EU-Korea FTA: a stepping stone towards better subsidies’ control at the international level

Anna Jarosz-Friis, Nicola Pesaresi and Clemens Kerle

On 15 October 2009 a free trade agreement (FTA) between Korea and the EU, the EU’s first with a trading partner in Asia, was initialled (2). It is the most ambitious FTA ever negotiated by the EU, containing the most comprehensive deal on subsidies of any bilateral trade agreement so far. For the first time a bilateral trade agreement will contain substantive WTO+ rules on subsidies on goods that are enforceable through bilateral dispute settlement with commercial sanctions.

1. The Global Europe strategy bears first fruits

In its Global Europe communication (3) of 2006, the Commission set out how the renewed Lisbon strategy for growth and jobs (4) should be supplemented with an external agenda for creating opportunities in a globalised economy, encompassing our trade and other external policies. The core argument of the Global Europe communication is that the rejection of protectionism at home must be accompanied by activism in creating open markets and fair conditions for trade abroad.

Part of that approach was to conclude ‘next generation’ FTAs with important trading partners that combine high levels of protection with large market potential. Korea, ASEAN, Mercosur, India and Ukraine emerged as priorities. In terms of content it was felt that these new FTAs would need to be comprehensive and ambitious in coverage, comprising the highest possible degree of trade liberalisation, including far-reaching liberalisation of services and investment. At the same time FTAs should also tackle non-tariff barriers through regulatory convergence wherever possible and include stronger provisions for IPR, competition and state aid.

1.1. The case for state aid provisions in FTAs

Provisions on state aid and subsidies have traditionally only played a minor role in bilateral trade agreements. Existing provisions are generally rather vague and practically non-enforceable (5). However, the rationale for including such rules in FTAs is not difficult to grasp.

The aforementioned cornerstone of the Commission’s external strategy to create jobs and growth in Europe, namely opening markets abroad, can no longer be achieved by simply lowering tariffs. Global Europe recognises that non-tariff barriers behind the borders of the EU’s trading partners will have to be dismantled in order to fulfil its market access objectives. The granting of state aid can, of course, amount to a non-tariff trade barrier which limits effective market access.

Foreign companies can gain an undue advantage from unchecked state aid disbursed by their governments which is not available to European firms. The potential advantages of trade liberalisation by tariff reductions can therefore be mitigated or even undone by trade-distorting subsidisation in the market for which greater access is sought.

More generally, subsidies can also lead to or maintain inefficient location of economic activity, resulting in a decrease of overall welfare. Likewise, international coordination failures can lead to subsidy races with negative effects on overall welfare.

The above reasons — amongst others — led to the inclusion of state aid control in the Treaty of Rome where it became the cornerstone of an integrated internal market. Time and time again, most recently during the financial crisis, EU State aid control has

(1) The content of this article does not necessarily reflect the official position of the European Commission. Responsibility for the information and views expressed lies entirely with the authors.

(2) The initialling of the FTA signifies the closing of negotiations with a stable legal text, which the European Commission will formally present to EU Member States in early 2010. Following the signature of the agreement by the EU Presidency and the Commission, the FTA will be presented for approval by the European Parliament. Entry into force of the agreement would then be expected in the second half of 2010. See Press Release IP/09/1523, 15.10.2009.


(5) See for example the Euro-Mediterranean Agreements, the 1972 agreement with Switzerland, or the cooperation and association agreements with South Africa, Turkey, Russia, and Moldova. The difficulties regarding enforceability are generally ascribed to the fact that the provisions on state aid in these agreements are not subject to a binding dispute settlement mechanism.
proven to be an essential coordination tool for Member States, preventing harmful subsidy races and preserving the free flow of goods and services across borders. A similar logic applies on an international level, and provides the justification and rationale for including provisions on subsidies in FTAs.

It goes without saying that multilateral or even global subsidy control would be preferable to bilateral control. However, as will be shown in turn, there is a large discrepancy between the EU’s rules on state aid and those that apply to its trading partners.

**1.1.1. The shortcomings of existing multilateral rules on subsidies compared to EU state aid control**

Contrary to the EU (or the EEA), which has adopted its rather unique system of state aid control, most other countries accept state aid/subsidy control only at the multilateral level, under WTO rules. According to the WTO’s Agreement on Subsidies and Countervailing Measures (the SCM agreement), two types of subsidies are forbidden, and others are challengeable if they distort trade and cause injury to the industry of the country concerned. In practice, the EU has rarely challenged foreign subsidies as proving that a subsidy is responsible for harming the domestic industry is very difficult. Another explanation is found in the fact that — in spite of state aid control in the EU ensuring that state aid is well-targeted at market failures and objectives of common interest, is proportionate and therefore distorts competition only to a limited extent — the EU remains one of the largest subsidy-providers in the world.

Apart from the difficulties related to enforcement, there are some other important limitations of the WTO’s rules on subsidies. First, the SCM does not cover subsidies to services. Secondly, in terms of procedure, the WTO’s subsidy rules only provide for prospective remedies against measures that are already in force and have caused a (demonstrated) adverse effect on a WTO Member. State aid control, on the other hand, requires ex-ante authority.

**1.2. The WTO+ provisions in the EU-Korea FTA**

The initialling of the Korea FTA marks an important milestone for the Global Europe strategy, and provides a good opportunity to take stock and assess the outcome. In doing so for the subsidies section, there is one essential question that needs to be asked: Has a WTO+ been achieved? In other words, has the other party committed to more stringent rules on subsidies than those that exist under the WTO?

In sum, compared to State aid control, other WTO members still have considerable leeway to grant subsidies, which in turn risks diminishing the benefits of trade liberalisation. As enhancing subsidy control at multilateral level appears unrealistic for the near future, bilateral solutions are the next best option for the EU.

The final result in the FTA’s subsidies section immediately shows that the objective of a WTO+ has been met, and the regulatory gap between our own regime and that applicable to Korea has been narrowed. In a nutshell, the WTO+ rules are as follows:

- prohibition of two additional categories of subsidies — unlimited guarantees and subsidies for ailing companies without a credible restructuring plan;
- comprehensive enhanced transparency provisions on the granting of subsidies;
- an enforceable, and therefore credible, dispute settlement system with commercial sanctions;
- a rendezvous clause to discuss extending the scope of the agreement to the services sector.

As regards the prohibited categories, the agreement builds on the notion of a subsidy according to the relevant WTO rules, combined with a lower burden of proof as regards the affectation of trade, and bans those that we have identified as being the most distortive (and which are always incompatible with the EU’s state aid rules).
First, the parties cannot therefore guarantee the debts or liabilities of certain enterprises without any limitation. The added value lies in the fact that an unlimited guarantee of this type, which would amount to a highly distortive permanent operating aid, would breach the agreement.

Second, the parties can only grant support to ailing companies if they present a reasonable restructuring plan that ensures long-term viability and contribute themselves to the costs of restructuring. This provision transposes the centre-piece of our compatibility analysis under the rescue and restructuring guidelines into this bilateral agreement, and ensures that ailing companies are not artificially kept alive through public subsidies alone. This will increase the chances of efficient European companies expanding their market shares at the cost of Korean firms with unviable business models.

The transparency provision of the subsidy section obliges the parties to report annually the total amount, types and sectoral distribution of subsidies. Moreover, parties have to provide further information on any subsidy upon request.

This is an important WTO+ provision as it tackles a particular weakness of the WTO system, briefly touched upon above, namely the incompleteness of subsidies notifications, which can hardly be remedied due the characteristics of the system and the absence of effective sanctions. The information gained through this obligatory information exchange mechanism will facilitate enforcement both under the FTA as well as under the WTO, where lack of information has sometimes hampered enforcement attempts in the past.

In the context of current negotiations it was not possible to extend the scope of these new rules to services (they apply to goods only). The agreement provides, however, that the parties should use their best endeavours to develop rules applicable to subsidies to services and that they will hold a first exchange of views on subsidies to services within 3 years from the entry into force of the FTA. This ensures that the EU engages an important trading partner in a constant dialogue on subsidies, and will enable it to address potential future problems in this field in an already existing forum.

Perhaps most importantly and for the first time ever the FTA contains provisions on subsidies which are enforceable via a dispute settlement mechanism. A party that considers that the other party has infringed the agreement can launch a consultation on the contentious matter, which would be referred to an arbitration panel if the consultation does not lead to a satisfactory outcome. The decision of the panel would be binding and enforceable with commercial sanctions. This equips these provisions with an effective enforcement mechanism that will significantly enhance their practical value.

Beyond the legal aspects, one of the expected results of the overall agreement including the dispute settlement mechanism lies with the incentives it provides for the parties to engage in a bilateral dialogue with a view to remedying problematic subsidy practices. This is further enhanced by a regular bilateral platform for discussing subsidies, be it through exchange of information on request, or through dialogue in the Trade Committee. The bilateral character of such exchanges may prove a useful channel of informal consultations compared to the more public character of all WTO platforms.

### 3. A first step towards a global control of for subsidies?

The FTA with Korea embodies the first tangible results of the EU’s efforts to introduce more comprehensive disciplines on subsidies in trade agreements with third countries. The initialling of this agreement could not be timelier — in the midst of a worldwide economic crisis, the EU and Korea are sending a strong anti-protectionist signal to the rest of world. Not only is the EU determined to keep trade open and free; this agreement, once ratified, will also contribute to avoiding an international subsidy race, and will help European firms abroad to compete on the merits with their Korean peers.

It remains to be seen to what extent the EU will succeed in obtaining similar results in ongoing and future FTA negotiations, some of which have proven to be extremely challenging. In any event the initialling of this FTA constitutes an important stepping stone for similar agreements and can hopefully serve as a point of reference which the EU can use when attempting to persuade trading partners to commit to rules on subsidies that mirror those contained in the Korea FTA, on either a bilateral or even a multilateral level.