

**A STUDY ON THE NEW INCENTIVE SCHEME FOR FOREIGN  
DIRECT INVESTMENT IN KOREA AND ITS CONFORMITY TO THE  
WTO ASCM**

**By**

**Young-Hwan Sohn**

**THESIS**

Submitted to  
School of Public Policy and Global Management, KDI  
in Partial fulfillment of the requirements  
for the degree of

**MASTER OF ECONOMIC POLICY**

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*Dedicated to Eunyoung Cheon*

## **ACKNOWLEDGEMENTS**

Many people have given their precious time and generous support to this thesis.

First of all, I want to thank the indefatigable faculty and staff of School of Public Policy and Global Management, KDI – in particular, Dean Gill-Chin Lim, Prof. Jong-il You, my academic adviser and Kyong-Sun Lee, who edited English text of this study. I also want to express my gratitude to Yoon-Ha Yoo, Sang-Moon Hahm, Ju-Ho Lee, and Moon-Joong Tcha – who have not only benefited me with their excellent teaching throughout the academic year, but have also given me invaluable guidelines and words of encouragement when I needed them most.

## ABSTRACT

### A STUDY ON THE NEW INCENTIVE SCHEME FOR FOREIGN DIRECT INVESTMENT IN KOREA AND ITS CONFORMITY TO THE WTO ASCM

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Young-Hwan Sohn

To go over material on Korea's foreign investment incentives and to see if it conforms to WTO Agreement on Subsidies and Countervailing Measures. And, to search for way to improve and amend when and where necessary. There have been no cases where non-conformities between investment incentives and the WTO Agreement that grew into international trade disputes. That is, to date, no countries have complained to the WTO that tax benefits or subsidies granted for foreign investment inducement purposes by another country in jurisdiction harmed the former country in any way, nor has any country ever taken countervailing measures against another country. A comprehensive look at international disputes concerning subsidies has shown that there is no clear answer as to whether investment incentives cause any complications in WTO Agreement on Subsidies. It can therefore be concluded that no clear internationally recognized criteria or positions on foreign investment and investment incentives have been presented so far.

Although it has not been raised as an international issue yet, seeing that more and more countries are providing more and more incentives in order to induce more investment in their own countries, there is real and noteworthy enough possibility of disputes arising from non-conformities between investment incentives offered and implementation of the WTO Agreement on Subsidies and Countervailing Measures. Seen from this perspective, it is important that Korea takes a look at its new investment incentives and see if it goes against any part of the WTO Agreement and make any revisions necessary in order to prevent potential disputes from surfacing.

Korea's investment incentive system may be in conflict with some provisions of the WTO Agreement on Subsidies and Countervailing Measures. Such conflicts, or non-conformities, as pointed out in the previous sections should be amended as soon as possible in the following way. First, delete export rate and domestic procurement rate criteria from incentives related to reduction/exemption of rents and parceling prices for public properties owned by local governments. Second, adopt a much wider concept of industries for incentives provided to business dealing with high technology and industrial support services.

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## **I. INTRODUCTION: PURPOSE AND METHOD OF STUDY**

### **1. Background**

Korea experienced the fastest economic growth of all developing countries and was envied and admired by many countries around the world. With the hosting of the 1986 Asian Games and 1988 Seoul Olympics, it was growing into an economically powerful country until it faced one of the worst crisis in its modern history in late 1997. With the financial crisis, Korea's and its financial institutions' credit ranking fell to that of underdeveloped countries for a while.

Many factors contributed to this recent hardship. One of these factors is that, compared to other countries, Korea did not pay enough attention to inducing foreign investment and its domestic conditions were not appropriate for foreign investors to make their investments. Following this in early, Korea gave its investment incentives almost a complete facelift. This study attempt to find out if the newly implemented investment incentive system is in conformity with international standards, especially the WTO Agreement on Subsidies and Countervailing Measures. By taking a look at parts that do or do not conform, an attempt is also made to suggest the ways and directions in which Korea's investment incentives should be headed.

## **2. Purpose**

To go over material on Korea's foreign investment incentives and to see if it conforms to WTO Agreement on Subsidies and Countervailing Measures. And, to search for way to improve and amend when and where necessary.

## **3. Method**

This paper is organized in the following manner:

Purposes and methods of research, theoretical review of investment incentive, WTO agreement on subsidies and countervailing measures, specificity in granting subsidy, types, and features of subsidies, Korea's investment incentive system and WTO agreement, and future directions for Korea investment incentive system. Study was mostly done by looking into documents on investment incentives and laws and regulations related to it.

## **II. THEORETICAL REVIEW OF INVESTMENT INCENTIVES**

### **1. Theoretical Basis for Investment Incentives**

#### **A. General Investment Incentives**

The theoretical basis for investment incentive was first raised by A. Pigou and was from the welfare economics point of view. It focuses on how the market doesn't properly reflect positive externalities generated through investment in production. There is a need to correct the differences and investment incentive offers one way of doing that. Positive externalities may originate from the economy of scale, creation of new technologies and intelligence, and improvement of worker's functions. A difference can occur between the social rates of return and the producers of these positive externalities or spillover effects because they cannot be enjoyed in full by the investors. The argument is that such differences must be compensated through investment incentives if investment is to be optimized throughout the society (Lee/Lee 1998, p. 18).

The fact that investment incentive can be provided is also raised from the standpoint of economic development theory. The most representative example would be arguments relating to the protection of inducing industries. That is, the advantages generated from increased investment and lower unit production costs may often be not fully absorbed due to an immature market. In these cases, it may be necessary to offer incentives to these businesses so that they may become more efficient and more competitive. Incentives seen as necessary from such point of view were actually

offered in Korea in the past and in newly industrializing East Asian countries (Lee/Lee 1998, pp. 18-19).

## B. Incentives Provided to Foreign Investment

The basis for investment incentives in the previous section is seen from general perspectives. This section will look into the economic basis for investment incentive offered to foreign investors. Incentives on foreign investment is offered for the same basic reason as general investment incentive, that is to maintain the differences in social and personal (private) rates of return on investment. Only difference is that in the case of foreign investment, special circumstances that accompany foreign investment must also be taken into consideration when considering the rates of return.

Foreign investment does not just mean simple transfer of capital. Foreign investment involved transfer of various intangible assets, including technology, management know-how, skills, and usage of networks of multi-national corporations. If a foreign investor can internalize all these intangible assets, investment return rates will be able to reflect the net benefits of investment and incentive may not be necessary. The portions that are not internalized by foreign investing companies are transferred to investment inducing countries as positive externalities. In this case, the investment inducing country's incentives to foreign investors can be justified (Lee/Lee 1998, p. 19).

Foreign investment may not only bring transfer of externalities, such as technology and other intangible assets, but may also bring differences between social and private

investment rate returns in the investment inducing country through externalities that ensue the pervasive effects of industry and economies of scale.

Two other arguments are raised as bases for incentives in addition to incentives following the differences between foreign investment's social and private rates of return on investment. First, incentives may be offered as compensation when government interference results in falling short of expected profits. Most typical example of this is where developing countries give customs duty exemptions to foreign investment companies in importing capital materials, parts and raw materials. When it is deemed that some specific policies implement by the investment inducing country are causes for curtailed rates of return on investment, a direct step must be taken to amend that policy. However, this may be difficult for the investment inducing country to do due to various policy priorities that must be considered. In these instances, an alternative approach to solving these problems may be to offer incentives (Lee/Lee 1998, p. 19).

Second, incentives may be offered in order to compensate for the costs incurred to the foreign investor due to public services not provided by the investment inducing country. When the investment inducing country's public education system is lacking and cannot produce technically skillful personnel needed by the foreign investment companies, the investment inducing country may subsidize, in part or in whole, the costs that go into education and training of such labor (Lee/Lee 1998, p. 20).

## 2. Different Types of Investment Incentives

There are many different types of incentives. In particular, since the late 1980s, incentives on foreign investment have been diversifying as countries worldwide competed in offering incentives to induce more foreign investment. Even within one country, different incentives may be offered by different levels of governments (central and local governments). Further, these various incentives differ greatly in their objectives.

Despite this diversity in investment incentives, they can largely be divided into two categories: fiscal incentives and financial incentives). Incentives that do not fall under neither of these categories but are nonetheless incentives related to investment can, for the sake of convenience, be called miscellaneous incentives. Fiscal incentives are utilized far more by underdeveloped or developing countries than by developed countries. The more developed the country, the more they tend to offer financial incentives. The reason that fiscal incentives are used more by underdeveloped and developing countries seems to be that direct financial subsidies are burdensome on their expenditure (Lee/Lee 1998, p. 20-21).

#### A. Fiscal Incentives

Fiscal incentive is the type used most for foreign investment. According to a study done by UNCTAD, in the early 1990s, only 4 of the countries surveyed did not offer fiscal incentives to foreign investors. And, a comparison of mid 1980s and early 1990s showed that use of fiscal incentives is rising without changing much in form.

The most representative form is the reduction in corporate tax. The standard rate of corporate tax that applies to all companies are reduced for foreign investment companies. In some cases, the corporate tax is exempted all together. This is called the “tax holiday” and generally lasts for the initial 5 years following the investment. Depending on circumstances, this holiday may be extended and may last as long as 10-25 years.

In anticipation of not being able to enjoy the tax benefits during the tax exemption/reduction period due to inability to produce profits, sometimes these losses are permitted to be countervailed against future profits.

Instead of direct curtailing of the tax rate of giving a tax holiday, another form of fiscal incentive is to lower tax rates all across the schedule or to deduct a set amount from the taxes due. This form of incentive is usually employed in developed countries (Lee/Lee 1998, p. 21).

## **1. Fiscal Incentive**

- Exemption/Reduction of corporate tax
- Full exemption of all taxes
- Countervailing of losses incurred during tax holiday against future profits
- Recognition of accelerated repayment
- Deduction on investment and reinvestments
- Reduction/Exemption of social welfare charges
- Earnings deduction based on employment related expenditures

- Earnings deduction based on specific expenditures (e.g. related to marketing and promotional activities)
- Tax exemption/reduction based on added values created
  - Tax exemption/reduction based on procurement in invested country
  - Recognize tax deduction of added values created
- Import related incentives
  - Exemption of customs duty on imports of capital materials, parts and raw materials
  - Tax deduction of import duties
- Export related incentives
  - Exemption of export duties
  - Tax benefits on profits produced from exporting
  - Tax benefits on certain future exchange revenues
  - Link export records with domestic sales to give tax exemption/reduction
  - Drawback of customs duties
  - Tax deduction for amount founded on procurements obtained solely in the invested country
  - Earnings deduction on capital expenditures and overseas expenditures for export industry

## 2. Financial Incentives

- Direct capital subsidy related to investment project or subsidies on production and marketing costs
- Loans in the character of subsidies
- Payment guarantees

- Export letter of credit guarantee
- Public venture capital participating in high-risk businesses
- Special rate government insurance for foreign exchange fluctuations, devaluation and other non-commercial risks

### 3. Other Incentives

- Assistance in providing infrastructures
- Technical support and other support services including securing funds procurement, project execution and management, advance study on investment, market information, study on the possibility of raw material supplies, provide production quality control and marketing technology, education & training and reeducation, development of know-how
- Priority on government procurements
- Market entrance restrictions and monopoly rights
- Protection from import economies
- Special measures in relation to foreign exchanges

*Source: UNCTAD-DTCI (1996), World Investment Report, 1996, Table IV, 4. p. 180. in Brewer/Young (1997), p. 181.*

For example, instead of depreciation for fixed assets such as factory and equipment, accelerated repayment or immediate refund is allowed so that foreign investors can adjust their tax profits to fit their own (different) circumstances. Another method is to deduct a certain amount of total investment from the taxes due. Or, earning deduction method is criticized also and deducts a certain employment related costs

from tax standards. Sometimes a connection is made between specific outcomes of the foreign investment with tax reductions. For example, relating local contents to tax reduction. In some cases, social security contributions, which are not taxes but which by nature are forced, are exempted.

There are also fiscal incentives that are related to foreign investment company's imports and exports, like exempting import duties on capital materials, parts and raw materials that a foreign investment company imports for its business. And international practices indicate that such exemption of customs duties last for about 5 to 10 years, sometimes 15-25 years. Fiscal incentives related to import/exports of foreign investment companies are more commonly offered to free trade zones.

Fiscal incentives are also offered in relation to exports of foreign investment companies. The most representative being exemption of export duties. And sometimes special earnings deductions or tax deductions are applied to profits produced from exports. In particular, tax benefits are given to exports that bring about foreign currency revenues. Or, capital expenditures from exporting companies are recognized as special costs at times when calculating taxes (Lee/Lee 1998, p. 23).

Countries competing to offer fiscal incentives to attract foreign investment may trigger harmful tax competition. It especially refers to when geographically closed located countries lower tax burdens in order to induce foreign investment bringing about discords among those countries or even may be giving rise to financial dangers in some of those countries. It can be said that Korea's extending the period of tax exemption/reduction to 10 in enacting the Foreign Investment Promotion Act had

more than a little to do with offering competitive tax benefits compared to that of other major foreign investment inducing countries in Asia like Malaysia (Lee/Lee 1998, p. 24).

And, although EU is intensifying economic unification by introducing a unified currency in 1999, individual member countries are showing signs of lowering taxes on capitals with high mobility to attract foreign investment. In order to prevent harmful tax competition under global economy system, OECD believes that international understanding and establishment of action and penal codes are necessary. Recently, EU actually did enact the Code of Good Practices for Business Taxation, even though it is unbinding (Lee/Lee 1998, p. 24).

## B. Financial Incentives

Financial incentive is where foreign investment companies receive direct financial benefits aside from taxes. According to a study done by UNCTAD, in the early 1990s, 59 of the 83 countries studied provided financial incentives. It was also shown that financial incentives are offered more by developed countries.

The most representative form of financial incentive is to provide subsidy on investment related capital investment or to subsidize production or marketing costs. Most of the financial incentives offered to foreign companies in USA or UK are offered by the central government, larger local government bodies, or other levels of local governments. Financial incentives are usually related to the size of

employment. UK's Regional Selective Assistance is in this category. These types of assistance have advantage in that they are easy to manage because a provision can be inserted in the regulation stipulating that the assistance already paid may be retrieved should the conditions for investment not be met (Lee/Lee 1998, pp. 24-25).

There are various other types financial incentives available in addition to direct cash assistance. One of these is providing loans at low interest rates. Or, another way is for the investment inducing country to provide payment guarantee to the foreign investment company in obtaining loans. The government of the investment inducing country or its public financial institution may provide guarantees on export letter of credit also. At times, government contributed public funds may be invested jointly with the foreign investment in high-risk investment projects. Sometimes, government insurance that apply special rates to changes in foreign exchange rates, devaluation, and other non-commercial risks are provided as financial incentives (Lee/Lee 1998, p. 25).

### C. Other Types of Incentives

There are other ways and aspects in which foreign investment companies may receive assistance from the investment induced governments which cannot clearly be defined as either fiscal incentive or financial incentive. For example, the government may build social overhead capital (SOC) facilities that the foreign investment company needs. Providing various other forms of assistance services may also be seen as types of incentives.

Supports in infrastructures and other services in Korea's Free Trade Zones, UK's special industrial regions, and high-tech industrial complexes in other countries are good examples of incentives that come in the form of provision of SOCs and other supportive services (Lee/Lee 1998, p. 25).

Many different types of services can be included in the support services that foreign investment companies may receive in the process of their investment and business activities. For example, capital providers may be found and introduced to foreign investors. Or, technical support or other support services may be provided, including project execution and management, advance study on investment, learn market information, seek raw material sources, technical support in production control and marketing, education & training and re-education programs, and development of know-how.

Government procurement companies may give priority to foreign investment companies as a way of providing special benefits and incentives. Incentive may also include restricting other companies from entering the market or giving monopoly rights to foreign investors. These types of incentives are used most often by underdeveloped countries and central/eastern European countries. Further, special measures concerning foreign exchanges are sometimes permitted (Lee/Lee 1998, p. 26).

### 3. Effects of Investment Incentives

Most countries, in order to attract foreign investment to their countries, offer diverse forms of incentives. However, many research results show that incentives are not decisive factors in foreign investment companies, especially multi-national companies, in selecting where to invest. For multi-national companies, factors that they consider important in their selection are size of the market and its growth possibilities, production costs, level of technology, infrastructure, political and social stability, and regulatory restrictions. In an actual study done by 30 multi-national companies on 74 investment projects in the areas of automobile, computer, petrochemical and food processing industries concluded that investment incentives were not considered at all in their decision making (Lee/Lee 1998, p.26).

However, this study did positively prove that general opinion that investment incentives do contribute making an attractive investment opportunity even more attractive. Although there are research results that show that incentive can effect the overall flow of investment, but still with little difference in results that show that incentives do not play an important role in investment decisions. However, when a general region of investment has been chosen but not a specific area or country (e.g. a Korean company saw the dire need to invest in Europe and had decided make the investment and is looking for a specific location of investment), incentives have been shown to have an important effect in specific location selection. That is, investment incentives play a pivotal role in deciding whether the company will choose Scotland, select Wales instead, or whether it decides to invest in Northern France. In cases like European Union where market unification effects are deepening, in the final stages of

reviewing where candidates for investment are narrowed to 2 or 3 areas, investment incentive factors make up for the overall investment environment and, thereby, may become a major element in selecting where to make the investment (Kim 1997, p.128).

Foreign investors show different reactions to different types of incentives depending on their strategies. Export-oriented foreign investors to whom cheap labor is important, prefer fiscal incentives over market protection or other types of incentives. On the other hand, market-oriented investors would obviously prefer incentives like market protection over fiscal ones. Where incentive provided at regional level are concerned, it has been shown that cash assistance is much more effective than fiscal incentives in inducing investment. Recently, many countries have been offering incentives for transfer of advanced technology, for establishment of research & development centers, etc. Some researches have concluded that creation of free trade investment zones, like advanced technology complexes, are much more effective incentives than fiscal or financial incentives as far as strategically investment inducement is concerned (Lee/Lee 1998, p. 27).

As pointed out already, many different types of investment incentives are offered by countries worldwide in order to stimulate foreign investment in their countries. Investment incentives have close connections to many of the investment inducing countries' objectives, such as export promotion, job creation, technology transfer and revolution. UNCTAD stated that export related incentives have been the most effect incentives. Korea's Export Free Zone has been receiving much attention as successful example of foreign investment inducement even after the financial crisis that hit the country in November 1997 and is backing up these study conclusions.

Although many countries are offering varying types of incentive packages, it has been pointed out that much care is needed in designing and operation if those incentives are to effectively achieve small goals that they set out to do in the first place. When incentives are offered to attract specific foreign investment, the incentives must be designed to fit the special characteristics of the investment. And, when incentives are offered at different levels of governments, coordination is important. If designing and coordination are not carefully done, investment incentives may bring about harmful side effects (Lee/Lee 1998, p. 28).

### **III. WTO AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES**

#### **1. Background to Negotiations**

The WTO Subsidy Agreement begins with Article 1 (Definition of a Subsidy). This Agreement defines subsidy as when there are benefits ensued from a financial contribution by a government or any form of income or price support in the sense of Article 16 of GATT 1994 (Ahn and Yoo, p. 15, Korea Chamber of Commerce, p. 17).

USA and EC each took different positions in establishing the legal concepts of subsidy. On one hand, the US, in their attempt to expand the concept of subsidies, defined subsidy as all activities that benefits on specific industries. On the other hand, the EC argued that subsidies exist only when there is a cost to government (Yoo, p. 7).

As a result of negotiations to bring these difference together, the WTO Subsidy Agreement stipulate "a financial contribution by a government" and "a benefit thereby conferred" as the conditions for justifying subsidy. This means subsidies shall be seen as any benefits that befall a private company as a result of government measures even though there is no cost incurred to the government in doing this. This in essence means acceptance of US claims that a subsidy consists of "benefits to the recipient." Further, by noting that a financial contribution by a government may take place indirectly through a private organization, the Agreement included indirect subsidies, claimed by the US, into the scope of a subsidy (Ahn and Yoo, p. 15).

The definition of a subsidy, especially "a financial contribution by a government", ended up being very complex as a result of negotiations between US and EC. Therefore, more arguments may arise out of different interpretation of "a financial contribution by a government" than from "benefits" (Ahn and Yoo, p. 15; Yoo, p. 7).

## 2. Definition of a Subsidy

Subsidies that come under regulatory control are those cases in which benefits are conferred through a financial contribution by a government in relation to trading of goods and in which such benefits are conferred upon a recipient with specific characteristics.

## *Article 1*

### *Definition of a Subsidy*

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);
  - (ii) government revenue that is otherwise due is foregone or not collected (e.g. fiscal incentives such as tax credits)<sup>1</sup>;
  - (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.

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<sup>1</sup> 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.

In order to review the objectives of financial contribution by a government or a public body, it must first be understood that the concept of "government" provided for in this Agreement is a wide range concept that includes not only public bodies but also private bodies controlled by the government. Further, public bodies include government bodies in which the government may take direct or indirect participation and special bodies that are under government control or have the right to act with public authority. Here, the government receives power of authority on subsidy grants from the government or is granted part of the fund, thereby, including private bodies whose activities are not very different from that of government practices. Government's financial contribution refers to liability of the public accounting. Liability in public accounting occurs when ✂ funds are transferred to the private sector through such medium as gratuitous support, waiving the debts, loans, and share participation; ✂ when funds are potentially transferred to the private sector via loan guarantees; ✂ when it take over private sector's debts; ✂ when government gives up tax revenues by giving tax deductions; ✂ when government provides the private sector with goods or services other than SOCs; or ✂ when government purchases goods from the private sector. However, government's participation in the private sector activities without any liability to the government's public accounting is not considered as subsidy (Ahn and Yoo, p. 18; Korea Chamber of Commerce, p. 18; Yoo, pp. 9-10).

Gratuitous support, which falls under direct transfer of funds, is different from loans or share participation in that government does not expect anything back in return for the funds provided. And, potential transfer of funds or liability burdens include various insurances provided by the government. Direct taxes given up by the

government include tax exemption, drawbacks, deferred payment in the form of tax reduction, earnings deduction, special depreciation, and guaranteed fund system. While indirect taxes, exemption of value added tax, consumption tax, accumulated indirect tax, drawbacks, and deferrals and reduction of customs duties are considered as taxes forfeited by the government. However, according to Article 16 of GATT Agreement and to Annex to this Agreement, customs duties or internal taxes assessed on domestic consumption goods are exempted for export goods when customs duties or internal taxes refunded on the condition that the amount of refund not exceed taxes paid are not seen as subsidies (Korea Chamber of Commerce, p. 19).

Further in relation to specificity of subsidy grants, SOCs, as long as no actual restrictions are placed on the recipients, are not seen as subsidies. If SOCs were to be monopolized by a specific company or industry, or if the government provides SOCs to a company based on a decision that is not deemed to be neutral or objective, such actions set off countervailing measures from the country which the goods in question are imported. In addition, price support in Article 16 of the GATT 1994 refers to various financial supports provided by the government to the companies in order to stabilize the prices of goods produced by the companies and a subsidy must go through the specificity test stipulated in Article 2 of this Agreement if it is to be classified as countervailing. Government's double grain price system or export price support systems are considered as price supports. According to the definition of a subsidy, financial contribution, an essential condition in defining subsidy, may come into being without any cost to the government. If a burden occurs to the account of a private body that receives orders from the government, it shall be seen as a cost to the government even though no direct cost has been incurred to the government. That is

the necessary conditions for a subsidy as defined is not met just by the government bringing some financial burden to the public account, but applies equally to various activities that have the same effect (Korea Chamber of Commerce, p. 19).

However, for government's special measures to the private sector to be defined as a subsidy, condition of benefits to the beneficiary must be satisfied at the same time along with a financial contribution by a government. Benefits to the recipient is decided by Article 14 of this Agreement on Calculation of the Amount of a Subsidy in Terms of the Benefit to the Recipients. Of the countries that have assessed countervailing duties prior to this, that is US, Canada, EU, and Australia, all except the US judged the existence of subsidy as "cost to the government" concept. But in this Agreement, "benefit to the recipient" concept is newly introduced, thereby, establishing a new definition of a subsidy. That is US's position was upheld in the Uruguay Rounds. In Canada, EU and Australia, the existence and size of a subsidy were based on borrowing rate and lending rate which meant that a burden had to take place in the government's public accounting for a subsidy to exist. Therefore, the object of countervailing duties was decided by cost to the government concept and not benefit to the recipient (Korea Chamber of Commerce, p. 20).

On the other hand, US had differed from GATT 1947 provisions and used benefits to the recipient concept in judging subsidies so that a subsidy was seen to exist if a recipient receives benefits from special measures taken by the government even if there was no direct cost to the government. In this case, "benefit" refers to the amount that exceeds the cost to be paid when recipient uses alternative methods in the market and this excessive amount becomes the object of countervailing duties.

Therefore, when applying benefits to the recipient concept, subsidy exists if a company benefits from government's preferential treatment even in the absence of any burden to the government's public accounting (Korea Chamber of Commerce, p. 21).

Benefits to the recipient appear in different forms depending on the government's method of financial contribution. That is,

(A) The whole amount of grants are benefits to the recipient. Whereas in mitigation of debts, the principal and interests to be paid at the time of mitigation become the benefits. In cases of loans, the difference between amount paid by the recipient company on government loans and the amount paid on the loan it can actually procure in the market becomes the benefit. Differences arise in benefits that a company receives in obtaining government loans depending on creditworthiness of the companies and on the lending institutions.

(B) If the equity infusion by the government is not outside the sphere of customary investment practices of the private investment, it is seen to have produced no benefits. That is, if there is no difference between the price of shares purchased by the government directly from the company and the market price of the shares purchased by general investors from the company, no benefits have been produced. In this instance, equity infusion by government in an unequity-worthy firm, that is a firm on such bad financial grounds that no prices are formed in the market for its shares, the benefits to the company are decided based on the difference between that company's rate of return on investment and rate of return shortfall (RORS) for a firm of the same

industry (Korea Chamber of Commerce, p. 21).

(C) In loan guarantees, the difference between amount to be paid by the company that received government loan guarantee at the time of loan and the amount that it would have to pay without the government loan guarantee is seen as benefits to the company.

(D) The benefit produced from government's forfeiting of tax revenues is the difference between the taxes that a company has to pay in the absence of special taxes and taxes that it has to pay when special taxes do exist. Exemption of direct taxes, drawbacks, and reduction/exemption of taxes, earnings deduction, special depreciation, and preparation funds systems which are all forms of deferred payments, the benefits to the recipient are the amount of reduction/exemption that results from the tax system in question. The same is also true for exemption of indirect taxes, drawbacks, and deferments. However, only excess reduction/exemption and excess drawbacks are seen as benefits to the recipient for indirect taxes in which this Agreement sets special stipulations as provided for in "Illustrative List of Export Subsidies).

(E) Benefits resulting from provision of goods or services originating from the government, or purchasing of goods by the government are also judged along with commercial considerations. Benefit result when government gives preferential treatment in providing goods or services to certain firms within its area of jurisdiction or if it purchases goods produced by these companies at high prices.

Also, as provided for in the Illustrative List of Export Subsidies of this Agreement,

the government may provide production elements (domestic goods or import goods) at more advantageous conditions than production of domestic goods for manufacturing of export goods, but if the conditions provided for production of export goods are better than those commercially viable in the international market, then the problems concerning subsidy grants arise.

(F) Benefits from earnings support occurs if compensations that a firm must normally pay to workers are taken care of the government through financial supports. However, if the government's earnings support is only an additional profit to workers and is not related to firm's responsibilities, then benefits are not produced (Korea Chamber of Commerce, p. 22).

(G) In cases of price supports, government's cost in stabilizing specific firms or specific industries can be seen as providing benefits to firms, but various forms of price stability systems in which existences of subsidies are difficult to decide must be judged case by case depending on individual circumstances (Korea Chamber of Commerce, p. 23).

#### **IV. SPECIFICITY IN GRANTING SUBSIDIES**

In granting subsidies, the existence or non-existence of specificity, that is advance restrictive problems like whether the government implements any special measures to restrict the range of benefit in payment of subsidies and post problems that present more practical issues like whether the firms made fair use of such measures, or

accessibility must be considered. If the specificity of a subsidy brought about disadvantageous effects to economic profits of other contracting countries, countervailing measures may be implemented afterwards.

Therefore, in vice versa, no specificity in a subsidy means that even if other contracting countries are disadvantageously affected due to the granting of the subsidy, no counter measures, whether it be bilateral or multilateral, may be taken. Article 2 of WTO Agreement on Subsidies and Countervailing Measures provides for specificity as follows (Ahn and Yoo, p. 29; <http://www.lgeri.com>; Yoo, p. 19; Korea Chamber of Commerce, p. 27).

## *Article 2*

### *Specificity*

2.1 In order to determine whether a subsidy, as defined in paragraph 1 of Article 1, is specific to an enterprise or industry or group of enterprises or industries (referred to in this Agreement as “certain enterprises”) within the jurisdiction of the granting authority, the following principles shall apply:

- (a) Where the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises, such subsidy shall be specific.
- (b) Where the granting authority, or the legislation pursuant to which the granting authority operates, establishes objective criteria or conditions<sup>2</sup> governing the eligibility for, and the amount of, a subsidy, specificity shall not exist, provided that the eligibility is automatic and that such criteria and conditions are strictly adhered to. The criteria or conditions must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification.
- (c) If, notwithstanding any appearance of non-specificity resulting from the application of the principles laid down in subparagraphs (a) and (b), there are reasons to believe that the subsidy may in fact be specific,

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<sup>2</sup> Objective criteria or conditions, as used herein, mean criteria or conditions 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.

other factors may be considered. Such factors are: use of a subsidy programme by a limited number of certain enterprises, 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.<sup>3</sup> In applying this subparagraph, account shall be taken of the extent of diversification of economic activities within the jurisdiction of the granting authority, as well as of the length of time during which the subsidy programme has been in operation.

2.2 A subsidy which is limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority shall be specific. It is understood that the setting or change of generally applicable tax rates by all levels of government entitled to do so shall not be deemed to be a specific subsidy for the purposes of this Agreement.

2.3 Any subsidy falling under the provisions of Article 3 shall be deemed to be specific.

2.4 Any determination of specificity under the provisions of this Article shall be clearly substantiated on the basis of positive evidence.

Paragraphs 1(a) and 1(b) of Article 2 contains advance limits on access. It stipulates that specificity is deemed to exist if the granting authority or concerned regulations clearly limit granting of the subsidy to certain enterprises or industries within the jurisdiction of authority, or enterprise or industry counties (referred to as certain enterprises in this Agreement) pursuant to regulations or actual practice. “Certain enterprises” here does not refer to “all enterprises” with the area of jurisdiction but only includes certain number of enterprises or industries. Therefore, if a subsidy is to be granted to all enterprises within a area of jurisdiction, no problem of specificity arises. The other hand is where granting authorities or concerned regulations clearly state eligibility and amount of subsidy in an act, regulation, or official document based on objective and neutral criteria. And if meeting these conditions automatically means becoming a recipient, then no specificity exists (Ahn and Yoo, p.

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<sup>3</sup> In this regard, in particular, information on the frequency with which applications for a subsidy are refused or approved and the reasons for such decisions shall be considered.

31; Yoo, p. 21; Korea Chamber of Commerce, p. 28).

If recipients of subsidies are limited to certain number of specific enterprises, “specificity” comes into being. But no objective criteria using data like industry classification system has yet been established on whether specificity is created if the industry or industrial zone is somewhat limited. Generally, all factors that may affect specificity are simultaneously considered with comprehensive, integrated decisions reached. However, International Trade Commission of the US, the leading country on the issue of specificity, is of the opinion that specificity is not seen to rise if recipients are not designated according to industries but on objective and neutral criteria (e.g. high-tech industries or small and medium enterprises). But specificity is seen to come into being even for subsidies meant for small and medium enterprises if it is limited to certain small and medium industries (Yoo, p. 21; Korea Chamber of Commerce, p. 29).

In relation to this, specificity is seen to exist if the government offers tax supports to specific enterprises or industries or if it implements the system selectively with limited range of enterprises as recipients in mind in reality, but no specificity exists if the system is applied equally to all enterprises and manufacturers alike.

However, USITC argues that specificity again comes into being if the government gives additional tax deductions on specific goods only. Decisions on tax rates or changes to tax rates generally applied by the government of the jurisdictional area shall carry no specificity (Korea Chamber of Commerce, p. 29).

Still, because price or earnings supports are aimed at specific enterprises (districts) or industries (districts), it contains characteristics of specificity from the beginning and “price and earnings stabilizing policies”, a part of macro-economy, generally does not contain specificity and therefore does not apply to price and earnings supports provided for in this Agreement (Yoo, p. 21).

Further, supporting an individual enterprise or industry in a situation where many subsidy granting systems are in mutually concerned relationships, the relationships among those systems must also be reviewed before deciding whether specificity exists or not. However, in cases of social infrastructures, specificity does not exist unless the government limits enterprises from launching businesses in SOC construction areas. This is because SOC facilities do not have specificity if they can be used by all enterprises involved in business in the SOC area and not just by few specific enterprises or industries. Care should be taken here because specificity does not exist if accessibility to SOC is limited by its location and special characteristics and not by government measures (Korea Chamber of Commerce, p. 30).

Specificity is deemed to exist even in cases where subsidy is granted with no limits if subsidy after being granted is used mostly by some enterprises or industries or if government makes selective choices of recipients. Regulations on post granting and actual accessibility of subsidies are briefed in paragraph 1(a) of Article 2 of this Agreement. Specificity issues can arise afterwards when only limited number of few enterprises make use of the subsidy, when subsidies end up being used by only few enterprises, when subsidies are granted in unequal proportions to only a few enterprises, or when granting authority makes selective decisions in granting subsidies.

In these cases, the diversity of economic activities of the granting authority and the enterprises or industries receiving the subsidies must all be taken into consideration in deciding the existence or non-existence of specificity. The US call this the Four-Prong Test and sees specificity as existing if any one or more of these conditions are satisfied. Specificity can be said to be absent only when none of these are met (e.g. countervailing duty assessment on Software Lumber and Management discussed at US/Canada FTA subcommittee meeting in 1994).

At this point, in relation to problems of judging specificity, we need to review the position taken by the US, the country that internationally assesses the most countervailing measures in number and is leading the world in this area.

The US (Office of International Trade, Department of Commerce) considered both the pre- limitation issues and post- accessibility issues at the same time and came up with the following 3 basic principles on which specificity issues are to be judged. First, does a foreign government limit the accessibility to the system? Second, is the system proportionate, or does there exist a major user? Third, has the government taken any selective actions in the granting procedure? (Korea Chamber of Commerce, p. 30-31).

Specificity involving specific geographical regions is dealt with in paragraph 2.2 of Article 2 of the Agreement. According to paragraph 2.2, specificity exists if a granting authority provides subsidy to a certain enterprise located within a designated geographical region within its jurisdiction, or vice versa. A subsidy that is accessible to all enterprises located within a designated geographical region within the

jurisdiction of the granting authority is seen to be non-specific. That is, no specificity is seen to exist if the central government designated a specific area and gives all enterprises within that geographical region the equal opportunity to access the subsidy. If the aforementioned interpretation is correct, then the permissible subsidy for underdeveloped regions mentioned in paragraph 2 of Article 8 has no special significance. That is, paragraph 2 of Article 2 allows policies aimed at regional development to be fully utilized.

Therefore, provisions of paragraph 2 of Article 2 argued for by Canada at the time is expected to set off a major attacks once the WTO is launched. Looking at it now, this provision can be interpreted as there being no specificity if the central government chooses a designated geographical region within its jurisdiction and grant subsidies to all enterprises in the area. That is, if the government can compensate for the costs incurred to enterprises for launching businesses in disadvantageous site locations in a fair and undiscriminating way, it cannot become the object of countervailing measures (Korea Chamber of Commerce, p. 31).

At the same time, on the other hand, the prohibited subsidy stipulated in Article 3 of the Agreement may become the target of countervailing measures by countries sharing common understanding because prohibited subsidies are specific without any exceptions (Korea Chamber of Commerce, p. 32).

## V. DIFFERENT TYPES OF SUBSIDIES AND THEIR SPECIAL CHARACTERS

### 1. Prohibited Subsidy

The WTO Agreement on Subsidies and Countervailing Measures chose the traffic light approach and divided subsidies into 3 categories: prohibited subsidies, actionable subsidies, and non-actionable subsidies.

Prohibited subsidies cannot be used at source, while actionable subsidies may do so on the condition that it is subject to countervailing if it adversely affects other contracting countries. And, non-actionable subsidies may be used without being too tied down to counter measures. Further, remedy procedures for are varied according to subsidy types, thereby clarifying the settlement of disputes via multilateral medium like the WTO (Korea Chamber of Commerce, p. 43; Yoo, p. 28).

Although there were difficulties in the process, in the final WTO Agreement on Subsidies and Countervailing Measures, prohibited subsidies were restricted to export subsidies and import transfer subsidies, which have trade distortion effect. Introduction of subsidies exceeding in quantity or certain rates over sales are stipulated as countervailing subsidies (Korea Chamber of Commerce, p. 43).

#### *Article 3*

#### *Prohibition*

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<sup>4</sup>, whether solely or as one of several other conditions, upon export performance, including those illustrated in Annex I<sup>5</sup>;
- (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.

## (B) Interpretation

Prohibited subsidies are divided into export subsidies and import transfer subsidies. Export subsidies refer to subsidies granted upon export performance in law or in fact and include those listed in the Illustrative List of Export Subsidies. Although payment of export subsidies have nothing to do with export performance in law, it does include expected exports, actual exports or earnings resulting from export subsidies. Here, export performance means basically activities based on exports but is not of concept that it includes all activities that have even little to do with exports. That is, just the fact that subsidies are granted to all exporting enterprises does not make it an export subsidy. Above all else, subsidies based on export performance or granted on the condition of carrying out exports responsibilities are considered to be export subsidies.

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<sup>4</sup> 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.

<sup>5</sup> Measures referred to in Annex I as not constituting export subsidies shall not be prohibited under this or any other provision of this Agreement.

In this case, export responsibility is interpreted to include not only the items clearly stipulated but all relations connected to export responsibilities in fact. However, a system that applies equally to exports and domestic goods alike cannot be said to belong to export performance provisions. Therefore, export subsidy is not established simply when the size of the export subsidy is proportional to actual export size, but when a subsidy is granted under export activities as pre-conditions, then they all become export subsidies.

Basically, export subsidy puts forward as examples various forms of financial contributions which the 12 important types listed in Illustrative List of Export Subsidies may take.

However, this List does not list all prohibited export subsidies and therefore inserts general conditions under the term “export performance” in paragraph 9(a) of Article 3.1 on prohibition on export subsidies (Ahn and Yoo, p. 40; Korea Chamber of Commerce, p. 44; Yoo, p. 29).

The Illustrative List of Export Subsidies gives as examples 12 types of financial contributions that a government may make to exporting enterprises. That is, they are direct subsidies granted to enterprises or industries according to export performance. In relation to this, the US includes cases in which subsidy is directly granted depending on export performance and where benefits are produced. Direct subsidy refers to direct transfer of funds that directly benefit enterprises or general government measures like tax reduction/exemption. On the other hand, giving incentives on subsidy grants to financial institutions by applying rediscounted rates in

stages when granting funds in specific areas or lowering prices of goods by the government via expansion of supply of certain goods to benefit enterprise are seen as indirect subsidies.

Currency retention schemes, export encouragement awards paid as bonuses on exports and some practices similar to these belong to the category of export subsidies. That is, allowing export enterprises to retain foreign currency for its export purposes or in order to sell to a third party country or where such systems are encouraged are considered as export subsidies that apply foreign exchange rate to export enterprises are considered to be an export subsidy except where it is operated under the IMF Agreement.

If the government provides transport and transportation costs under favorable conditions when shipping export goods rather than domestic goods, then this is seen as export subsidy. Further, if the government orders a transporting enterprise that is commissioned by the government to apply lower transport costs to export goods than for domestic consumption goods, this becomes a preferential measure for exports although no burden has been created in the government's public accounts. However, if the differences in the transport costs are due to existing customary practices among enterprises, or when they are commercially explainable, they are not considered as export subsidies.

When the government directly or indirectly provides import goods, domestic goods and service that go into producing export goods at more advantageous conditions than for production of domestic consumption goods, then they are seen as export subsidies.

That is, the government must not provide raw materials or services under better conditions for production of export goods than it would for production of goods to be domestically consumed. However, when government provides raw materials that are not under import control, if these raw materials, whether it be import or domestic goods, are supplied for export production at a higher price than at world market prices, this shall not be seen as export subsidy. But cases like these will not occur in a country that does not regulate imports. If raw materials under import control are provided to exporting enterprises at more advantageous conditions than to producers of domestic consumption goods even though that price may still be higher than world market prices, it then becomes an export subsidy. It also is seen as an export subsidy if direct burden is brought to the government's public accounts.

Direct taxes or social security costs that enterprises have to pay but are exempted, given drawbacks, or deferred in partial or whole for export cases are seen as export subsidies. However, according to footnote 57 of the Agreement, industrial or commercial enterprise mentioned in that paragraph can be seen to mean general enterprises.

When calculating tax standards for direct taxes, special deductions allowed in relation to exports rather than assessing them for production of domestic consumption goods are seen as export subsidies.

Following conditions must be met in order for exemption or drawbacks of indirect taxes that are assessed in the final stages of goods production or distribution to be considered as export subsidies. If the exemption or drawback of indirect taxes on

export goods exceed the amount of indirect taxes assessed on domestic consumption goods, then such exemptions and drawbacks are seen as establishing export subsidies. Exemption or drawbacks of indirect taxes assessed in the final stages of production are not export subsidies unless they are excess exemptions or excess drawbacks.

Goods and services such as machines, labor, materials, energy, oil are broad range of production elements that are used for production of export goods that exceed the exemption, refunds, or deferments of accumulated indirect taxes that are assessed in the middle stages of goods production. However, should exemption, refund, or deferment of all accumulated indirect taxes be possible, these shall not be seen as export subsidies unless they are excess exemptions, excess refunds, or excess deferments. In this case, the object of exemption, refund or deferment are not the wide range of production elements like machines and labor listed above but “input elements used up in the production process” are limited to input elements in materialized form, energy, fuel and oil consumed during production, and catalysts. The reason for narrowing down the list of element that can be exempted, refunded or deferred was to curtail exceptions of export subsidies.

If inputs that are consumed in the production of export goods are assessed on imports but are refunded in excess, then they are seen to form export subsidies. However, in cases where an enterprise does not manufacture and export goods made with imported raw materials but using alternative domestic raw materials instead, the import materials are seen to have been used in the manufacturing of export goods and customs duties and import assessments may be reduced if the import of those raw materials and counter exports took place in a reasonable period not lasting longer than

2 years. Guidelines on such substitution drawback system are separately provided for in Annex III to this Agreement.

Even information deemed inappropriate for preservation of long-term operation costs or losses can become export subsidies if export insurance rates or guarantee rates are set low enough. The US Department of Commerce deems export subsidies as existing if 5 years' export insurance rates are inappropriate for preservation of long-term operational costs or losses and sees the difference between the insurance premium that the firm pays and the benefit that it receives as the benefits from such export subsidy.

Export subsidies come into being in the following cases: if the government grants export credits at lower interest rates than procurement costs; if it gives partial or whole reduction of funds procurement costs to exporting firms; or if the government on behalf of the financial institution pays in part or whole the costs that must be borne in order to procure funds to be used in export credits. That is, if the government pays part of all of interests or costs that a firm must pay in being granted export credits or if the government pays part or whole of handling institution's costs in order to give incentive to the financial institution that deals with export credits, then in both cases export subsidies have come into existence. However, this will not hold true for signatory countries to OECD Guidelines on Export Credits and OECD Multilateral Shipping Agreement, Aircraft Agreement, Nuclear Plant Agreement as long as export credits are granted in accordance with these agreements.

The 11 lists presented as examples above were decided upon numerous discussion at

GATT focused on past practices of certain specific countries and are very clear in content. However, other export subsidies not clearly stated in these lists are very diverse in content and vague so that its conditions can also only be very general. Therefore, paragraph 12, covering all other export subsidies, stipulates that cost to the government and price difference stipulated in paragraph 4 of Article 16 of GATT 1994 shall set the conditions for export subsidies. However, in light of the definition of subsidy in Article 1 of this Agreement, cost to the government is not absolutely necessary for export subsidy to come into being and cost to the accounts of private bodies that have been commissioned, entrusted, or controlled by the government may still indicate export subsidies.

Import transfer subsidies was previously classified as domestic subsidies in the Tokyo Round of Subsidy and Countervailing Measures Negotiation, but is classified as prohibited subsidy in the WTO Agreement on Subsidies and Countervailing Measures. Import transfer subsidy is a unique or one of many important conditions that is granted when domestic goods are used in place of export goods. That is, import transfer subsidy comes into being if subsidy is granted in cases where use of domestic goods is imposed, use of domestic goods is promoted, or import transfer is put in as a condition. This stipulation was adopted at the insistence of the US and Japan, but there is no precedence of this stipulation being implemented so far so that it makes it difficult to establish the range of application. The only clear example is in the case of trade materials where it is compared to import goods and preferential treatments are given to domestic goods. Here, it can be said that characteristics of prohibitive subsidy exists (Ahn and Yoo, p. 41-48; Korea Chamber of Commerce, p. 45-49; Yoo, p. 31-46).

## 2. Actionable Subsidy

(A) WTO member countries must not bring about adverse effects to profits of other members countries in the process of satisfying the definition and specificity of subsidies. If adverse effects are brought to a member country as a result of granting subsidies that are specific in character, countervailing measures may be taken through multilateral or bilateral channels at WTO. In this sense on adverse effects to other member countries, this Agreement is consistent with the Tokyo Rounds. First, subsidies with specificity are consistent with concepts in paragraph 3 of Article 8 of other countries' Agreement on Subsidies and Countervailing Measures. Second, subsidies with specificity must not harm the domestic industries of other member countries. Subsidies may become the target of countervailing measures if the price of subsidy granted goods falls, is exported in masses, and reduces the profit rates of other member country's domestic industries or enterprises. Third, if the competitiveness of goods in question is enhanced through granting of subsidy on customs duty conceded goods, then it bring practical harm to the benefits of other member countries following the WTO customs concessions. Therefore, such government measures must be prevented. Fourth, subsidies that seriously prejudice other member country's profits must be watched for in advanced and prevented.

Article 5 of the WTO Agreement on Subsidies and Countervailing Measures state the following provisions regarding adverse effects of subsidies (Korea Chamber of Commerce, p. 49-50).

## *Article 5*

### *Adverse Effects*

No Member should cause, through the use of any subsidy referred to in paragraphs 1 and 2 of Article 1, adverse effects to the interests of other Members, i.e.:

- (a) injury to the domestic industry of another member<sup>6</sup>;
- (b) nullification or impairment of benefits accruing directly or indirectly to other Members under GATT 1994 in particular the benefits of concessions bound under Article II of GATT 1994<sup>7</sup>;
- (c) serious prejudice to the interests of another Member.<sup>8</sup>

This Article does not apply to subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture.

## (B) Article 6

In order for countervailing measures of countries with common understanding following a granting of subsidy by a member country, a serious prejudice must have occurred in the country at question. Therefore, Article 6 of the WTO Agreement on Subsidies and Countervailing Measures stipulates in detail, the contents of which are as follows.

## *Article 6*

### *Serious Prejudice*

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<sup>6</sup> The term “injury to the domestic industry” is used here in the same sense as it is used in Part V.

<sup>7</sup> The term “nullification or impairment” is used in this Agreement in the same sense as it is used in the relevant provisions of GATT 1994, and the existence of such nullification or impairment shall be established in accordance with the practice of application of these provisions.

<sup>8</sup> The term “serious prejudice to the interests of another Member” is used in this Agreement in the same sense as it is used in paragraph 1 of Article XVI of GATT 1994, and includes threat of serious prejudice.

6.1 Serious prejudice in the sense of paragraph (c) of Article 5 shall be deemed to exist in the case of:

- (a) the total ad valorem subsidization<sup>9</sup> of a product exceeding 5 per cent<sup>10</sup>;
- (b) subsidies to cover operating losses sustained by an industry;
- (c) subsidies to cover operating losses sustained by an enterprise, other than one-time measures which are non-recurrent and cannot be repeated for that enterprise and which are given merely to provide time for the development of long-term solutions and to avoid acute social problems;

direct forgiveness of debt, i.e. forgiveness of government-held debt, and grants to cover debt repayment.<sup>11</sup>

6.2 Notwithstanding the provisions of paragraph 1, serious prejudice shall not be found if the subsidizing Member demonstrates that the subsidy in question has not resulted in any of the effects enumerated in paragraph 3.

6.3 Serious prejudice in the sense of paragraph (c) of Article 5 may arise in any case where one of several of the following apply:

- (a) the effect of the subsidy is to displace or impede the imports of a like product of another Member into the market of the subsidizing Member;
- (b) the effect of the subsidy is to displace or impede the exports of a like product of another Member from a third country market;
- (c) the effect of the subsidy is a significant price undercutting by the subsidized product as compared with the price of a like product of another Member in the same market or significant price suppression, price depression or lost sales in the same market;
- (d) the effect of the subsidy is an increase in the world market share of the subsidizing Member in a particular subsidized primary product or commodity<sup>12</sup> as compared to the average share it had during the

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<sup>9</sup> The total ad valorem subsidization shall be calculated in accordance with the provisions of Annex IV.

<sup>10</sup> Since it is anticipated that civil aircraft will be subject to specific multilateral rules, the threshold in this subparagraph does not apply to civil aircraft.

<sup>11</sup> Members recognize that where royalty-based financing for a civil aircraft programme is not being fully repaid due to the level of actual sales falling below the level of forecast sales, this does not in itself constitute serious prejudice for the purposes of this subparagraph.

<sup>12</sup> Unless other multilaterally agreed specific rules apply to the trade in the product or commodity in question.

previous period of three years and this increase follows a consistent trend over a period when subsidies have been granted.

6.4 For the purpose of paragraph 3(b), the displacement or impeding of exports shall include any case in which, subject to the provisions of paragraph 7, it has been demonstrated that there has been a change in relative shares of the market to the disadvantage of the non-subsidized like product (over an appropriately representative period sufficient to demonstrate clear trends in the development of the market for the product concerned, which, in normal circumstances, shall be at least one year.) “Change in relative shares of the market” shall include any of the following situations: (a) there is an increase in the market share of the subsidized product; (b) the market share of the subsidized product remains constant in circumstances in which, in the absence of the subsidy, it would have declined; (c) the market share of the subsidized product declines, but at a slower rate than would have been the case in the absence of the subsidy.

6.5 For the purpose of paragraph 3(c), price undercutting shall include any case in which such price undercutting has been demonstrated through a comparison of prices of the subsidized product with prices of a non-subsidized like product supplied to the same market. The comparison shall be made at the same level of trade and at comparable times, due account being taken of any other factor affecting price comparability. However, if such a direct comparison is not possible, the existence of price undercutting may be demonstrated on the basis of export unit values.

6.6 Each Member in the market of which serious prejudice is alleged to have arisen shall, subject to the provisions of paragraph 3 of Annex V, make available to the parties to a dispute arising under Article 7, and to the panel established pursuant to paragraph 4 of Article 7, all relevant information that can be obtained as to the changes in market shares of the parties to the dispute as well as concerning prices of the products involved.

6.7 Displacement or impediment resulting in serious prejudice shall not arise under paragraph 3 where any of the following circumstances exist<sup>13</sup> during the relevant period:

- (a) prohibition or restriction on exports of the like product from the complaining Member or on imports from the complaining Member into the third country market concerned;
- (b) decision by an importing government operating a monopoly of trade or state trading in the product concerned to shift, for non-commercial

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<sup>13</sup> The fact that certain circumstances are referred to in this paragraph does not, in itself, confer upon them any legal status in terms of either GATT 1994 or this Agreement. These circumstances must not be isolated, sporadic or otherwise insignificant.

reasons, imports from the complaining Member to another country or countries;

- (c) natural disasters, strikes, transport disruptions or other *force majeure* substantially affecting production, qualities, quantities or prices of the product available for export from the complaining Member;
- (d) existence of arrangements limiting exports from the complaining Member;
- (e) voluntary decrease in the availability for export of the product concerned from the complaining Member (including, *inter alia*, a situation where firms in the complaining Member have been autonomously reallocating exports of this product to new market);
- (f) failure to conform to standards and other regulatory requirements in the importing country.

6.8 In the absence of circumstances referred to in paragraph 7, the existence of serious prejudice should be determined on the basis of the information submitted to or obtained by the panel, including information submitted in accordance with the provisions of Annex V.

6.9 This Article does not apply to subsidies maintained on agricultural products as provided in Article 13 of the Agreement on Agriculture.

### (C) Interpretation

Since serious prejudice must occur to the profits of other member countries before countervailing measures can be taken against that country, thereby, establishing actionable subsidies, the following paragraphs will attempt to interpret Article 6 of the Agreement which covers this topic in detail.

The concept of serious prejudice was introduced for the first in the WTO Agreement on Subsidies and Countervailing Measures and is different from other actionable subsidies in that it contains advance detection functions which in some sense lend it characteristics of prohibitive subsidies. However, the provision on serious prejudice

is to be implemented for 5 years after the Agreement goes into effect and is to be reviewed at that point in time. Further, this provision does not apply to developing countries.

Actions may be taken on subsidies that bring about serious prejudice even if it does not result in any direct damages to other member countries and the defending country must prove that the use of the subsidy at issue did not adversely affect the profits of other member countries before it continues to make use of that subsidy (Ahn and Yoo, p. 63-66; Korea Chamber of Commerce, p. 53; Yoo, p. 51-52).

A specific member country may take action when it discovers that another member country used a subsidy in excess over 5% of the rate based on cost to the government, granted subsidies in order to preserve business losses to certain industries or enterprises, or found out that direct reduction/exemption of debts were being given. In this case, in order to continue the use of subsidy in question, the accused country must prove that granting of the subsidy import was curtailed in the domestic market, curtailed exports of another member country in a third country, price undercutting or price suppression took place, or that world market possession rate did not rise. When a specific member country adversely affects the profits of another member country by granting subsidy, the country that received damages has the burden of proof. But in the case of serious prejudice, the subsidy granting country and not the damaged country must prove that no harms were brought to another member country and gives it somewhat of a prohibitiveness in nature (Korea Chamber of Commerce, p. 54).

The conditions that may be used as proofs when bringing action on the question of existence of serious prejudice are as follows.

If the total subsidy rate to an enterprise or a specific exceeds 5% of the goods prices standards, a serious prejudice is deemed to have taken place. The calculation of subsidy for the sake of convenience is done on “cost to the government” basis and not on “benefits to the recipient” basis. In particular, for the speediness and convenience of securing proof, “cost to the government” concept was chosen in the calculation which utilizes government’s funds procurement cost instead of the “benefits to the recipient” concept because the latter is very complicated, time consuming and costly.

Serious prejudice is seen to taken place if the government grants subsidies in order to preserve business losses in certain industries. For example, if the breeding industry directly receives funds from the government in order to make up for the losses of its business and to prevent being going out of business, a serious prejudice exists.

If the government grants subsidies in order to preserve the losses to certain specific enterprises, the presumptions regarding serious prejudice are eliminated. Therefore, exceptional provisions like this can be said to be used as bankruptcy support systems.

A serious prejudice is deemed to have taken place in situations where the government waives the rights to bonds in its possession, provides gratuitous support for repayment of debt, and other similar situations where the government gives direct reduction/exemptions.

As discussed above, if a member country recognizes the four conditions that indicate the presence of serious prejudice and requests negotiations, the subsidy granting country must prove to the WTO Committee on Subsidies and Countervailing Measures that it did not adversely affect the profits of another member country in granting the subsidy at issue. In doing this, the subsidy granting country must use one or more of the following provisions in proving their innocence.

First, the subsidy granting country must prove that granting of the subsidy did not impede or replace the import of like goods of foreign production in the domestic market.

Second, the subsidy granting country must prove that granting of the subsidy did not impede or replace the import of other member countries' goods in a third country market. In particular, it must be proven using relative market information like trends and changes in the market for over a year for related goods that clearly show that market possession rate of the goods that received the subsidy did increase, did not decrease in a situation where it should have gone down, or did not decrease at a slower rate than would have in the absence of the subsidy.

To gather the necessary information in this process, the subsidy granting country may request statistical information from third country governments via questionnaires, or may request cooperation and support from third countries even in cases where it is taking on market analysis of its own accord.

Third, the subsidy granting country must prove using data on comparisons between

their good with the goods of like goods from other countries, as well as the price of subsidized like products. And, in doing price comparisons, it must properly take into consideration overall factors and may use export value when there are no appropriate objects for comparison.

Fourth, the subsidy granting country must prove that if the market possession rate of the good in question had increase in the 3 years immediately prior that such increase was not a continuous trend throughout the period in which the subsidy was granted.

However, as in following situations where exports are distorted due to factors other than the subsidy, the subsidy granting country need not prove that granting the subsidy did not bring about serious prejudice to another member country to the Committee.

First, restriction are placed on like goods exported from the country that initiated the action or banned all together, or when restrictions or prohibitions are places on the like goods from the action initiated country in the process of those goods being exported to a third country.

Second, when a monopolizing or national trade system maintaining country decides to change its line of imports from the action initiated country for non-commercial reasons.

Third, force maguire, such as natural disasters, labor disputes, or paralysis of transportation system, in the action initiated country effects the production, quality,

quantity, or price of the exported goods/

Fourth, when the action initiating country implements export restricting agreements.

Fifth, when the action initiating country voluntarily reduces its export for reasons such launching of new products.

Sixth, when various standards and conditions set by the action initiating country are not met.

In order to make fast and accurate judgment on serious prejudices, Annex V (Procedures for developing information concerning serious prejudice) contains separate provisions on information developing procedures (Korea Chamber of Commerce, p. 54-57).

### **3. Non-Actionable Subsidy**

Article 8

Non-actionable subsidy, a concept that was officially introduced for the first time in WTO Agreement on Subsidies and Countervailing Measures, is limited to the results of Uruguay Rounds, research and development subsidies, regional development subsidies, and environment subsidies.

Article 8 of the Agreement has the provisions on non-actionable subsidy which should first be looked at before going any farther.

## *Article 8*

### *Identification of Non-Actionable Subsidies*

8.1 The following subsidies shall be considered as non-actionable<sup>14</sup>:

- (a) subsidies which are not specific within the meaning of Article 2;
- (b) subsidies which are specific within the meaning of Article 2 but which meet all of the conditions provided for in paragraph 2(a), 2(b) or 2(c) below.

8.2 Notwithstanding the provisions of Parts III and V, the following subsidies shall be non-actionable:

- (a) assistance for research activities conducted by firms or by higher education or research establishments on a contract basis with firms if,<sup>15</sup>  
<sup>16, 17</sup>

the assistance covers<sup>18</sup> not more than 75 percent of the costs of industrial research<sup>19</sup> or 50 per cent of the costs of pre-competitive

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<sup>14</sup> It is recognized that government assistance for various purposes is widely provided by Members and that the mere fact that such assistance may not qualify for non-actionable treatment under the provisions of this Article does not in itself restrict the ability of Members to provide such assistance.

<sup>15</sup> Since it is anticipated that civil aircraft will be subject to specific multilateral rules, the provisions of this subparagraph do not apply to that product.

<sup>16</sup> Not later than 18 months after the date of entry into force of the WTO Agreement, the Committee on Subsidies and Countervailing Measures provided for in Article 24 (referred to in this Agreement as “the Committee”) shall review the operation of the provisions of subparagraph 2(a) with a view to making all necessary modifications to improve the operation of these provisions. In its consideration of possible modifications, the Committee shall carefully review the definitions of the categories set forth in this subparagraph in the light of the experience of Members in the operation of research programmes and the work in other relevant international institutions.

<sup>17</sup> The provisions of this Agreement do not apply to fundamental research activities independently conducted by higher education or research establishments. The term “fundamental research” means an enlargement of general scientific and technical knowledge not linked to industrial or commercial objectives.

<sup>18</sup> The allowable levels of non-actionable assistance referred to in this subparagraph shall be established by reference to the total eligible costs incurred over the duration of an individual project.

<sup>19</sup> The term “industrial research” means planned search or critical investigation aimed at discovery of new knowledge, with the objective that such knowledge may be useful in developing new products,

development activity<sup>20, 21</sup>;

and provided that such assistance is limited exclusively to:

- (i) costs of personnel (researchers, technicians and other supporting staff employed exclusively in the research activity);
  - (ii) costs of instruments, equipment, land and buildings used exclusively and permanently (except when disposed of on a commercial basis) for the research activity;
  - (iii) costs of consultancy and equivalent services used exclusively for the research activity, including bought-in research, technical knowledge, patents, etc.;
  - (iv) additional overhead costs incurred directly as a result of the research activity;
  - (v) other running costs (such as those of materials, supplies and the like), incurred directly as a result of the research activity.
- (b) assistance to disadvantaged regions within the territory of a Member given pursuant to a general framework of regional development<sup>22</sup> and non-specific (within the meaning of Article 2) within eligible regions provided that:
- (i) each disadvantaged region must be a clearly designated contiguous geographical area with a definable economic and administrative identity;
  - (ii) the region is considered as disadvantaged on the basis of

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processes or services, or in bringing about a significant improvement to existing products, processes or services.

<sup>20</sup> The term “pre-competitive development activity” means the translation of industrial research findings into a plan, blueprint or design for new, modified or improved products, processes or services whether intended for sale or use, including the creation of a first prototype which would not be capable of commercial use. It may further include the conceptual formulation and design of products, processes or services alternatives and initial demonstration or pilot projects, provided that these same projects cannot be converted or used for industrial application or commercial exploitation. It does not include routine or periodic alterations to existing products, production lines, manufacturing processes, services, and other on-going operations even though those alterations may represent improvements.

<sup>21</sup> In the case of programmes which span industrial research and pre-competitive development activity, the allowable level of non-actionable assistance shall not exceed the simple average of the allowable of non-actionable assistance applicable to the above two categories, calculated on the basis of all eligible costs as set forth in items (i) to (v) of this subparagraph.

<sup>22</sup> A “general framework of regional development” means that regional subsidy programmes are part of an internally consistent and generally applicable regional development policy and that regional development subsidies are not granted in isolated geographical points having no, or virtually no, influence on the development of a region.

neutral and objective criteria<sup>23</sup>, indicating that the region's difficulties arise out of more than temporary circumstances; such criteria must be clearly spelled out in law, regulation, or other official document, so as to be capable of verification;

- (iii) the criteria shall include a measurement of economic development which shall be based on at least one of the following factors:

one of either income per capita or household income per capita, or GDP per capita, which must not be above 85 per cent of the average for the territory concerned;

unemployment rate, which must be at least 110 per cent of the average for the territory concerned;

as measured over a three-year period; such measurement, however, may be a composite one and may include other factors.

- (c) assistance to promote adaptation of existing facilities<sup>24</sup> to new environmental requirements imposed by law and/or regulations which result in greater constraints and financial burden on firms, provided that the assistance:

(i) is a one-time non-recurring measure; and

(ii) is limited to 20 per cent of the cost of adaptation; and

(iii) does not cover the cost of replacing and operating the assisted investment, which must be fully borne by firms; and

(iv) is directly linked to and proportionate to a firm's planned reduction of nuisances and pollution, and does not cover any manufacturing cost savings which may be achieved; and

(v) is available to all firms which can adopt the new equipment and/or production processes.

8.3 A subsidy programme for which the provisions of paragraph 2 are invoked shall be notified in advance of its implementation to the

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<sup>23</sup> "Neutral and objective criteria" means criteria which do not favour certain regions beyond what is appropriate for the elimination or reduction of regional disparities within the framework of the regional development policy. In this regard, regional subsidy programmes shall include ceilings on the amount of assistance which can be granted to each subsidized project. Such ceilings must be differentiated according to the different levels of development of assisted regions and must be expressed in terms of investment costs or cost of job creation. Within such ceilings, the distribution of assistance shall be sufficiently broad and even to avoid the predominant use of a subsidy by, or the granting of disproportionately large amounts of subsidy to, certain enterprises as provided for in Article 2.

<sup>24</sup> The term "existing facilities" means facilities which have been in operation for at least two years at the time when new environmental requirements are imposed.

Committee in accordance with the provisions of Part VII. Any such notification shall be sufficiently precise to enable other Members to evaluate the consistency of the programme with the conditions and criteria provided for in the relevant provisions of paragraph 2. Members shall also provide the Committee with yearly updates of such notifications, in particular by supplying information on global expenditure for each programme, and on any modification of the programme. Other Members shall have the right to request information about individual cases of subsidization under a notified programme.<sup>25</sup>

8.4 Upon request of a Member, the Secretariat shall review a notification made pursuant to paragraph 3 and, where necessary, may require additional information from the subsidizing Member concerning the notified programme under review. The Secretariat shall report its findings to the Committee. The Committee shall, upon request, promptly review the findings of the Secretariat (or, if a review by the Secretariat has not been requested, the notification itself), with a view to determining whether the conditions and criteria laid down in paragraph 2 have not been met. The procedure provided for in this paragraph shall be completed at the latest at the first regular meeting of the Committee following the notification of a subsidy programme, provided that at least two months have elapsed between such notification and the regular meeting of the Committee. The review procedure described in this paragraph shall also apply, upon request, to substantial modifications of a programme notified in the yearly updates referred to in paragraph 3.

8.5 Upon the request of a Member, the determination by the Committee referred to in paragraph 4, or a failure by the Committee to make such a determination, as well as the violation, in individual cases, of the conditions set out in a notified programme, shall be submitted to binding arbitration. The arbitration body shall present its conclusions to the Members within 120 days from the date when the matter was referred to the arbitration body. Except as otherwise provided in this paragraph, the DSU shall apply to arbitrations conducted under this paragraph.

## (2) Interpretation

As mentioned already, subsidies that concern specificity and can be used generally are non-actionable subsidies and no countervailing measures of any kind can be taken on

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<sup>25</sup> It is recognized that nothing in this notification provision requires the provision of confidential information, including confidential business information.

these subsidies. Even if these subsidies are specific in nature, subsidies aimed at research & development, regional development and environmental protection are seen as non-actionable subsidies as far as this Agreement concerned. Countervailing actions may be taken against such subsidies if it results in serious adverse effects to the economic profits of another member country after it is granted (Ahn and Yoo, p. 81; Korea Chamber of Commerce, p. 60; Yoo, p. 69).

a) Subsidies aimed at research & development in specific areas must meet the following conditions in order to be classified as non-actionable. If the government provides for up to 75% of the research costs and/or up to 50% of the development costs for “development activities prior to competition” which precedes commercialization stages in grants, this shall be seen as a non-actionable subsidy in cases of an industrial research done by a higher education institution or a research center upon contract with an enterprise.

In this case, the industrial research means researches or studies intended to discover useful knowledge in development of new products, new production processes, new services or making significant improvements to existing products, production processes or services (Ahn and Yoo, p. 82-83; Korea Chamber of Commerce, p. 61; Yoo, p. 70-71).

Also, “development activities prior to competition” includes substitutable goods, service conceptualization, initial testing of designs, and pilot projects. It does not, however, include industrial application or transfer to commercial development or uses. Although everyday or regular alterations of existing products, production line,

production process, services, and other works may result in improvements through the changes but still cannot be considered as “development activities prior to competition” (Korea Chamber of Commerce, p. 61).

In the scope of specific support allowed for instances that include both industrial research and pre-competition development activities, the level of support for these two activities must not exceed simple average (62.5%). Also, because this Agreement does not apply to basic researches that are expansions of general scientific or technological knowledge independently undertaken by higher education institutes or research centers, it can be said that they are not subject to regulations on subsidies (Ahn and Yoo, p. 83; Yoo, p. 71).

The level of support permitted as research and development subsidies are calculated based on the costs incurred throughout development and planning periods. And, the costs on which such calculation is based must have incurred from the following uses.

✂ Labor costs for researchers, technicians, and other employees hired solely for the purposes of research activities; ✂ tools, equipment, land, and building costs that are used permanently for research activities; ✂ consultation and services costs used solely for research activities including purchased research, technology, intellectual property rights; and ✂ other operational costs incurred directly as result of research activities. However, in regard to research and development subsidies, experiences and activities of various countries and international organizations will be taken into consideration in re-establishing the concepts of major terminology within 18 months after the WTO Agreement takes effect (Korea Chamber of Commerce, p. 61-62).

b) Subsidies for regional development are considered to be non-actionable if they are granted in a non-specific form in the meaning of paragraph 1 of Article 2 with disadvantageous regions as the object of designation which objectively based in accordance with general regional development plans. The decision on the judgment of disadvantageousness of a region should be made based on objective and comprehensive economic development indices that indicate long-term and not temporary economic difficulties. In particular, per capita income for the region for the previous 3 years, per capita household earnings, or per capita GDP must be less than 85% of the national average. Or, for the same period, the unemployment rate should exceed the national average by 11%. Further, these regions must be of administrative unit that is uniform economically and administratively speaking (Ahn and Yoo, p. 84; Korea Chamber of Commerce, p. 62; Yoo, p. 72).

The reason for requiring neutral and objective basis is to resolve any regional imbalances that may exist while not giving improper level of benefits to any one specific region. So, support conditions for “regional development subsidies” must be set differently according to industries and level of development, and support repayments should be expressed in terms of investment cost or job creation cost concepts. Such criteria should be clearly stated in acts, regulations or official document that can be used as evidence and information on whom the subsidy is available to should be widely disseminated in the region in order to prevent recipients being limited to specific industries or enterprises. In particular, subsidies must not be tied down to specific small regions that cannot have great effect on the overall regional development (Korea Chamber of Commerce, p. 62).

c) Environment subsidy is a one-time support that attempts to get existing facilities (factories or buildings) that have been operation for more than 2 years to adjust to new environment related laws and regulations and can be as much as up to 20% of the improvement costs. The amount of subsidy is indirectly related to an enterprise's pollution reduction plans and must be in proportion to reductions levels. Any introduction of new equipment, machinery, and production processes must be made available and possible for use by all enterprises. However, costs for operation or replacement of equipment and facilities that have received government support before is receiving it now so that such future costs must fully be borne by the enterprise should be excepted from this (Ahn and Yoo, p. 84; Yoo, p. 72).

Before implementing non-actionable subsidies with specificity, such as research and development subsidy, regional development subsidy, and environment subsidy, the WTO Committee on Subsidies and Countervailing Measures should be informed of the following.

- ① Type of subsidy (grant, loan, tax reduction/exemption, etc.)
- ② Unit value of subsidies, total annual subsidy if unit value is not available (if possible, previous year's unit value indicating average subsidy) or total estimated subsidy amount
- ③ Policy goals and purpose of subsidy
- ④ Period of subsidy to be granted and time schedules set for other subsidies
- ⑤ Statistical data for calculation of the trade effects of the proposed subsidy

Member countries that make use of non-actionable subsidies with specificity must keep the Committee informed of its recent operational statuses every year. In addition, information on total cost for individual systems and amendments to the systems from the previous year must also be forwarded to the Committee. Other member countries may request information on individual case studies on the systems. When requested by a member country, the WTO Secretariat must review the content of the information received by the Committee and request further material from the country that plans to grant subsidy when necessary. The WTO Secretary must inform the Committee of the result of its review and the Committee is required to make speedy re-review of the conclusions (the conclusion received by the Committee itself if the Committee is not requested to go over this material by the Secretariat) reached by the WTO Secretariat so that it can make a decision on the appropriateness of the subsidy when requested to do so by the Secretariat (Korea Chamber of Commerce, p. 63).

## **VI. KOREA'S INVESTMENT INCENTIVE SYSTEM AND WAYS TO IMPROVE**

### **1. Fiscal Incentive**

#### **A. Subjects of Tax Reductions/Exemptions**

The Foreign Investment Promotion Act, enacted since 17 November 1998, greatly expanded upon the tax reductions/exemptions provided by its “predecessor” the Foreign Funds Procurement Act in overall content including the period of

reduction/exemption and available subjects. The focal point of tax reduction/exemption is the reduction/exemption of corporate tax or earning tax for business profits of foreign investment companies. Generally, when the foreign investor is juridical corporation, it is requires to pay corporate taxes while foreign investors of private individual statuses are required to pay earnings taxes. However, according to the Foreign Investment Promotion Act, if the foreign investor qualifies as eligible for tax reduction/exemption, that foreign investor receives reduction on earnings taxes of his/her earnings from the business. And, those eligible for this tax reduction are also eligible for reduction of local taxes and customs duties.

According to the Foreign Investment Promotion Act, those eligible for reduction/exemption of corporate taxes are basically limited to investments involving new acquirements. No tax benefits are conferred upon existing share takeover methods. The Foreign Investment Promotion Act sets aside 3 types of businesses as eligible for tax benefits. In the first category are businesses that involve highly advanced technology. In the second are industrial support service businesses that are necessary for enhancing national competitiveness. And in the last category are businesses run foreign investment companies located in foreign investment zones. In the past, only those dealing with high-tech businesses could receive tax benefits and in this sense the range of subjects eligible for tax benefits have been greatly expanded (Lee and Lee, p. 78).

#### B. Content of Tax Reductions/Exemptions

As mentioned previously, the contents of tax reduction/exemptions can be divided

into 3 classes. First is the reduction/exemption of earnings taxes and corporate taxes for foreign investment companies on their business earnings. Second is reduction/exemption of local taxes including acquisition tax, registration tax, property tax and comprehensive land tax on assets that they acquire or own for the purposes of their businesses in Korea. Third is reduction/exemption of indirect taxes and these include customs duties, special consumption tax, and value-added tax on capital materials that foreign investment companies introduce in order to run their businesses.

To receive reductions/exemptions on corporate tax, earnings tax and local taxes, the foreign investment company needs to apply to the Ministry of Finance and Economy (MOFE) indicating the valid time period for which it is eligible to receive these benefits (application for tax reduction/exemption). Or, before taking this step, the foreign investment company may find out in advance if it is involved in a business that is eligible for tax benefits. This application is also made to the Ministry of Finance and Economy (Application for Confirmation of Eligibility for Tax Reduction/Exemption). When requested with such applications, MOFE consults with other concerned ministries in making the decision on eligibility and informs the applicant of its decision. Foreign investment companies have asked many questions concerning application for confirmation of eligibility for tax benefits. That is, even though they received a positive response to their application for confirmation, they later have suspicions about whether they will be sure to receive those the promised benefits. As long as the provisions are clearly stipulated in the related laws and regulations, its efficacy is sure and clear. On the other hand, where local taxes are concerned (expansion of reduction and exemptions ranges by local governments), MOFE is required to consult with the head of the local government where the

business proposes to locate itself before letting the foreign investment company know of what benefits it is eligible for. More detailed look into the contents of tax reductions/exemptions are as follows (Lee and Lee, p. 79).

(i) Reduction/Exemption of Earnings Taxes

(a) Contents of Reduction/Exemption

The amount (calculated tax due x percentage of foreign investment) of reduction/exemption on earnings resulting from businesses eligible for tax reduction/exemption run by foreign investment companies is 100% for the first 7 years and 50% for the next 3 years. This reduction/exemption takes effect from the first year in which earnings are produced. However, if no earnings are produced for the first 5 years, the reduction/exemption is seen to take effect from the day when the business first began 5 years ago. This provision helped to resolve any problems arising from foreign investment companies not being able to enjoy tax benefits in the early stages of investment.

The same applies to corporate and earnings taxes on dividends from shares acquired by foreign investors (sometimes withholding of taxes is also possible) along with reduction/exemption of the same taxes on business earnings of sources of those dividends (100% for the first 7 years and 50% for the next 3 years) (Lee and Lee, p. 80).

(b) Effects of Tax Reduction/Exemption at the Time of Distribution

① Application of Reduction Rates for Tax Agreements

When foreign investment companies established in Korea distribute dividends to shareholders in their native country, 25% source tax is assessed on the dividends in relation to corporate and earnings taxes on those dividends. When the shareholder is juridical body, the source tax is assessed on corporate tax and earnings tax for private individuals. However, benefits from corporate taxes may be lost when normal tax rates are assessed to foreign investment companies established in Korea in this process. Therefore, in order to maintain the reduction/exemption benefits received on corporate taxes at their company level, same reduction/exemptions are applied in source taxing of dividends when distributing dividends.

Whether the foreign investor's country of residence and Korea have reached any tax agreements is also an important factor that needs to be considered in looking at the effects of tax benefits in assessment of taxes on dividends. Tax agreements when in existence generally provide for reduction of source tax rates on dividends. Although it varies from agreement to agreement, usually 10% source tax rate is the average. There is no problem with this for the first 7 years when corporate and earnings taxes are exempted because even before the 10% pursuant to tax agreement can be applied, complete exemption of dividends has taken place pursuant to the Foreign Investment Promotion Act (Lee and Lee, p. 80).

The problem starts in the next 3 years when 50% reduction takes effect. Because

source tax rate of 25% is assessed on 50% reduced which means that 12.5% should be assessed. If 10% is stipulated in a tax agreement, the problem of which rate to apply arises. In the end, 10% is applied since a tax agreement takes priority over domestic laws. Therefore, following a 7-year 100% exemption pursuant to the Foreign Investment Promotion Act, the 50% reduction that takes place for the next 3 years does not mean much benefit for the foreign investment company if it distributes dividends to shareholders in their country of residence. Of course, this is only the case when that country of residence has signed a tax agreement with Korea and the rate stipulated in that agreement is lower than 12.5%.

At the same time, during the 7 years when 100% exemption is in effect, the tax agreement takes precedence over the domestic law which raises a question of whether 10% tax rate should apply in this case. But this does not result in any serious dilemma because a tax agreement complies with the international standard that it cannot create new tax rights and therefore additional taxes cannot be assessed here. In effect, during the 7-year exemption period, foreign investment companies receive the full benefit of 100% tax exemption (Lee and Lee, p. 81).

## ② Tax Sparing System and Effects of Reduction/Exemption for Tax Agreements

The effects of reduction/exemption of corporate and earnings taxes provided to foreign investment companies may vary depending on what the double taxation prevention methods applied to foreign investment companies are in a tax agreement signed between the two countries and whether tax sparing system is guaranteed by the tax agreement in cases tax deduction methods are applied.

Assuming that all earnings produced in a tax year are to be distributed out in dividends, when earnings deduction method is applied (e.g. where a German investment company establishes a company in Korea pursuant to the tax agreement signed between Korea and Germany), the exemption of corporate taxes in Korea is enjoyed by the investor.

On the other hand, if tax deduction method is applied, the reduction/exemption of corporate taxes in Korea in the absence of tax sparing system, it only has the effect of expanding taxes in the country of foreign investor's residence. Therefore, when dividends are distributed without a tax sparing system, the foreign investor cannot make any use of the fiscal incentives provided by Korea. The tax sparing system can be good in that it can lead to profit-making in corporate stages in Korea. In a situation where profits are distributed and no tax benefits can be enjoyed, the profits will be reinvested in Korea (Lee and Lee, p. 81-82).

#### (ii) Reduction/Exemption of Local Taxes

Reduction/exemption of local taxes means reduction/exemption of acquisition tax, registration tax, property tax and comprehensive land tax on assets that a foreign investment company acquires or owns for its business operations. In particular, because the comprehensive land tax is accumulative in structure in tax calculation, reduction/exemption occurs via deduction of related assets from the tax standards.

The basic reduction of local taxes is 100% for the first 5 years from the

commencement of business and 50% for the next 3 years. However, local governments may extend the period of reduction/exemption to 15 years pursuant to Article 9 or the Local Tax Act (cases for exemption of taxes, needs approval from the Minister of Government Administration and Home Affairs), and may should it choose offer higher rates of reduction/exemption (Lee and Lee, p. 82).

(iii) Reduction/Exemption of Customs Duties, etc.

Refers to exemption of customs duties/special consumption taxes and value-added taxes that are assessed in the clearance process in relation to introduction of capital materials to be used in the business of foreign investment company eligible for tax benefits. The value-added tax mentioned here is the import value-added tax (Lee and Lee, p. 82).

## 2. Financial Incentives

In addition to fiscal incentives, foreign investment companies may also receive other supports from the central government or local governments in relation to factory construction and employment. Supports other than reductions and/or exemptions of taxes that are available are financial incentives, which consist of support concerning lease and sale of national or public properties, local government subsidies, etc.

### A. Incentives Related to Leases and Sellings of State/Public Properties

The Minister of Finance and Economy, administrators of national properties, and heads of local governments (in case of public properties) may regardless of State Property Act and Local Economy Act sign private contracts with foreign investment companies to lease or sell state-owned or public-owned land, buildings, etc.

(i) Extension and Installment on Payment

When selling, due date for sales payment may be postponed or payment may be made in installments. The concerned Enforcement Decree stipulates that in cases of state properties, it may be postponed for up to 1 year and 20 years installment plan. For public properties owned by local governments, the postponement and installment periods may be set according to regulations or precedents (Lee and Lee, p. 84).

(ii) Reduction/Exemption of Rents for State Properties

State properties can be leased for up to 50 years and rents may be reduced or exempted. The Minister of Finance and Economy and administrators of state properties may consult and agree to reduce or exempt rents for state properties (restricted to land in foreign investment zones, foreign companies-only industrial complexes, national industrial complexes, etc.). Foreign investment companies that wish to enjoy such benefits should apply for it with the administrator of the respective state property. The Enforcement Decree sets out 3 different levels of reduction/exemption for state properties.

Reduction of up to 100 %: Business that contributes significantly to increasing

employment rate or national economy that (a) is a business operated by a foreign investment company in a foreign investment zone, (b) business that has received tax reduction/exemption of corporate tax and etc. whose investment value is over US\$1,000,000.

Reduction of up to 75%: Business that contributes significantly to increasing employment rate or national economy that (a) is a business in which a foreign investor plans to operate a manufacturing company with a value of over US\$10 million, (b) is a business that contributes significantly to expansion of social infrastructures, coordination of industrial structure or to financial independence of a local government (decided upon deliberation of the Foreign Investment Committee).

Reduction of up to 50%: In cases of leasing state properties located within national industrial complexes (Lee and Lee, p. 85).

(iii) Reduction/Exemption of Rents for Public Properties and Discounted Parceling  
Prices

(a) Contents

In case of reductions on rental charges of public properties, the details, including eligibility and reduction rates, depend on the effects on the creation of jobs, transfer of technology, and financial independence of local governments among other economic effects that foreign investment bring and are decided by local governments after taking all these factors into consideration.

The local government, along with the reduction of rental charges, may offer discounts on parceling out prices also. If a public organ (project company of a industrial complex development project as provided for in items 1 and 2 of paragraph 2 of Article 16 of the Act on Industrial Locationing and Development) stipulated by the Enforcement Decree may rent lands and etc. that it owns to foreign investment companies at reduced rates or offer discounted parceling out prices and the local government may assist in making up the differences incurred from such reductions (Lee and Lee, p. 85).

(b) Revised Working Rules on Precedents (Regulations) on Management of  
Public Properties Owned by Local Governments

The Ministry of Government Administration and Home Affairs (MOGAHA) newly prepared the legal foundation (Article 92-2) for reduction of rental fees and etc. for properties owned by local governments via amendment of Enforcement Decree of the Local Finance Act on 16 July 1998. Following this, guidelines on reduction of rental fees for lands owned by local governments was handed down to tem on 0 August. The local government were guided to reflect the contents of MOGAHA's revisions in their regulations that were to be revised by the end of September.

A local government may shall decide discounted parceling out prices and reduction of rental fees or investment, creation of jobs, and export costs of foreign investors (Lee and Lee, p. 86).

(a) Parceling Out Price: ranging from 25% to 100%

Basis	100% reduction	75% reduction	50% reduction
Investment amount	> US\$20 mil.	US\$10 – 20 mil.	US\$ 5 – 10 mil.
Creation of jobs	> 300	> 200	> 100
Export rate	100%	> 75%	> 50%
Domestic procurement rate	100%	> 75%	> 50%

(b) Rental fees: ranging from 50% to 100%

Basis	100% reduction	75% reduction	50% reduction
Investment amount			
Creation of jobs	> 1,000	> 500	> 300
Export rate	100%	---	> 50%
Domestic procurement rate	---	> 70%	> 50%

Source: Lee and Lee, p. 86

## B. Various Subsidies

According to the Foreign Investment Promotion Act, a local government may grant employment subsidies and etc. to foreign investment companies when needed to promote foreign investment, as provided for in regulations and the Enforcement Decree. The Enforcement Decree defines this employment subsidy as subsidy granted following and in proportion to the size of new jobs created.

Further, a local government may grant subsidies other than employment subsidy, such as education & training subsidy, etc. There is no information as yet on different types of subsidies offered by local governments (Lee and Lee, p. 87).

### 3. Incentives Provided to Foreign Investment Zones

## A. Criteria for Designation of Foreign Investment Zones

A mayor or governor may, in order to induce foreign investments prescribed in the Enforcement Decree, when necessary designate certain areas/zones where foreign investors have shown interest in making their investments as foreign investment zones upon deliberation by the Foreign Investment Committee.

Foreign investments that are subject of foreign investment zone designations as stipulated by the Enforcement Decree are manufacturing businesses or establishment of new factory facilities for operation of businesses that are subject to tax reductions or exemptions, and meeting any one of the following conditions.

✂ Amount of foreign investment is over \$100 million

✂ Foreign investment company with foreign investment ratio of over 1:2 (>50%) and with employment size if over 1,000 at all times

✂ Foreign investment company with foreign investment of over \$50 million and with employment size if over 500 at all times

✂ Foreign investment company with foreign investment of over \$30 million and with employment size if over 300 at all times (only applies when parts or all of national industrial complexes or local government industrial complexes being designated as foreign investment zones)

*Source: Lee and Lee, p. 89*

The Enforcement Decree, aside from these manufacturing businesses and industrial support service businesses, allows for the designation of foreign investment zones for

construction of tourism, hotel and international conference facilities with an investment value of over \$30 million and for foreign investments valued at over \$50 million that are invested in construction of facilities for resort businesses in areas designated by the provincial government of Cheju or by acts under the Ministry of Finance and Economy.

When a mayor or a governor wishes to designate a foreign investment zone, he/she must prepare a designation plan or a development plan (for local industrial complexes) and submit it to the Minister of Finance and Economy (Lee and Lee, p. 90).

When a foreign investment company that has moved into a foreign investment zone is not able to meet the conditions of designation criteria, including total investment value and employment size, the mayor or governor may set a certain period within a 6-month range and request the foreign investment company to satisfy those conditions by the date given. If a foreign investment company does not satisfy the criteria within the given time period, the mayor or the governor must cancel the designation of that foreign investment zone upon deliberation of the Foreign Investment Deliberation Committee. However, when there are unavoidable circumstances prevent the foreign investment meeting those requirements with the given time, the foreign investment company may be given one-time extension of the originally given time period (Lee and Lee, p. 90).

#### B. Incentives Provided to Foreign Investment Zones

When a foreign investment is designated as foreign investment zone, it is able to enjoy almost all benefits conferred by the Foreign Investment Promotion Act. Companies operating from these zones will receive the same tax reductions/exemptions granted to businesses involved in advanced technology and industrial support services. It may also receive reductions/exemptions when purchasing, being allotted or renting factory sites, in addition to various other subsidies.

In addition to these fiscal and financial incentives, foreign investors located in these designated zones may also receive conveniences related to expansion of fundamental facilities and support. Article 19 of the Foreign Investment Promotion Act contains the provisions on other supports provided to foreign investment zones. Costs and burdens that go into developing foreign investment zones, as well as supports building of ports, roads, irrigation facilities, railroads, communication & electric facilities. Further, Traffic Inducement Fee, pursuant to Urban Traffic Readjustment Promotion Act, is exempted for facilities and building structures located within foreign investment zones.

Mayors/governors or organization in charge of managing foreign investment zones must give priority to the convenience of foreign investors or foreign investment companies in their considerations. They are also required to make active efforts to expand various infrastructures, including financial institutions, information & communication facilities, and logistics facilities, that are needed to support their businesses. Full support should also provided to foreign investors or foreign companies with medical facilities, educational facilities, and housing (Lee and Lee, p.

90-91).

Article 20 of the Foreign Investment Promotion Act stipulates special provisions which prevent other acts and administrative regulations from applying to foreign investment zones. For example, in relation to division of land with foreign investment zones, restrictive measures provided for in other acts such as the Act on the Utilization and Management of the National Territory. And, businesses operating from these designated zones are recognized as having registered as trade or trading agent businesses so that easing import/export restrictions stipulated by the Foreign Trade Act. Duty-free import for exports to bonded areas is also allowed for foreign investment zones (Lee and Lee, p. 91).

#### 4. State's Support to Local Governments on Their Foreign Investment Inducing Activities

The government's policy on supporting local governments in their activities to induce foreign investment is to provide the maximum support possible when requested by local governments. The government may loan them the money needed to purchase lands to be rented to foreign investors, rent land at reduced rates, give discounts on parceling out prices, subsidize education and training fees, provide other subsidies, and help with other funds needed for inducing foreign investment. Local governments may also received assistance in 4 other areas.

Criteria and procedures for providing financial support to local governments are

decided by the Foreign Investment Deliberation Committee in accordance with the Enforcement Decree. The Enforcement Decree stipulates that the Committee is to consider all factors, including the economic effects of the foreign investment (e.g. creation of jobs, transfer of technology, etc.) and location conditions in establishing the criteria and procedures. Therefore, specific details on these criteria and procedures have not been decided yet. The Foreign Investment Promotion Act does however state that the efforts and performance records of local governments in inducing foreign investment should be considered in setting criteria for financial support (Lee and Lee, p. 95).

#### **4. WTO AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES AND FUTURE DIRECTIONS FOR KOREA'S FOREIGN INVESTMENT INCENTIVE SYSTEM**

Previous Chapters discussed in detail incentive systems introduced to Korea its effort to induce foreign investment and about the WTO Agreement on Subsidies and Countervailing Measures. The question here is whether there is any possibility for these new investment incentives seen in the light of the WTO Agreement can be posed as trade issues. That is, is Korea's newly introduced incentive system in conformity with the WTO Agreement or is it or are any parts of not consistent with the WTO Agreement?

There have been no cases where non-conformities between investment incentives and

the WTO Agreement that grew into international trade disputes. That is, to date, no countries have complained to the WTO that tax benefits or subsidies granted for foreign investment inducement purposes by another country in jurisdiction harmed the former country in any way, nor has any country ever taken countervailing measures against another country. A comprehensive look at international disputes concerning subsidies has shown that there is no clear answer as to whether investment incentives cause any complications in WTO Agreement on Subsidies. It can therefore be concluded that no clear internationally recognized criteria or positions on foreign investment and investment incentives have been presented so far.

Although it has not been raised as an international issue yet, seeing that more and more countries are providing more and more incentives in order to induce more investment in their own countries, there is real and noteworthy enough possibility of disputes arising from non-conformities between investment incentives offered and implementation of the WTO Agreement on Subsidies and Countervailing Measures. Seen from this perspective, it is important that Korea takes a look at its new investment incentives and see if it goes against any part of the WTO Agreement and make any revisions necessary in order to prevent potential disputes from surfacing.

The question of how well investment incentives suit the WTO Agreement should be answered by reviewing in detail the WTO Agreement sections on subsidies against investment incentives offered by Korea.

The first area to be studied is whether the investment incentives fall under the category of prohibitive subsidies. In the WTO Agreement, the most representative

prohibitive subsidies are import and export related subsidies that are granted according to import/export performances. One, at least, of the incentives offered by Korea are prohibitive in character. The incentive at issue is reduction/exemption of parceling out prices and rents on public properties owned by local governments. In the management regulations regarding local government owned public properties proposed by the Ministry of Government Administration and Home Affairs (MOGAHA) to the local governments on July 16, 1998, MOGAHA stated that reduction/exemption of rents or parceling out prices for public properties be based on export rate and domestic procurement rate. Conditions for provision of such incentives clearly fall under WTO Agreement as export subsidies and import transfer subsidies, and therefore can be said to be prohibitive subsidies. Hence, if foreign investment companies that were granted these types of subsidies were to export their goods, the importing country has every right to raise complaints. This means that MOGAHA's management regulations regarding public properties should be revised to delete the basis on which the benefits are granted. That is remove export rate and domestic procurement rates from its contents.

Next matter to look at is whether any of Korea's incentives can be categorized as countervailable. The following 3 aspects should be considered in making a judgment on this. First, does making this incentive available only to foreign investors give it specificity? Second, if no to the first, does the incentive in its present form pose any specificity issues? Third, if yes to the second, how can it be revised to remove that specificity?

To date, there have been no international precedents regarding the first question from

which can be said that there is no clear basis on which a judgment can be made. But in light of international trends so far and considering that specificity is related to very concrete and real criteria like specific enterprises and industries, it does not seem as if that specificity will be met simply by the fact that investment incentive may be granted to all foreign investors.

The second question is the focal point of this thesis since it involves the contents of the incentive to be granted to foreign investors. The decision on specificity of investment incentives may be treated individually according to different types of incentives. As analyzed already, Korea's investment incentives mostly make use of tax reductions or exemptions and can be divided into two main categories. One is tax benefits given to businesses involving advanced technology and industrial support services. The other is tax benefits to foreign investors located in foreign investment zones.

As for tax benefits given to businesses involving advanced technology and industrial support services, seeing that the recipients of this incentive consist of 500 subdivided industries by a government notice, it is hard to deny that this incentive is being granted only to specific industries. Therefore, it is very likely that specificity as defined by the WTO Agreement will be recognized for this incentive and improvements should be made to eliminate such industrial specificity from the incentive. Application of standards suggested by the US International Trade Commission may be one method of doing that. That is, do not set recipients as certain specific industries but base them on more neutral and objective standards (e.g. high-tech industries or small and medium enterprises). For example, do not divide

the high technology industries and industrial support service businesses into subdivisions, but alter the standards to indicate that eligible recipients shall be industries with technologies surpassing domestic industries. This type of rectification method has already been chosen and is being practiced by Singapore.

Incentives provided to foreign investment zones may not pose any problems as far as its basic objectives are concerned because they are offered to any enterprise that moves into a certain location to do business. In this sense, no specificity is detected here. However, complication could arise from the fact that even this type of incentive in practical sense is not based on a regional concept as it initially appears to be. That is the recipient enterprise is selected first, then foreign investment zone is designated later, making it an incentive fitting the characters of individual industries and leaving some doubt as to whether specificity exists or not. Subsidies whose related laws and regulations generally have objective and neutral conditions like the number of employees or size of enterprise, or whose recipients are automatically selected are seen to be non-specific. And seen from this perspective, when incentives provided to foreign investment zones are based on such objective criteria, then there is not question of specificity. Korea's Foreign Investment Promotion Act faces no problems with specificity in this sense because the Act clearly states those objective and neutral conditions.

In conclusion, Korea's investment incentive system may be in conflict with some provisions of the WTO Agreement on Subsidies and Countervailing Measures. Such conflicts, or non-conformities, as pointed out in the previous sections should be amended as soon as possible in the following way. First, delete export rate and

domestic procurement rate criteria from incentives related to reduction/exemption of rents and parceling prices for public properties owned by local governments. Second, adopt a much wider concept of industries for incentives provided to business dealing with high technology and industrial support services.

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