the rules of origin initially "agreed by SADC were simple, general and consistent with those in other developing country PTAs, including COMESA."[568] However, even before these simple rules could be developed, Member states reviewed and strengthened them to the point where they have now been adjudged to be complex. Some of the reasons that had been advanced for the change of the rules were that strict rules of origin would promote regional integration by encouraging producers to source raw and intermediate materials from within the SADC region and that these strict rules of origin would prevent trade deflection.[569]

Hence, apart from the general rules that the Protocol has, there are now rules that are specific to different sectors that vary widely across chapters, headings and subheadings.[570] For instance, in the textile and apparel industry in SADC (as compared to COMESA), there are specialised rules of origin (the double stage transformation) that have been adjudged to be very restrictive in a region which does not produce all the required raw materials to meet

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[566] TT Shimazaki "North American Free Trade Agreement! Rules of Origin – Free Trade or Trade Barrier?" (1997) 25(1) *Western State University Law Review* 1 at 27.
[567] Brenton, Flattersand Kalenga 2005 *Africa Region Working Paper Series No. 83* 13.
[568] F Flatters "SADC Rules of Origin: Undermining Regional Free Trade" http://www.academia.edu/20587346/SADC_Rules_of_Origin_Undermining_Regional_Free_Trade (accessed 9th October 2016).
[569] T Iwanow "Technical Report: SADC Rules of Origin in Textiles and Apparel: Review and Policy Options" http://satradehub.org/images/stories/downloads/pdf/technical_reports/roo%20paper.pdf (accessed 9th October 2016).
[570] Brenton, Flatters and Kalenga 2005 *Africa Region Working Paper Series No. 83* 17.

the standards as set by these rules of origin.[571] These rules requiring substantial transformation (such as the double stage transformation) have been found to be problematic because they are subjective as they have to be determined on by case to case basis by the customs authorities of the importing country who determine whether indeed the product has been substantially transformed to be deemed originating.[572] This process may be complicated and may impose potentially high transaction costs to importers because all components, ingredients or inputs used in a manufacturing process will need to have their origin traced and documented.[573] As stated above, this causes importers and exporters to end up forgoing benefits of trading preferentially under the FTA. For example, it has been reported that Woolworths does not use SADC preferences at all in sending regionally produced consignment of food and clothing to its franchise stores in non-SACU SADC markets, instead it simply pays full tariffs because it currently deems the process of administering rules of origin documentation to be too costly.[574] In his research, Gillson also noted that Shoprite spends US$5.8 million per year in dealing with red tape measures such as filing certificates and obtaining import permits to secure US$13.6 million in duty savings under SADC.[575]

This chapter, while not commenting on the appropriateness of having strict rules of origin (as that is beyond its ambit) would find it hard to justify why countries that have decided to have strict rules of origin with the aim of preventing trade deflection would then allow some countries to retain policies such as the use of EPZs. The current state of affairs shows that the aspirations of SADC as a trading block are to encourage intra-regional trade and prevent deflection through strict rules of origin. However, Member States are somehow acting contrary to this as the existence of the EPZ legislation in their current form negates the efforts of the Protocol as the EPZs may end up escalating the evil that these strict rules of origin try to curb.

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[571] Iwanow "Technical Report: SADC Rules of Origin in Textiles and Apparel". COMESA, do not have specific rules of origin for textiles and apparel and apply general rules to all manufacturing sectors.
[572] Malkawi 2010 *Acta Juridica Hungarica* 279.
[573] *Ibid*.
[574] I Gillson "Deepening Regional Integration to Eliminate the Fragmented Goods Market in Southern Africa" (2010) *Africa Trade Policy Notes Note # 9*.
[575] *Ibid*.

This practice would also not be justified under the Protocol, as even though Article 28 of the Protocol allows according preferential treatment to third countries, there is another obligation that is placed on the members in Article 29 of the Protocol. The Protocol in Article 29 requires member states to their best endeavour to coordinate their trade policies in respect of relations with third countries to facilitate and accelerate the achievement of the objectives of the Protocol. The adoption of policies which encourage the use of EPZs and the enactment of attendant legislation by SADC member countries which has these duty deferrals and duty drawbacks provisions cannot be justified under this best endeavour principle. What these countries are doing is not coordinating their policies to achieve SADC objectives but rather they counter the attainment of the same as they are encouraging trade deflection through the operation of firms in the EPZs. It is also clear from the discussion above that the use of EPZs in the two RTAs and the more restrictive rules of origin as found in SADC makes the goal of trade liberalisation intended for RTAs in terms of the WTO somewhat unlikely. This is because EPZs encourage deflection while the rules of origin in SADC affects smooth flow of goods and makes preferential trade more costly.

7.9 Rules regulating subsidies in SADC and COMESA

Since some of the incentives granted to companies in EPZs have been deemed to breach the SCM Agreement as they have been construed to be prohibited export subsidies aimed at companies that produce goods intended for export only, it is necessary to consider the rules regulating subsidies in the two RTAs in consideration in this chapter.

7.9.1 Subsidies regulation in SADC

When examining most of the provisions under the SADC Protocol on Trade, it is revealed that there seems to be a close connection between the rules set under the Protocol and rules being found in the WTO Agreement, and there are even situations when the Protocol has just adopted on an "as is" basis the WTO rules.[576] This is also the situation when it comes to regulation of subsidies. Article 19 of the SADC Protocol on Trade is the one that regulates subsidies. It provides as follows:

[576] HK Mutai "Regional Trade Integration Strategies Under SADC and the EAC: A Comparative Analysis" (2011) Vol 1 *SADC Law Journal* 81 at 84.

'1. Member States shall not grant subsidies which distort or threaten to distort competition in the Region.
2. Notwithstanding paragraph 1 of this Article, a Member State may continue to apply a subsidy in accordance with Article III.[577]
3. A Member State may, for the purposes of offsetting the effects of subsidies and subject to WTO provisions, levy countervailing duties on a product of another Member State.
4. Notwithstanding the provisions of paragraph 1 of this Article, a Member State may introduce a new subsidy only in accordance with WTO provisions.'

The definition of what is a subsidy in the Protocol is found in Article 1 and it provides that subsidies in the Protocol have the "same meaning and interpretation as in the WTO Agreement on Subsidies and Countervailing Measures"[578]. However, it is not clear whether this adoption of the definition of subsidy under the SCM Agreement also means that all the concessions and privileges provided under the SCM Agreement should also be acknowledged in intra-SADC trade.[579] It is also not clear whether the subsidy regulation under SADC adopts all the regulations under the SCM Agreement apart from the definitions found in Article 1 of the SCM Agreement, for example the classification of subsidies into

[577] According to Article 3 of the Protocol, Members states are allowed to maintain some trade measures that may be considered against the objectives and spirit of the Protocol (such as subsidies that distort trade) until it is determined by the Committee of Ministers that the administration of such trade measures must stop. This is because Article 3 encourages phased elimination of tariffs and non-tariff barriers. However, it should be noted that this scenario can no longer exist as the SADC FTA is now in full force. Article 3 of SADC Protocol on trade provides as follows:

"1. The process and modalities for the phased elimination of tariffs and non-tariff barriers shall be determined by the Committee of Ministers responsible for trade matters (CMT) having due regard to the following:
(a) The existing preferential trade arrangements between and among the Member States.
(b) That the elimination of barriers to trade shall be achieved within a time frame of eight (8) years from entry into force of this Protocol.
(c) That Member States which consider they may be or have been adversely affected, by removal of tariffs and non-tariff barriers (NTBs) to trade may, upon application to CMT, be granted a grace period to afford them additional time for the elimination of tariffs and (NTBs). CMT shall elaborate appropriate criteria for the consideration of such applications.
(d) That different tariff lines may be applied within the agreed time frame for different products, in the process of eliminating tariffs and NTBs.
(e) The process and the method of eliminating barriers to intra-SADC trade, and the criteria of listing products for special consideration, shall be negotiated in the context of the Trade Negotiating forum (TNF).
2. The agreed process and modalities for eliminating barriers to intra-SADC trade shall upon adoption, be deemed to form an integral part."

[578] Article 1 of SADC Protocol on Trade.

[579] C Ng'ong'ola "The Reconstruction of the Southern African Development Community: Some International Trade Law Perspectives" (2000) 117 *SALJ* 256 at 279.

actionable and prohibited subsidies and the obligations accompanying such classification and also S&DT accorded to developing countries under Article 27 of the SCM Agreement

7.9.2 Subsidies regulation in COMESA

In terms of the COMESA Treaty, being guided by the undertakings which aim at achieving economic integration and cooperation, Member States agreed that any practice which negates the objectives of free and liberalised trade shall be prohibited.[580] Under the multilateral trading system one such practice is the granting of subsidies. Under COMESA, subsidies are regulated by Article 52 of the Treaty. The first two paragraphs of this article regulate the use of subsidies by Member States of COMESA. They provide as follows:

> "1. Except as otherwise provided in this Treaty, any subsidy 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 the Member States, be incompatible with the Common Market.
>
> 2. A Member State may, for the purposes of offsetting the effects of subsidies and subject to regulations made by the Council, levy countervailing duty on any product of any Member State imported into another Member State equal to the amount of the estimated subsidy determined to have been granted directly or indirectly, on the manufacture, production or export of such product in the country of origin or exportation."

The COMESA Treaty differs from the SADC Protocol on Trade in that the latter defines what a subsidy is by stating that it will have the definition as provided under WTO law while the COMESA Treaty does not define it, nor does it relate it to the SCM Agreement. Even though such is the case, it can be seen from the quoted Article that the substantive obligation of states regarding subsidies and countervailing duties are the same.[581] However, under the COMESA Treaty subsidies are not differentiated into export and import substitution subsidies as is the case under the SCM Agreement.[582]

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[580] Mwenda 1997 *Afr.J. Int'l & Comp. L.* 330; Article 55 of COMESA Treaty.
[581] Oduor 2005 *Tul.J.Inti'l & Comp. L.* 195.
[582] *Ibid*.

7.10 EPZs incentives and the regulation of subsidies in SADC and COMESA

Most of the incentives that are granted to companies operating in EPZs in Malawi are contrary to rules regulating subsidies within the realm of multilateral trading system as found in the SCM Agreement as explained in paragraphs above. Nevertheless, chapter 4 of this research has shown that there are exceptions that are extended to countries like Malawi which are least developed when it comes to export subsidies as provided in the SCM Agreement. It remains to be seen whether provisions of the Export Processing Zones Act of Malawi are in tandem with its expectations as a Member State of COMESA and SADC.

The COMESA Treaty, unlike the SADC Protocol on Trade which adopts the definition of a subsidy under the SCM Agreement, does not differentiate between export and import substitution subsidies. It states that 'any subsidy granted' which distorts competition is incompatible with the common market. The lack of a definition in the COMESA Treaty is problematic as it would be difficult to identify a measure as being a subsidy by COMESA standards. Even though the Treaty does not define what a subsidy is, it can be construed that the subsidies being incompatible with the Treaty have the same meaning as the one found in Article 1 of the SCM Agreement. This is because it is the SCM Agreement that regulates subsidies under the multilateral trading system and, COMESA being an RTA which was formed under GATT 1994 which regulates RTAs in the WTO, it is proper for it to adopt the definition provided under the SCM Agreement. This is also clear as the Treaty has adopted the WTO provisions in some articles of the Treaty.[583]

However, even if we construe that the meaning of a subsidy is the same as that in the SCM Agreement, the COMESA Treaty does not differentiate between actionable and prohibited subsidies as is the case under the SCM Agreement. This would mean that every trade measure that fits the definition of a subsidy may be subjected to countervailing measures. In addition to this, as discussed in chapter 5 of this study, in terms of the SCM Agreement, developing countries are accorded S&DT as Members of the WTO acknowledge that subsidies may be a crucial tool in pursuance of economic development. Under the SCM Agreement, prohibition of export subsidies does not apply to LDCs and developing countries

[583] For instance, the Treaty has adopted the Most Favoured Nation Principle in its Article 56 and the National Treatment Principle in its Article 57 of the Treaty.

whose GNP per capita is less than US$1000. Considering that COMESA is composed exclusively of developing countries and a number of them are LDCs, the regulation of subsidies in their current form creates a dilemma as to how this issue of S&DT should be handled at regional level. For instance, countries which are LDCs and have EPZ Schemes such as Malawi would be justified to use the same even if they employ incentives which might be deemed to be prohibited subsidies as they are covered by the exemption under the SCM Agreement at the multilateral level. However, at regional level they may be acting contrary to the dictates of the COMESA Treaty and hence the incentives in the EPZs may be found to be subsidies contrary to Article 52 of the COMESA Treaty which regulates subsidies.[584]

The SADC Protocol on Trade provides that member states shall not grant subsidies which distort or threaten to distort competition in the region.[585] In defining subsidies as stated above it adopted the definition as found in the SCM Agreement and further states that introduction of a new subsidy by a member state can only happen if it is done in accordance with WTO provisions which in this case would still be the SCM Agreement.[586] It is not clear however whether the reference to WTO provisions also extends to provisions dealing with the special and differential treatment accorded to developing countries in the SCM Agreement.

The question that must be considered is whether these concessions and privileges should also be acknowledged in the Protocol.[587] If the answer is in the negative it means the concessions are not available in the Protocol and that will mean incentives in the Export Processing Zones Act deemed prohibited export subsidies in chapter 4 of this study are not in tandem with Article 19.1 of the SADC Protocol.

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[584] Even though the COMESA Treaty has provisions dealing with LDCs in its chapter 22, that's from Article 144 to Article 150. These provisions do not regulate subsidies and cannot be stretched to encompass the S&DT granted to developing and LDCs in the SCM Agreement considering the fact that the Treaty does not adopt the regulation of subsidies under the SCM Agreement.

[585] Article 19(1) of SADC Protocol on Trade.

[586] Article 19(4) of the SADC Protocol on Trade.

[587] Ng'ong'ola 2000 *SALJ* 279.

However, under the Protocol there is a uniform application of rules across membership except where expressly stated.[588] It is doubtful whether in this case we can construe that the variation permitted under the SCM Agreement is warranted under the protocol. It must be noted that the varying levels of development among the SADC membership is only reflected in the tariff phase down strategy.[589] This strategy recognised that SADC Member States were at varying degrees of economic development hence all of them could not be expected to reduce the customs duties at the same time. In terms of tariffs the actual phase-down are/were asymmetrical.[590]

Therefore, for the purposes of implementation of the tariff phase down programme, when the SADC Protocol on Trade came into force in 2001, Member States were divided into three categories; Category I, Southern African Customs Union (SACU) members; Category II, non-SACU members qualifying as developing countries, in this group were Mauritius and Zimbabwe; and Category III, the non- SACU members qualifying as least-developed countries which include Angola, Mozambique, Democratic Republic of Congo, Madagascar, Malawi, Tanzania and Zambia.[591] The countries in category I were expected to be the first in achieving the required threshold for tariff reduction and had to do this by year five of the implementation of the strategy which was in 2005; category II countries were to reach the threshold by year seven or eight of implementation, that was by 2007-2008 and category III countries were expected to reach the threshold after year 8 but not exceed year 12 of the implementation of the strategy, thus not beyond 2012.[592] Since it has not been expressly stated when dealing with subsidies, then it would be safe to conclude that this is not what the member states had intended to be the case when they were referring to the WTO provisions.

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[588] Dube *Liberalisation and Regulation of Trade in the Southern African Development Community (SADC): A Critical Analysis of the SADC Trade Protocol's Provisions and its Implementation* 73.
[589] *Ibid*.
[590] D Swanepoel An Analysis of Regional Integration Issues in Africa, Focusing on SADC-COMESA-EAC Tripartite FTA http://www.tralac.org/wp-content/blogs.dir/12/files/2011/uploads/Swanepoel_Final_20110620_edu.pdf (accessed 3rd June 2017).
[591] Ng'ong'ola 2000 *JIEL* 498; "Implementation of SADC Trade Protocol on Track" *SADC New Features SANF 08 No 52* August 2008, https://www.sardc.net/en/southern-african-news-features/implementation-of-sadc-trade-protocol-on-track/ (accessed 3rd September 2017).
[592] "Implementation of SADC Trade Protocol on Track" *SADC New Features SANF 08 No 52.*

However, as discussed in chapter 6 of this study, the way trade remedy measures such as anti-dumping duties, countervailing duties and safeguards are treated do vary from one RTA to another. This is mainly because there are different interpretations of Article XXIV of the GATT 1994. Since there is no conclusive interpretation of Article XXIV of the GATT 1994 which governs the principles regulating the relations between the WTO regime and RTAs (in particular on how to treat trade remedy measures) it has led to a situation where there are discrepancies in the way they are treated.[593] The diversity in the treatment of trade remedy measures include abolition of the measures in some RTAs, strengthening disciplines for imposition in RTAs and in some mere reference to WTO Agreements.[594] However, it was argued in chapter six, that as far as subsidies are concerned WTO Members cannot contract out of the SCM Agreement by concluding RTAs that regulate subsidies differently as compared to the SCM Agreement.

From the brief description of the two RTAs above it may be observed that regulation of subsidies in SADC and COMESA even though on paper seem to be strong in that they do not allow the use of subsidies, they are full of ambiguities as they employ terms which are vague. Not only that, the other weakness of the rules comes in the way these regulations are implemented or the inaction by the members of these RTAs when it comes to making sure that they implement them. This is evident from the continued adoption of measures such as EPZs in which parties to SADC and COMESA continue to do, breaching subsidies regulations as provided in the two RTAs through the granting of incentives that are subsidies in nature.

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[593] N Sagara "Provisions for Trade Remedy Measures (Anti-dumping, Countervailing and Safeguard Measures) in Preferential Trade Agreements" (2002) RIETI Discussions Paper Series 32.

[594] *Ibid*; The SCM Agreement prohibits export subsidies and imports substitution subsidies meaning whenever a country is found to be granting these subsidies, countervailing measures must be imposed but some RTAs have abolished countervailing duties among these RTAs are the Closer Economic Partnership Arrangement between China-Hong Kong (China-Hong Kong CEPA), China-Macao (China-Macao CEPA), European Communities, European Free Trade Association (EFTA), the European Economic Area (EEA); R The, TJ Prusa and M Budtta "Trade Remedy Provisions in Regional Trade Agreement" (2007) *WTO Staff Working Paper*. The same applies to anti-dumping even though the administration of the anti-measures are required to be on MFN basis per Article 9.2 of the ADA some RTAs have opted to abolish them in their RTAs, this is the case in the EFTA, EEA, EFTA-Albania FTA, EFTA-Singapore FTA, EFTA-Chile FTA, Australia-New Zealand Closer Economic Relations Trade Agreement (ANZCERTA), Canada-Chile Free Trade Agreement (CCFTA), China-Hong Kong CEPA and China-Macao CEPA; Huang *Trade Remedy Measures in the WTO and Regional Trade Agreements* 120.

Perhaps from a pragmatic point of view, since all countries in SADC and COMESA are developing countries and a number of them are LDCs, it would not be practical to expect them not to employ EPZs which became popular since their success in Asian countries. Then perhaps these two RTAs have a choice to make of whether or not to include the provisions dealing with S&DT, as is the case in the SCM Agreement. But as things stand, the use of the EPZ is seen to be contrary to the regulation of subsidies in the two RTAs and not in line with their goal of coordinating policies within the two RTAS.

It is also interesting that most of these countries, instead of bringing their trade policies in line with what is provided under the SADC Protocol on Trade or COMESA Treaty, the countries are doing the opposite. The discussion above on EPZs is a manifestation that Member States in the two RTAs are deliberately opting for unilateral liberalisation approaches and this reflects negatively on their official commitment to regional approaches to the challenges facing the trading blocs as allowed under Article XXIV of the GATT 1994.[595] For instance, even though Malawi enacted its piece of legislation in 1995, when it was amending the Act in 2013 (as a member of SADC and COMESA), the incentives which are contrary to subsidies regulations were retained. The same is the case with Tanzania which in its revised Export Processing Zones Act of 2012 the import duty exemptions were retained.

On the other hand, we are yet to see countries in the two trading blocs utilising the subsidies regulations they have adopted to regulate their affairs within the two trading blocs. This is also true when it comes to implementation of other trade remedy measures such as anti-dumping measures and safeguards within RTAs found in Africa. On regional level it seems that the parties in the two trading blocks are reluctant to utilise trade remedy measures such as countervailing measures, anti-dumping measures and safeguards in their trade relations. This reluctance can be appreciated if we consider that the only popular case reported in the two trading blocs to have involved implementation of trade measures is Kenya's implementation of bilateral safeguards in COMESA on sugar and wheat flour

[595]D Keet "Export Processing Zones (EPZs) in the Southern African Region" https://dotkeet.wordpress.com/2012/10/14/export-processing-zones-epzs-in-the-southern-african-region/ (accessed 20th September 2017).

imports from other member states.[596] This is beside the fact that this study has shown that a number of countries in the two trading blocs contain trade measures that breach regulations dealing with subsidies.

The discussion above has shown that some incentives being granted in EPZs found in some countries in the two RTAs breach subsidy regulations in the two RTAs, it is surprising that no country in the two RTAs has taken any action to enforce the obligations regarding subsidies. Perhaps the inclusion of these provisions is mere lip service to international trends and if such is the case Member States in the two RTAs are undermining their obligations regarding subsidies as found in the SCM Agreement, particularly the one prohibiting the granting of export subsidies. Furthermore, this inaction in itself undermines the purpose of the formation of RTAs in terms of the WTO.

However, some have alluded to this being as a result of several factors, among them being the non-existence of national legal institutional frameworks that are necessary for trade remedy actions.[597] A country can only impose trade remedy measures if it has national regulations prescribing the conditions and process and an authority that can handle such cases.[598] The other major factor is that the trade remedy measures are costly both in terms of financial resources and in terms of human resources.[599] The application of trade remedy measures requires substantial financial and human resources as well as expertise such as well-trained lawyers and economists who are to conduct investigations that would have to comply with all the relevant provisions of the WTO Agreements and RTAs.[600]

However, the question that must be considered is whether there is need that the two RTAs should regulate the use of EPZs in the RTAs. Since EPZs are seen by developing countries as essential as a tool for export promotion, perhaps it is high time that the SADC Protocol on Trade and the COMESA Treaty should come in and regulate their use to make sure that the

[596] W Denner "Trade Remedies and Safeguards in Southern and Eastern Africa" in A Bösl et al (Ed) *Monitoring Regional Integration in Southern Africa Yearbook* Vol 9 (2009) 67.
[597] O Illy "African Countries and the Challenges of Trade Remedy Mechanisms within the WTO" (2016) *Society of International Economic Law; Online Proceedings Working Paper No. 2016/03* https://ssrn.com/link/SIEL-2016-Johannesburg-Conference.html (accessed 30th May 2017).
[598] *Ibid.*
[599] *Ibid.*
[600] Denner "*Trade Remedies and Safeguards in Southern and Eastern Africa*" 67.

use of the EPZs should not impede the attainment of the goals and objectives of SADC and COMESA. Otherwise, with the current state of affairs, there is need that Member States must bring these EPZs in harmony with the object and spirit of the SADC Protocol on Trade and COMESA Treaty, and given the very nature of EPZs and their encouragement of trade deflection, this seems like an impossible option.

7.11 Conclusion

This chapter has assessed whether the use of EPZs that grant incentives which have been deemed to be prohibited export and import substitution subsidies under the multilateral trading system to companies operating in these zones are in tandem with the object and purpose of RTAs. The focus has been on COMESA and SADC and it has been shown that the two RTAs regulate subsidies in a similar way. However, the regulations as found in the two RTAs lack clarity as the rules are vague. This may cause enforcement difficulties considering that all the Members of the two RTAs also belong to the WTO and as such are bound by the SCM Agreement which has provisions that may differ to the ones existing in the RTAs. It has also been shown that some countries in the two RTAs (one of which is Malawi) have adopted the use of EPZs as one of the strategies to spur export trade contrary to the dictates of the two RTAS as these countries are granting prohibited subsidies to companies operating in these zones. This trend however shows that the implementation of the subsidies regulation in these RTAs is weak or if it is not weak it is out of touch with the reality prevalent in the two RTAs. This chapter therefore questions whether or not it is high time that the two RTAs adopt regulations to regulate the use of EPZs as it has been shown that these measures are popular in countries in sub-Saharan Africa, and are unlikely to disappear in the near future, so that the use of the same is in tandem with the goals of the RTAs and subsidy regulations in the RTAs.

CHAPTER 8: RECOMMENDATIONS AND CONCLUSION

8.1 Introduction

The discussion in this research has considered the operations of EPZ schemes, particularly Malawi's EPZs as provided in the Export Processing Zones Act, in the context of Malawi's obligations at multilateral and regional level. The discussion has found it to be problematic in both, although the study has also found SADC and COMESA's regulation of subsidies to be problematic and the regulation of subsidies in terms of the SCM Agreement has some inconsistencies. Therefore, the recommendations of this study are three-fold: on domestic level (Malawi), at regional level (SADC and COMESA) and on multilateral level (amendments to the SCM Agreement).

8.2 Domestic level

8.2.1 Notification to the WTO

The transparency mechanism of the WTO is one way through which the WTO rules and practices influence the trading system.[601] Transparency in the WTO has been described to mean "the degree to which trade policies and practices and the process by which they are established, are open and predictable."[602] It is essential and fundamental to the modern governance of the international trading system as it aims at enhancing effectiveness of the WTO Agreements by reducing uncertainty about policy, both for trading partners and other actors.[603]

One of the ways of achieving transparency is through the process of notification. In the language of the WTO, notification is defined as "a transparency obligation requiring Member governments to report trade measures to the relevant WTO body if the measures might have an effect on the other Members."[604] In terms of subsidies, the basic subsidies notification requirement is contained in Article 25.2 of the SCM Agreement and Article XVI:1 of the GATT 1994.[605] Article XVI:1 of GATT 1994 requires Members to notify any subsidy

[601] T Collins-Williamsand R Wolfe "Transparency as a Trade Policy Tool: The WTO's Cloudy Windows" (2010) 9(4) *World Trade Review* 551 at 551.
[602] Collins-Williams and Wolfe 2010 *World Trade Review* 552.
[603] Collins-Williamsand Wolfe 2010 *World Trade Review* 553.
[604] Collins-Williams and Wolfe 2010 *World Trade Review* 559.
[605] Technical Cooperation Handbook on Notification Requirement; Agreement of Subsidies and Countervailing Measures https://www.wto.org/english/tratop_e/scm_e/notification_handbook_e.pdf (accessed 30th August 2017).

whether specific or not which directly or indirectly causes trade effects. However, Article 25.3 of the SCM Agreement provides that "Members shall notify any subsidy as defined in paragraph 1 of Article 1, which is specific within the meaning of Article 2, granted or maintained within their territories." This means that currently Members of the WTO are supposed to notify it of any subsidy which is specific.

The Appellate Body has held in *Brazil - Aircraft*[606] that the purpose of Article 25 of the SCM Agreement is the promotion of transparency and it does not affect the legal status of the subsidies so notified. However, it is a fact that some S&DT for developing country Members depend on certain additional notification requirements. For example, as shown in chapter 5 of this study, the extension of some subsidies programmes that provided export subsidies under Article 27.4 of the SCM Agreement required that the countries had to notify these programmes to the SCM Committee and in their notification, they had to undertake that they would not increase the levels of subsidies.

However, it is a reality that several developing countries do not authentically declare their established subsidies - an example would be Malawi.[607] As was stated in chapter 4 of this study, Malawi has always said that it does not administer subsidies programmes. But this research has shown in chapter 4 that some incentives that are granted to export enterprises operating in EPZ schemes fits the description of subsidies as provided in Article 1 of the SCM Agreement and are specific. The said incentives are the exemption of export enterprises operating in the EPZs from paying indirect taxes and duties when they import capital goods to be used in the EPZ schemes to produce export products, exempting EPZs companies from paying withholding tax on dividends, exempting these export enterprises from paying taxes when they buy packaging materials made from Malawi and prior to 2011 exempting EPZs companies from paying corporate tax.

This simply means that Malawi's notification to the WTO as far as the subsidies are concerned is contrary to what exists on the ground, and as such it is in breach of notification

[606] Appellate Body Report, *Brazil – Aircraft* Para. 149.
[607] Cling and Letilly 2001 *DIAL Working Paper DT/2001/17* 26.

requirement. It must therefore rectify this by making the necessary changes in its notification to the WTO.

8.2.2 Exemption of export enterprises operating in the EPZs from payment of corporate taxes

In chapter 5, it was indicated that Article 27 of the SCM Agreement allows LDCs to continue granting export subsidies. It was concluded in that chapter that since Malawi is an LDC, some of the incentives that Malawi's EPZ scheme offers such as exemption from paying import duties and taxes when export enterprises import capital goods and exemption of withholding tax on dividends, even though they can be classified as export subsidies, they are covered by the Article 27 exemption. In chapter 4 it was stated that prior to 2011, the government of Malawi exempted companies in the EPZs from paying corporate tax and this was indicated in schedule eleven of the Taxation Act. Corporate tax being a direct tax, if companies operating in the EPZs are to be exempted from its payment, this treatment would fit the description of an export subsidy, however, if the WTO Member granting this exemption is an LDC, the Member would be exempted from the breach by Article 27 of the SCM Agreement.

The reason for scrapping the tax exemption from EPZ companies had to do with revenue collection, as this happened when donors had pulled out from helping Malawi and the government was forced to find alternative means of funding its operations. However, there is need to balance revenue collection and achievement of the objectives which necessitated the adoption of the EPZs schemes. For Malawi, the EPZ schemes are there to promote exports and diversification of the same as the regime targets production of non-traditional export products. They were also adopted to help alleviate unemployment and encourage the use of new technologies by export enterprises. This is as provided in section 7 of the Export Processing Zones Act.

Elimination of fiscal incentives granted to EPZ companies benefits a country with increased revenues.[608] However, the elimination of incentives may also result in lower investment by

[608] Waters 2013 *Duke Law Journal* 508.

foreign companies.[609] Hence it would be good to mitigate investor flight, as research has shown that fiscal incentives may be one of the more important considerations for investors.[610] It is also true, as shown in chapter 3 of this study, that "developing countries wishing to promote indigenous non-traditional exports have often found that the creation of a trade-friendly environment does not suffice to induce a local export supply response."[611] This was shown in chapter 3 of the study, where in the second phase of Malawi's trade policy development, the relaxation of government controls on the economy failed to induce indigenous producers to come in to fill the void for export supply that was created by efforts of liberalising of the economy.

In Malawi, trade patterns continue to reveal a widening gap in trade deficit and limited diversification. For instance, in the period between 2009 and 2013, exports increased by 159% while imports increased by 245%.[612] To put these percentages in perspective, in 2010 for instance, Malawi imported US$2.3 billion worth of goods and services which accounted for 43 percent of the GDP and only exported goods and services worth US$ 1.2 billion, which amounted to 22 % of the GDP.[613]

In Malawi's export strategy for 2013 to 2018, it is acknowledged that there is need to increase incentives to investors and improve Malawi's underlying economic enabling environment.[614] Hence, it does not make sense that a country that is infested with structural challenges such as access to energy, finance and transportation services would be scrapping some of the incentives that can have a pulling effect on would-be investors, especially not if they are legally entitled to do so given their status as an LDC. There is need to bring back this tax exemption incentive in the form of corporate tax, even if this were to come in form of a tax holiday, whereby companies in the EPZ schemes would just be exempted for a number of years as compared to the perpetual exemption granted prior to 2011. The

[609] Waters 2013 *Duke Law Journal* 506.
[610] Farole *Special Economic Zones in Africa* 146.
[611] Johansson and Nilsson 1997 *World Development* 2116.
[612] Ministry of Industry and Trade *"Buy Malawi Strategy"* http://moit.gov.mw/downloads/quick/Buy%20Malawi%20Strategy.pdf (accessed 10th May 2017).
[613] Ministry of Industry and Trade *"Malawi Nation Export Strategy 2013 – 2018"* (2012) https://www.scribd.com/document/116699902/Malawi-National-Export-Strategy-Main-Document (accessed 15th May 2017).
[614] Ministry of Industry and Trade "*Malawi Nation Export Strategy 2013 – 2018*".

exemption in the form of a tax holiday is provided in countries like Kenya and Tanzania, making them more attractive for investment than Malawi. Thomas Farole in his research on Special Economic Zones in Africa, concluded that tax incentives play an important role catalysing investments in some special economic zones (of which EPZs are one of them), particularly in the early stage of development.[615] Therefore, there is need that Malawi government should bring back the corporate tax exemption it was granting to EPZ companies prior to 2011. As an LDC, Malawi is exempted from compliance with certain provisions of the SCM Agreement such as Article 3.1(a) prohibiting export subsidies, and so there is no reason why Malawi should not make the most of this exemption while it is still in existence to encourage its export growth.

8.2.3 Allow EPZ companies to sell into the customs area

As stated above, one of the reasons why the exemption from paying corporate tax granted to EPZ companies had to be stopped in 2011 was because government wanted to raise funds for its operations. It has been argued that the sacrifice in terms of taxes in the case of EPZ schemes in Malawi are not worthy as they result in government loss of the much-needed revenue.[616] However, in the paragraphs above, it has been argued that the incentives are necessary as they induce a pulling effect to would-be investors. Therefore, this study recommends that to mitigate this loss and make sure that the government reaps more from the EPZ regime, government should allow that more products produced in EPZs be sold in the domestic market. This would help mitigate the duties and taxes that are due but not collected because of the scheme, as the goods that will be sold into the customs area will be paying taxes such as VAT and excise tax as provide in section 15C (2) of the Export Processing Zones Act. This of course, would also be another way of making the benefits of the EPZ regime not contingent on export production, hence making the incentives provided in the zones not export subsidies.

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[615] Farole *Special Economic Zones in Africa* 146.

[616] Vincent Nkhoma in his research in 2007 while acknowledging that EPZs can be pivotal for diversification of economy, foreign exchange generation and export growth argued that the EPZ regime in Malawi has been a drain of the government resources as the tax relief structure are a big sacrifice on the part of government as it represents significant forgone revenue in a country whose budget depends to a large extent on tax collections: Nkhoma 2007 *Integrated Framework Policy Analysis Working Paper Series No. 7*.

This would mean that direct tax exemption and indirect tax exemption on imports of capital goods would remain in place so long as they are not contingent on export performance. However, since duties on imported inputs are not collected, if the product manufactured in the EPZ is ultimately sold in the customs area, the producers will have a choice of either paying the import duties that have not been collected on the inputs or paying taxes for the finished product.[617] This would provide an advantage to the producers in the EPZs in cases of inverted tariff structure, in which the duties on components (that are paid when importing inputs/raw materials) are higher than duties on finished products.[618]

Not only that, but this would also help facilitate spill overs of knowledge and technology to the local economy as this could enhance the potential for forward linkages in the economy.[619] This in a way would help to encourage the forward links which are normally limited by zones regulations in most countries.[620] For example in Malawi, section 15 of the Export Processing Zones Act restricts the selling of products from the zones into the customs area. Of course, before EPZ companies can sell their goods into the domestic area there is need to consider the potential harm this could have on the domestic businesses. [621] This might result from the fact that, unlike the local companies, EPZ companies are at an advantage due to the economies of scale they enjoy because of the incentives they receive which lower their operational costs and also because they use advanced technologies. If the local companies are exposed to the competition that would arise with the coming in of products from the zones, the local suppliers would not cope.[622]

However, this might not be a problem in Malawi as the companies in the zones are supposed to produce non-traditional export products and in a way, it means the indigenous companies in the customs area, most of whom do not produce these non-traditional export products, will not be direct competitors with the EPZ companies. Secondly, in Malawi this

[617] Torres 2007 *Global Trade and Customs Journal* 221.
[618] *Ibid.*
[619] Keck and Low (2004) *WTO Staff Working Paper ERSD-2004-03* 20.
[620] Farole *Special Economic Zones in Africa* 93.
[621] Waters 2013 *Duke Law Journal* 507.
[622] *Ibid.*

would augur well with the "Buy Malawi"[623] strategy that the ministry of trade and industry has adopted to encourage people to buy goods produced locally. This strategy has shown that the trade deficit continues to increase and some of the products that are imported for consumption are readily available or there is a potential to produce them in the country which can result in significant savings on the import bill.[624] The "Buy Malawi" strategy is there to develop the capacity of local companies to enable them produce goods that "comply with set standards and meet buyers' preferences on price, quality, quantity and consistency."[625] It is hoped that the strategy will encourage companies to import inputs needed for production of goods that are to be sold in the domestic market rather than people importing for consumption. This strategy could benefit from EPZs, as companies in the zones already import inputs that are used to produce goods that are meant for export.

Therefore, instead of exporting the whole lot, they should be allowed to sell more into the domestic market. In a way EPZ companies already have the capacity and the assumption is that the EPZ companies produce goods of good quality that can compete on an international market. Hence this strategy could benefit Malawi if more goods produced from EPZs can be sold in the domestic market. The selling of goods from the zones into the domestic market is not a new phenomenon, as section 15C of the Export Processing Zones Act provides that export enterprises may sell export products in Malawi, but the sales should not exceed percentages prescribed under the Act or on a certificate issued under the Act. The section also states that the sale is subject to payment of appropriate duty and tax.[626] Currently, only 10 % of the produced goods in the zone are allowed to be sold locally after seeking approval from Ministry of Trade and Industry.[627] The "buy Malawi" strategy could benefit more, if an increased percentage of goods from the zones were allowed to be sold on the local market. Therefore, this research recommends that the Act be amended by increasing the percentages of goods produced from the EPZs allowed to be sold on the domestic market.

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[623] The "Buy Malawi" strategy was adopted in 2016 by the Ministry of Trade and Industry and vision and goal of the strategy is stimulate local production and growth by inspiring consumers to embrace locally produced goods and services and by building the competitiveness of enterprises.
[624] Ministry of Industry and Trade "Buy Malawi Strategy".
[625] Ministry of Industry and Trade "Buy Malawi Strategy".
[626] Section 15C (2) of Export Processing Zones Act.
[627] Malawi Trade and Investment Centre *Tax Incentives in Malawi.*

8.3 Multilateral level

8.3.1 Capital goods be included in footnote No. 61 of the SCM Agreement

In chapter 4 of this study, it was shown that capital goods are not included in the description of goods consumed in the production of export products as defined in footnote 61 of the SCM Agreement. The exclusion of capital goods means that they are not included as part of inputs that can be imported without paying duty and taxes as allowed under footnote 1 and annexes I through III of the SCM Agreement. If this exemption from payment of import duties and taxes is provided as part of a duty drawback scheme, it will be deemed that the exemption provided to capital goods is a subsidy as provided under Article 1 of the SCM Agreement.

This means the treatment of capital goods is different from all other inputs that are imported for use in the production process of an export product. This study recommends that the capital goods be included in footnote 61 description of goods used in production processes for the following reasons;

i. Footnote no. 1 which exempts indirect taxes for imports of input used in production of exports is mainly concerned with the destination principle of indirect taxation. This is coming from Ad Article XVI of the GATT and all what this Ad Article says is that "the exemption of an exported product from duties or taxes borne by the like product when destined for domestic consumption, or the remission of such duties or taxes in amounts not in excess of those which have accrued, shall not be deemed to be a subsidy." In this case the exemptions apply to inputs that are used to produce the exported good, and this exemption is not classified as a subsidy. However, it is possible that inputs can be very different from the exported good after they undergo transformation in the production process and export goods cannot be likened to the imported raw material. Hence, what is crucial is that these taxes and duties are consumed by the imported input used in the production process of the finished export product. In this case both raw materials and capital goods are used in the production process and both are supposed to pay duties and taxes when being imported but do not because they are used in the production process of an export

product. Therefore, footnote 61 should adopt an interpretation of "consume" that would include both goods that are physically incorporated and are found in the final product and those which are just used but cannot be traced in the final product as both benefit the export product produced.

ii. Even if we go by the definition provided of "goods consumed in the production process", it will be observed that some of the materials included as goods consumed do not fit the description required by the SCM Agreement. This is because the Agreement requires that the inputs that are consumed should be physically incorporated in the production process and should be physically present in the product exported as stated in paragraph 3 of part II of Annex II to the SCM Agreement. Footnote 61, states that 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." If this definition includes catalysts that do not go through any chemical change and cannot even be traced in the final product or oils which can be used to run the machines that produces the good in question, why not include the machines that produce the good?

iii. The other way of looking at it is to ask what effect the inclusion of duties/taxes borne by capital goods have on the trading system. The WTO is only concerned with those subsidies which distorts trade. The exclusion of indirect taxes and duties for raw materials used in the production of export products means that these do not cause trade distorting effects on the trading system. If this is the case, how would the exemption of capital goods used to produce the same export product cause a distorting effect, as these taxes also target the export product as the machinery are directly used in the production of the export product?

However, from a developing country and LDC point of view, this issue can also be considered in terms of Article 27 of the SCM Agreement which allows them to use subsidies for development purposes. This is because subsidies are instrumental for industrial and

social development.[628] Capital goods such as machinery for use in industries are at the centre of industrialisation. It would be difficult for developing countries and LDCs to compete fairly on the international market with developed countries as most of these developing countries use backward technologies. Hence, the pace of technological change and intensification of competitive pressures in liberalised trade regimes make it more important to use deliberate policies that will put developing countries at par with developed countries.[629] For example, the poor performance of African manufacturing is well documented and one of the reasons is that the structure of the manufacturing industry is backward and dominated by the minimal processing of natural resources and raw material industries.[630]

Allowing these countries to adopt new technologies easily would be the only way to help them attain the level of competitiveness that would enable them to trade easily on the international market. One way of doing this is to allow them to use subsidies, and excluding capital goods from being deemed a subsidy would help their companies access new technologies at a lower cost.

8.4 Regional level

This research has shown that RTAs are crucial for trade liberalisation and integration on the regional level. It has also shown that while RTAs can divert from the provisions of the GATT 1994, the same is not the case with all WTO Agreements. RTAs may only contract out of the WTO Agreement if this is expressly allowed in the Agreements or if there is a close connection between the Agreement and Article XXIV of the GATT 1994. This study has argued that the SCM Agreement is one such WTO Agreement that parties in an RTA cannot contract out of. The study has, however, also shown that the subsidies regulations in the SADC and COMESA Agreements may not be in tandem with the SCM Agreement and as such makes some recommendations to that effect.

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[628] DP Steger "The Subsidies and Countervailing Measures Agreement: Ahead of its Time or Time for Reform?" (2010) 44(4) *Journal of World Trade* 779 at 789.
[629] S Lall "Selective Industrial and Trade Policies in Developing Countries: Theoretical and Empirical Issues" (2000) *QEH Working Paper Series QEHWPS48* 2.
[630] Lall 2000 *QEH Working Paper Series QEHWPS48* 31.

8.4.1 Clarity of subsidy provisions in the SADC Protocol on Trade and COMESA Treaty

Both RTAs have regulations that prohibit their Members from granting subsidies in certain circumstances. However, these regulations are somehow not clear if consideration is had to the fact that all Members of the two RTAs are Members of the WTO and as such are bound by the SCM Agreement. The vague provisions found in the two RTAs may bring confusion as they may seem to contradict what is allowed in the SCM Agreement. It would be good if the two RTAs made their provisions clear so that Members would know what is expected of them.

a) The need for definition of a subsidy in the COMESA Treaty

The COMESA Treaty states that any subsidy which distorts or threatens to distort competition between Member States is incompatible with the Common Market.[631] However, this Article does not define what a subsidy is. The situation found in the COMESA Treaty is the same which existed in GATT 1947 and in the Tokyo Round subsidies code, which was criticised for lack of clarity. It would be difficult for Member States to enforce Article 52 of the COMESA Treaty as there is no standard to use in determining whether a trade measure is a subsidy or not. This is different from the SADC Protocol on Trade which adopts a definition of subsidies as found in the SCM Agreement. Therefore, there is need that parties to COMESA must define the term subsidy for ease of enforcement of the Treaty.

b) The need to classify subsidies

Just like the COMESA Treaty, the SADC Protocol on Trade states that Member States shall not grant subsidies which distort or threaten to distort competition.[632] However, unlike the COMESA Treaty, the Protocol adopted the definition of a subsidy as provided in Article 1 of the SCM Agreement and allows Members to introduce new subsidies only if that is done in accordance with WTO provisions.

The SCM Agreement differentiates between actionable and prohibited subsidies. The provision in the COMESA Treaty does not differentiate between the two, and the question is whether when the provision states that Members shall not grant any subsidy that distorts

[631] Article 52(1) of the COMESA Treaty.
[632] Article 19(1) of the SADC Protocol on Trade.

competition this also includes the actionable and non-specific subsidies. This is tricky as to begin with there is no definition of what a subsidy is. The SCM Agreement prohibits outright the granting of prohibited subsidies but Members can grant actionable subsidies so long as they do not cause injury or affect trade on other markets. This applies to all Members including the ones who are also party to the COMESA Treaty. It would be good for the COMESA Treaty to clarify what it really proscribes when it comes to subsidies. This is crucial considering that there is no definition, nor are there definitions in the Treaty that might be used to determine material injury to domestic industry.

In the SADC Protocol to Trade, even though the Protocol adopts the definition of a subsidy as given in the SCM Agreement, it does not say whether it also adopts the same classifications. Suffice it to say that it allows its Members to adopt new subsidies so long as it is done in accordance with the WTO. It is necessary that this be clarified as to whether it adopts the classification as provided in the SCM Agreement and the obligations that accompanies the classification. Currently it is vague and crude, and as things stand the Article can be subjected to varying interpretations to an extent that it is difficult for one to appreciate what the drafters of the Protocol wanted to achieve. This undermines the very purpose of an RTA: to liberalise trade in the region. Therefore, it is necessary that the two RTAs come up with the classification of subsidies or be clear as to what type of subsidisation the two RTAs proscribe.

8.4.2 The need to regulate the use of drawbacks in EPZs found in SADC and COMESA

In chapter 7 of the study, it was discussed how the use of duty drawback provided to EPZs companies may affect the goals of integration particularly in FTAs, as the preferential treatment accorded to goods from within the FTA is also extended to those from third parties. This may end up diluting the purpose of forming the FTA as there will be no incentive for countries within the FTA to trade with each other, as the preferential treatment is effectively accorded to third parties. As such there is no loss of any benefit to the Members of the FTA if they engage on trade with third parties at the expense of other Members of the FTA.

To avoid this from happening there is need to regulate the use of duty drawbacks in an FTA and CU. This is what has been followed in some of the RTAs. For instance, in NAFTA, Article 303 does not allow parties to grant duty drawback or duty referrals to imports that are used to produce goods that are intended to be sold within the FTA. Hence Sargent and Matthews in their research commented on what this meant for Mexico's maquiladora (EPZs) saying that firms working in these EPZs would no longer benefit from duty drawbacks on non-regional inputs as they used to prior to Mexico signing NAFTA.[633] This is one way of preventing deflection which parties foresaw would be a problem if this was left unchecked because Mexico uses EPZs.

This is also the situation in the East African Community: an RTA made up of three partner states being Uganda, Kenya and Tanzania. Even though EAC is made up of developing countries, it recognises that there are problems that may come with the use of EPZs, and hence it tries to limit the use of duty drawbacks in EPZs. The EAC Customs Union Protocol has some articles which regulate schemes that are meant for export promotion. Article 25 of the EAC Customs Union Protocol provides principles for export promotion schemes. Article 25(2)(a) of EAC Customs Union Protocol states that goods benefitting from export promotion schemes shall be solely for export and Article 25(2)(b) provides that if such goods are sold in the customs territory such goods shall attract full duties, levies and other charges provided in the CET. This means that these goods will not receive preferential treatment. Article 25(3) further sets a limit on the quantity of goods that may be sold in the customs territory. It provides that if these goods are sold within EAC, only 20 percent of the goods from the export scheme shall be sold within the customs territory.

The EAC Customs Union Protocol also contains an Annex which provides Export Processing Zone Regulations which aims at making sure that EAC Member States establish EPZs in a uniform fashion.[634] However, these regulations require that existing national legislation on EPZs must be aligned with the provisions of the EAC regulations. In line with the EAC Customs Union Protocol, the regulations only allow 20 percent of the goods in the EPZ to be sold in the customs territory.

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[633] Sargent and Matthews 2001 *World Development* 1741.
[634] Woolfrey "Special Economic Zones and Regional Integration in Africa".

The goods that have benefited from duty drawbacks are also treated differently even in COMESA. As stated in chapter 7, COMESA has a provision, even though it may be seen as weak, that regulates this. This is provided in Article 59 of COMESA Treaty and it provides as follows:

> "The Member States may, at the end of the ten years specified in Article 45 of this Treaty, refuse to accept as eligible for Common Market tariff treatment goods in relation to which drawback is claimed or made use of in connection with their exportation from the Member States in the territory of which the goods have undergone the last process of production."

Article 45 of the COMESA Treaty provides that a customs union of COMESA shall be established after 10 years from the date the Treaty entered into force. It means that after the formation of the customs union the Members may use Article 59 of the Treaty to bar goods that have benefited from duty drawbacks from being accorded preferential treatment. Of course, the problem with this provision is that it does not create a binding obligation as it has left the discretion to regulate duty drawbacks to individual Members.

Therefore, to attain to the fullest the goal of regional integration in SADC, there is need to include in the SADC Protocol on Trade a provision limiting the trade of goods that have benefited from duty drawback. This might mean barring their use in general or allowing just a small percentage of goods that have benefited from them to be sold within the FTA. However, the other way of doing this would be to allow the goods to be sold within the FTA on condition that preferential treatment will not be extended to them, in other words allow the goods to be sold after paying the necessary taxes and duties. Additionally, there is need that Article 59 of the COMESA Treaty be strengthened so that it creates a binding obligation, this may be done by replacing "may" used in the sentence with "shall". This would mean that the use of drawbacks would no longer be left to the discretion of individual Members.

8.4.3 Provisions of S&DT

It has been discussed in chapter 5 of this study that the SCM Agreement extends S&DT to developing countries and LDCs. The two RTAs, even though they are composed of developing countries and LDCs, do not have provisions for S&DT. The question that needs to be considered is whether it is necessary for the two RTAs to have provisions which grant S&DT when it comes to the use of subsidies. This is crucial as some treatment that may not be allowed by the two RTAs may be covered by Article 27 of the SCM Agreement. For instance, if a Member State that is an LDC grants export subsidies in the incentives extended to EPZ companies, and the goods produced by these companies are sold in the RTAs, should the other Members in the RTAs bring countervailing measures upon these goods or should the Members allow the goods to be sold without being subjected to countervailing measures? Therefore, this study recommends that SADC and COMESA be amended to recognise the more flexible subsidies regime allowed to developing countries in terms of the SCM Agreement. As there would be concurrent jurisdiction between the RTAs and WTO, it would be absurd if a subsidy would be prohibited in terms of COMESA and SADC but allowed in terms of the SCM Agreement, given that the goal or RTAs is to liberalise trade in the region. It is a fact that WTO adjudicating bodies do not have the authority to enforce provisions of an RTA as such provisions are enforced pursuant to the dispute settlement mechanism of the RTA.[635] It was also held by the Appellate Body in *Mexico – Soft Drinks*[636] that a Member of the WTO has a right to seek redress of a violation of obligations under Agreements covered by the WTO and when that happens a Panel cannot decline to exercise its validly established jurisdiction to bring a dispute before it even if such matter can also be dealt with by another forum such as a dispute settlement mechanism of an RTA.[637] This is because the WTO dispute settlement system serves to preserve rights and obligation of Members under Agreements covered by WTO law and as such the system cannot be used to determine rights and obligations outside the covered agreements, in this case obligations under SADC and COMESA.[638] The overlapping of jurisdictions would bring confusion and this would even be bad in the context of SADC and COMESA as the two RTAs would be barring

[635]K Kwak and G Marceau "Overlaps and Conflicts of Jurisdictions between the World Trade Organisation and Regional Trade Agreements" (2003) 41 *Can. Y.B. Int'l L.* 85 at 95.

[636] Appellate Body Report, *Mexico – Tax Measures on Soft Drinks and other Beverages* WT/DS308/AB/R (adopted 6th March 2006).

[637] Appellate Body Report, *Mexico – Soft Drinks* Para 52-53.

[638]Appellate Body Report, *Mexico – Soft Drinks* Para 56.

developing countries and LDCs in their trading blocks to exercise preferential rights that are granted by the multilateral trading system to the detriment of the LDCs and developing countries.

8.5 Conclusion

The paradigm shift engaged by developing countries from the use of import substitution policies which were full of policies aimed at protecting infant industries, to export led growth strategies, necessitated these developing countries liberalising their economies. However, the liberalisation of these economies meant that, for developing countries to attain development, they needed to have a share on the international market. However, underdeveloped industries and a lack of local entrepreneurs who could provide export supplies to fill the void meant that they had to look beyond their borders for investors. To woo these would-be investors to come and operate in their economies, it was necessary for the developing countries to provide incentives that would have the pulling effect on the investors.

One of the mediums of providing the incentives adopted by the developing countries is the use of EPZ schemes. This study has shown how the EPZs helped in the promotion of export strategies in Asian countries and the success they brought to these countries, has led to the EPZs being adopted by most developing countries in their pursuit of export promotion, particularly in Sub-Saharan Africa. It has been shown in the study that the EPZ schemes normally provide fiscal incentives that are contingent on export performance, as the incentives are only available to companies that produce for export and these companies are not allowed to sell into the domestic market.

In the study, it has been shown that the export contingency requirement of the incentives in the EPZ schemes, may make these incentives contrary to the rules regulating subsidies in the multilateral trading system as provided in the SCM Agreement which prohibits the granting of prohibited export subsidies. Of course, it has been shown that to LDCs, the breach may be covered by the exemption extended to them under Article 27 of the Agreement as far as export subsidies are concerned. However, the exemption does not

cover import-substitution subsidies, and if the incentives also provide import-substitution subsidies these would be contrary to the Agreement.

However, since the SCM Agreement does not proscribe against duty drawback that provide exemption from paying indirect taxes and duties on imports of inputs consumed in the production of export products, the EPZ schemes that only provide duty drawback as the incentives for the export enterprises will continue to flourish as tools for export promotion. Since most EPZ schemes provide duty drawbacks it can be concluded that these schemes will continue to be used by developing countries as catalysts for export growth, so long as the same does not extend the tax and duty exemption to imports in the form of capital goods.

For countries like Malawi that are LDCs, they have a chance to use EPZ schemes for economic growth, even if it means including incentives that may be adjudged to be export subsidies under Article 3.1(a) of the SCM Agreement as they are covered by the exemption under Article 27 of the SCM Agreement as explained above. Therefore, while other developing countries might be concerned that the space for deliberate targeted government industrial policy is being limited, the LDCs have all the space to them to engage these policies that have already proven to work in other developing countries, like the four tigers of Asia, so that their countries may try to take off on the path of development.

However, even though on a multilateral level that is the case, the research has shown that the rules regulating subsidies on regional level, in this case SADC and COMESA are not very clear as to what they regulate and would in a way end up clouding the concession provided to WTO Members in the SCM Agreement. The study therefore has further argued that even though the duty drawback provisions are crucial to EPZ schemes, these may not be in tandem with the goal of regional integration of the RTAs, particularly when it comes to FTAs and in this research, that would-be SADC. This is because the preferential treatment granted to Members of the FTA is also effectively extended to third parties.

Following the conclusion made in the research, the study has recommended that the Malawi government should continue pursuing the EPZ schemes but to take full advantage of

Article 27 of the SCM Agreement should reintroduce the corporate tax exemption granted to companies operating in the Zones. It has also recommended that the government can use the EPZ schemes to achieve its goals and aspirations under the "Buy Malawi" strategy if it allowed goods produced in the zones to be sold in the domestic market. This would also help to compensate for the taxes such as income tax, and indirect taxes that the companies in the zones are exempted from by allowing them to pay the internal taxes such as VAT and excise when they sell their goods in the domestic market.

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