

SUBSIDY AND ITS EFFECTS

Author(s):

J. Mehtiyev¹, R. Magda²

Affiliation:

¹ 5 Vanderbijlpark Campus, North-West University, Vanderbijlpark 1900, South Africa

² Hungarian University of Agriculture and Life Sciences, 2100 Gödöllő, Páter Károly u. 1.

Email address:

mehtiyevcelil@gmail.com; Magda.Robert@uni-mate.hu

Abstract: Governments follow a subsidy policy to encourage the use of certain goods by some consumers. Subsidy can be explained as also that firms-producers sell the determined goods at a cheaper price than the market price and subsidizing government collects the difference. They are tools which are widely used in the hands of governments and can be allocated to various economic issues. In general, it is used as a policy of price policy and anti-inflationary policy in the classical sense. In the modern sense, it is used for the purpose of general equilibrium, in other words, to equalize trade balance such as lowering prices and controlling inflation, preventing the long-term decline of industries. However, there are many significant negative effects of subsidies such as increase in taxes, leading to inefficiency of local industries, increase in borrowing, and disruption of identity between buyer and vendor prices in markets. One of the rules set on subsidies is the SCM Agreement. In the Agreement, subsidies were identified and rules were set on subsidies which could impact international trade. Since there are many types of subsidies, there should be more strict rules and policies about their implementation in order to eliminate and avoid potential barriers in international trade.

Keywords: subsidy, international trade, price discrimination, trade balance, export subsidy

1. Introduction

Subsidy terms - General overview

Subsidy is extensively applied by governments and it is a type of non-trade barrier. In other words, subsidies are state expenditures which are applied with the purpose of supporting production of goods and services. Since subsidy is state expenditures, it can be argued that state duties such as fire-fighting or police organizations are also subsidies. However, they are justified state practices, but not subsidies. So, the basic state duties cannot be considered as subsidy. Moreover, excluding state duties, a state should benefit from its expenditures. If a state provides assistance to its market economy within accepted competition conditions and that state does not benefit from this assistance, it cannot be considered as a subsidy.

After World War II, it was unrealistic to change and ensure world goods exchange without unclear definitions on the GATT premise. In this way, an alternate meaning of the subsidy is required to be utilized in the field of global trade law. Despite the fact that a few kinds of subsidies were out of line in the worldwide exchange strategy for over a century, there were no definitions of subsidy concept in the GATT time frame covering 1947-1995. This came about because of the multifaceted nature of the issue and the complexity in recognizing justified state practices and subsidies which were barriers in international trade.

Subsidy definitions

In 1994 Uruguay Round when GATT was transformed into WTO, important changes with respect to subsidies were introduced. As a result, new Agreement on Subsidies and Countervailing Measures, also called Subsidies Agreement, was adopted. The ultimate objective of the SCM Agreement was to strengthen discipline on trade-distorting subsidies that governments use to provide unfair competitive advantage for their firms. The definition of subsidy is first set out in the annex of the WTO Establishment Agreement and SCM Agreement. The definition of subsidy on SCM is determined as “a financial contribution by a government or any public

body within the territory of a member which confers a benefit". Apart from this concept, the definition of subsidy can be set in many different forms indicated below:

- The unequal financial aid given in the form of money by the State to influence production or export in various ways by taking into account the interests of society and in order to protect and promote producers or is called subsidy.
- Subsidies are supports and cash aids for the promotion and maintenance of the production of private and public undertakings by the state. With the coupon method, the state provides for the promotion and maintenance of the consumption of certain consumer segments to certain goods and services, while state support the production activities of certain producer groups in various ways. Subsidies are also called financial aid.
- Subsidy is referred as any financial contribution directly or indirectly provided by the exporting country.
- Subsidy exists if there is a direct transfer of funds, withdrawal of government revenues that must be paid, a financial contribution such as the provision of goods or services outside the general infrastructure, or financial or other income or price support by government or a public body.
- Provision of subsidy by a state can be expressed as money in order to influence production or export in various ways without any compensation by considering the interests of the society and to protect and promote producers and exporters.

Subsidy elements

There are two key elements that should exist in order to consider an incentive as a subsidy. They are:

- Financial assistance, income or price assistance by a state,
- Benefit to which the assistance is made.

Above mentioned two elements should coexist in order to mention about a subsidy. If there is no benefit provided to the assisted or supported party, a financial assistance cannot be considered as subsidy.

2. Types of subsidies and their effects

One of the important types of subsidy is defined according to types of grant in the financial assistance in SCM Agreement. These types could be subsidies made by a state or through third person or institution in the form of direct fund transfers, government revenues, and government procurement explained below

Types of subsidies based on types of grants

In SCM Agreement, one of the main types of subsidies is identified based on types of grants provided during financial assistance. They are:

- Direct fund transfers: If a state provides direct transfer of funds (aid, credit and equity capital) or debts (loan guarantees) and benefits from this assistance, it is considered as subsidy. An example of direct fund transfer is that if a government pays debt of its local export company to the bank instead of the company.
- Government revocation: This type of subsidy is considered in case a government gives up some taxes which actually have to be collected from a company or an individual. It should be emphasized that benefit element of subsidy should exist if the state gives up the collection of taxes.
- Government procurement: This type of subsidy appears when the sales of goods provide more revenue for the seller than they would earn under normal market conditions. It happens when a government is buyer and pays more for the purchase of certain goods to support that seller company. When the government pays the difference between a producer's actual income and a certain target income support is defined through government procurement. This type of subsidy is applied in order to protect the income levels of some companies in a particular sector, in other words, provision of income or price support.
- Financial assistance through a third party: Sometimes, the financial assistance is not carried out directly by a government. A government might pay for a fund mechanism and instructs it to execute special campaigns and functions in order to provide support industries. Even though such assistance is not provided directly by government, it is considered as a subsidy if there is a benefit provided based SCM Agreement. In some cases, a state may apply to support certain firms or sectors without direct payment, contributing to a specific fund, rather than directly providing financial contribution. In accordance with

WTO rules, such practices are also considered as financial contributions. Moreover, financial assistance through a third party can be delivered through a number of private legal persons or entities.

Types of subsidies based on scope of implementation

The other types of subsidies are defined regarding the scope of subsidy effect and implementation. Subsidies are divided into three groups according to its field of implementation

Company specific subsidies: These kinds of subsidies are assistance provided to a company or a holding that includes a group of companies aiming to increase competitiveness. Usually subsidized companies are perspective ones which might bring benefit to government if efficiency is increased.

Industry specific subsidies: Financial assistance provided to a particular industry. The main sectors which this kind of subsidies are applied is agriculture and energy sectors. Mainly the industries which have comparative advantage over competitors are applied subsidies.

Region specific subsidies: Subsidies provided by government to a specific geographical region. If there are subsidies provided only for the companies or industries in the borders of a specific region by the government, it is considered as region specific subsidy. However, there are some exceptions on this type of subsidy based on the assistance provider. For instance, if an authority which is responsible for a specific region and that authority provides any kinds of subsidies for all companies or industries inside the borders of it, it is not considered region specific subsidy (Didier, 2007).

Types of subsidies based on its implementation

The other types of subsidies are defined based on purpose of implementations. In SCM agreement, subsidies are divided into three groups based on the purpose they are implemented. They are forbidden subsidies, actionable subsidies, and non-actionable subsidies.

Forbidden subsidies

The other name given to forbidden subsidies are “Red” subsidies. In case of identification of such subsidies which are listed in SCM Agreement, they should be released or stopped immediately. According to the WTO, they are divided into two types as export subsidies and domestic input subsidies.

Export subsidies

The subsidies which are given with the purpose of specifically to increase export performance of a country are called export subsidies. The purpose of export subsidies is to reduce the price paid by foreigners by providing cost advantage to domestic producers and thus to encourage the export of the country. As a result, consumers in foreign countries are preferred to domestic consumers because the external price of subsidized exports is lower than the domestic price of the product. Most widely applied export subsidy types and their effects are mentioned below.

Direct subsidies for export performance: a subsidy program which entitles exporters to pay a certain percentage of their export amounts falls into this group. This type of export subsidy is the most widely used one.

Advantageous exchange rate applications: In this group, the subsidies are granted to the foreign currency obtained by the export by applying a more advantageous exchange rate than the market exchange rate. In order to analyze the effect of such subsidies, we can indicate an example. For instance, in a free market where 1 US dollar corresponds to 100 units of national currency, a subsidy program is stipulated if government purchases 1 US dollar for 120 national currencies. Government might be willing to apply this kind of subsidy because foreign exchange obtained from the action of export is more valuable for the state. This action might affect the international trade. The exporting companies can sell the products at a cheaper price and might go ahead of the competitors which can be considered an indirect violation of trade law (Didier, 2007).

Goods or services at advantageous prices: Providing electricity energy for some industries or companies which are exporting at lower prices can be stated as an example of provision of goods and services at advantageous prices. However, there is a point on this matter. If the price of products sold by export companies is less than the market price, in this case subsidy provision can be mentioned. Otherwise, if the price is the same with market price, then subsidization issue cannot be raised. In this example, it can be said

that it is not affecting international trade since there is no unfair pricing in the market. So, subsidy provided by government in the means of advantageous priced services can be a trade barrier for other competitors if they have a lower price than the market price.

Effects of export subsidies

The implementation of the export subsidy has two main direct effects on the domestic economy:

- Trade balance change effect,
- Export income effect.

As an export subsidy decreases the external price compared to the domestic price, the terms of trade are against the country. However, low external prices increase exports. If the elasticity of the demand for export goods of foreign countries is quite high, the export revenues of the country will increase. The foreign prices of these goods will decrease by a percentage and there will be a percentage increase in the quantity of exports which will be more than the price percentage which was decreased for foreign buyers.

Since export subsidies can be considered as a hidden trade barrier and they affect industries of foreign countries, implementation of export subsidies is undesirable and rejected by trade parties in global market. The export mechanism of export subsidies is considered to take the pulling power of resources from low-productivity areas to high-efficiency areas. Indeed, subsidized low-yield producers can also consume. Despite the potential benefits to domestic exporters and foreign consumers, export subsidies adversely affect the well-being of domestic consumers. First, domestic consumers pay a higher price than foreigners for the same goods that are subsidized. Secondly, as domestic taxpayers, consumers are also obliged to bear at least a portion of the financing costs of export subsidies provided to domestic producers because subsidy cost is provided by taxes collected from local consumers.

Domestic input subsidies

Domestic input subsidies are the other type of forbidden subsidies. According to 3.1 (b) article of SCM Agreement, interventions which prohibit usage of imported input products and policies require use of indigenous inputs rather than imported ones are considered domestic input subsidies. Such subsidies encourage the use of domestic inputs in the production process of a given product instead of imported inputs. Such subsidies block imports of input products and leads to the usage of domestic ones. Domestic input subsidies provide advantages for domestic manufacturers. However, from the perspective of international trade, such subsidies affects foreign industries as their sales to subsidizing countries will decrease.

Actionable subsidies

Actionable subsidy is “bounty, grant, or subvention enjoyed by the exporters of a country that may be challenged by an importing country if it injures its domestic industry” (WTO, 1995). Actionable subsidies are assistances which have negative impact on trade, however, with actions and countervailing measures by governments their impact can be decreased or abolished. In WTO reports, actionable subsidies are not listed. However, they are defined as if there is an adverse effect on a member country of WTO when it is implemented. WTO panels have stated that there are two conditions should exist in order to address actionable:

- Specificity: If granting authority limits the subsidy for other enterprises, it can be considered specific.
- Negative impact: According to SCM Agreement, it should be proved that the subsidy granted by a WTO member state has a negative impact on the interests of other WTO members so that an actionable subsidy can be mentioned. There are three types of negative impact which are damaging the domestic production branch of a WTO member state, eliminating or weakening the interests of other WTO member states in the framework of GATT 1994, and exposing the interests of another WTO member to serious effect.

Free subsidies

Free subsidy also called as non-actionable subsidy is called provision of financial assistance or benefit by government or an authority with the purpose of social benefit. They are also known as “Green” subsidies. Under certain conditions, subsidies implemented for the development of disadvantaged regions, development of underdeveloped regions, or for the support of industrial R&D activities and protection of the environment,

fall under this category. Such subsidies have positive effects on society. Any subsidy provided with the purpose of protection of environment is considered free subsidy. According the SCM Agreement, such subsidies are considered aids to adapt to environmental conditions. Mainly, such subsidies are provided for anti-pollution activities. The main character of this kind of subsidy is the benefit which is in favor of all humanity. Since, it benefits not only a country's environment, but also overall nature, any subsidy used with this purpose is acceptable by WTO. The main forms of free subsidies are:

- Subsidies for research and development activities;
- Subsidies for the development of less developed regions;
- Subsidies for environmental protection.

3. Conclusion

In this research, the impact of non-trade barriers on international trade was shown through analysis of subsidy. After 1995, new rules were set on non-trade barriers. One of such rule bases was SCM Agreement. In the Agreement, subsidies were identified, and rules were set on subsidies which could impact international trade. The more extensive conclusion that can be drawn from this analysis is that there are some benefits, however there are even more problems and challenges in case of non-trade related incentives including subsidy implementation. After the research, as a recommendation, I consider that since subsidy has positive effects as well, it should be applied on mainly infant industries without affecting international trade. For instance, subsidy can be granted to decrease the costs of production, however, the price should not be below the market price or it should not restrict any trade activity. In any case, subsidy grant should not affect international trade.

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