



# Achieving WTO Compliance for Special Economic Zones in Developing Countries

*Stephen Creskoff and Peter Walkenhorst\**

Many developing countries operate geographically delineated economic areas in the form of export processing zones, special industrial zones, or free trade zones. They experiment in these special economic zones (SEZs) with infrastructure, regulatory, and fiscal policies that are different from those implemented in the rest of the domestic economy with the aim of attracting foreign investment, creating employment opportunities, and boosting exports. **Special incentives for zone-based firms play a prominent role in most countries' programs.**

While SEZs are not specifically mentioned by name in any of the multilateral agreements concluded under the auspices of the World Trade Organization (WTO), several types of incentives that are typically part of SEZ policy are subject to disciplines under the WTO, most notably through pro-

visions in the Agreement on Subsidies and Countervailing Measures (SCM Agreement). This Note provides an overview of the application of WTO disciplines to incentive programs typically employed by developing countries in connection with SEZ programs. **It is intended to inform policy makers, zone administrators, and the development community about the WTO consistency of such incentive measures.** The analysis is concerned exclusively with multilateral law and leaves economic aspects concerning beneficial or adverse effects of such fiscal incentives aside. As in all legal analysis, different interpretations of particular provisions might be possible and the ultimate decision on the legality of a particular measure remains subject to the authoritative interpretation of the WTO and its members.

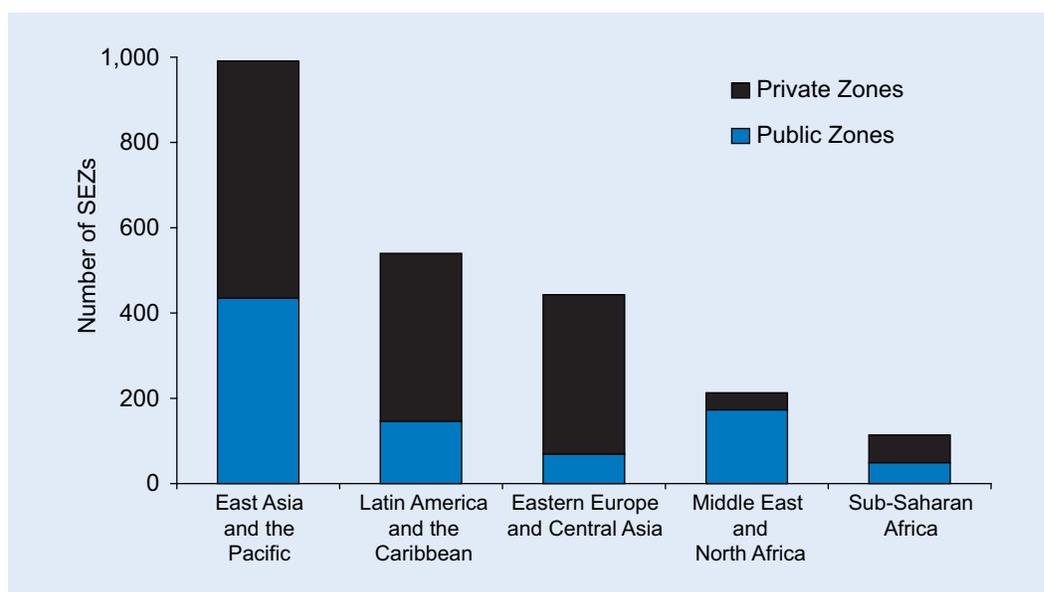
\* The authors are, respectively, an international legal consultant and partner at Creskoff & Doram LLP, and a senior economist in the World Bank's International Trade Department. The authors appreciate the invaluable advice and assistance received from several colleagues and experts during the preparation of this study. Special thanks are due to Sameena Dost of the World Bank's Legal Affairs Department; Clarisse Morgan and Bruce Wilson of the WTO Secretariat; Bruce Hirsh, Cecilia Klein, and Roy Malmrose of the Office of the U.S. Trade Representative; Anthony Kleitz of the OECD Secretariat; Richard O. Cunningham of Steptoe & Johnson LLP; Craig Giesz of AECOM; and Gökhan Akinci of FIAS. Any remaining errors are the sole responsibility of the authors, and the views expressed are not necessarily those of the World Bank, its Board of Directors, or the governments that they represent and should not be attributed to them.

## Nature and Prevalence of SEZs

SEZs are defined in this Note as geographically delimited areas, frequently physically secured, that are usually, but not always, outside the customs territory of the host country. They range in size from single factories to large cities. SEZs are under single management, either government or private sector. Businesses located within SEZs are normally eligible for benefits such as duty and tax exemptions on goods based on the fact that they are physically located within the zone. Different countries have used different names for zones with these characteristics. These include “‘industrial free zone’ and “‘export free zone’” in Ireland, “‘maquiladora’” in Mexico, “‘duty free export processing zone’” and “‘free export zone’” in the Republic of Korea, “‘export processing zone’” in the Philippines, “‘investment promotion zone’” in Sri Lanka, “‘foreign trade zone’” in India, and “‘free zone’” in the United Arab Emirates.” “Development areas” can also fit the definition of SEZ.

Developing countries have increasingly used SEZs as an important economic development tool. A recent survey found over 2,300 SEZs in 119 developing and transition countries around the world (Akinci and Crittle, 2008). Starting in the late 1970’s, China used SEZs to pioneer new economic policies, provide modern infrastructure, and attract investment for export-oriented industries. A 2008 WTO trade policy review of China found that as of 2006 there were 660 SEZs and other development zones authorized by the central government and an additional 1,346 development zones approved by local governments. Following the example of China, Vietnam has also extensively used SEZs to introduce new economic policies, provide improved infrastructure, and attract investment. As of July 2005, Vietnam had established 124 industrial and export processing zones, attracting 3,612 investment projects amounting to over US\$15 billion. But SEZ proliferation is not limited to Asia, and significant numbers of zones exist in all World Bank regions (figure 1).

Figure 1. Large Numbers of SEZs Exist in All of the World’s Regions



Source: Akinci and Crittle, 2008.

## SEZs and the Agreement on Subsidies and Countervailing Measures

WTO disciplines regarding *subsidies* are of greatest concern for the viability of SEZ programs in developing countries. SEZ-related incentives can be broadly grouped into three categories: (i) measures that are WTO consistent, (ii) measures that are prohibited or subject to challenge under WTO law, and (iii) and measures where WTO consistency depends on the facts of the particular case. It should be noted that pursuant to Special and Differential Treatment (SDT), least-developed WTO members and countries whose per capita gross national product is under US\$1,000 in 1990 dollars are currently generally exempt from the disciplines of the SCM Agreement (see appendix table A.1 for the list of countries). Moreover, 16 countries are currently exempt pursuant to phase-out provisions for certain “grandfathered” programs through 2015 (see appendix table A.2 for the list of countries). Hence, **the WTO disciplines have most immediate relevance for middle-income WTO members that are not exempt for certain “grandfathered” programs, but will also concern other developing countries in the future, as their exemption expires or their per capita income passes the US\$1,000 threshold.**

Concerning measures that appear WTO legal, **the SCM Agreement excludes from the definition of “subsidy” the core fiscal benefit provided by SEZs**—exemptions from duties and taxes on goods exported from SEZs. Hence, the following SEZ-related measures appear to be WTO legal:

- exemption of exported products from import duties
  - exemption of exported products from indirect taxes
  - exemption of goods consumed in the production process from import duties and indirect taxes when the end products are exported
  - exemption of production waste from import duties and indirect taxes when the waste is exported or discarded
  - exemption of goods stored in SEZs from duties and indirect taxes
  - nonspecific subsidies, including generally applicable tax rates imposed by national, regional, and local government authorities.
- Concerning measures employed in connection with SEZ programs that appear inconsistent with WTO disciplines, **two prohibited subsidies identified in Article 3 of the SCM Agreement are of greatest concern: export subsidies and import substitution or domestic content subsidies.** Export subsidies are subsidies that are contingent in law or in fact upon export performance. Domestic content subsidies are subsidies contingent on the use of domestic goods instead of imports. In particular, WTO-prohibited government subsidies in connection with SEZ programs include (but are not limited to) the following:
- a direct subsidy contingent on export performance
  - currency retention schemes involving a bonus on exports
  - preferential transport and freight charges for export shipments
  - provision of domestic products and services for exports at terms more favorable than those for domestic goods
  - exemption, remission, or deferral of direct taxes or social welfare charges if contingent on exports
  - allowance of special direct tax deductions for exports above those granted on goods for domestic consumption
  - exemption or remission of indirect taxes on exports in excess of those on goods sold for domestic consumption
  - exemption, remission, or deferral of prior-stage cumulative taxes on goods or services used in the production of exported products in excess of products

sold for domestic consumption (except for the exemption, remission, or deferral of such taxes on “inputs consumed” in the production process)

- provision of export credit guarantees or insurance programs at premium rates inadequate to cover long-term costs
- grants of export credits at rates below those which they pay for the funds, or at below market rates, or payment of all or part of the costs of obtaining credit
- subsidies contingent on the use of domestic over imported goods.

Concerning **measures where WTO consistency depends on the facts of the particular case**, there are several types of government policies that fall into this category, for example:

- duty and tax free treatment of production equipment used in SEZs
- provision of materials and components in exchange for compensation that may not reflect full market value
- government subsidies for infrastructure development in an SEZ.

**Note that WTO disciplines apply only to measures imposed by WTO members—that is, governmental measures.** Today, a majority of SEZs are privately owned, developed, and operated. Measures imposed by private SEZ operators are not subject to WTO disciplines, unless they implement a governmental measure.

### Other WTO Provisions of Relevance for SEZs

**In addition to the provisions of the SCM Agreement, a number of other WTO disciplines may apply to SEZ programs in developing countries.** These include most favored nation (MFN) treatment (GATT Article I); national treatment (GATT Article III); the limitation of fees and formalities connected with importation and exportation to the approximate cost of the services rendered (GATT Article VIII(1)); transparency

requirements (GATT Article X); the elimination of quantitative restrictions (GATT Article XI); the Agreement on Trade-Related Investment Measures; and the General Agreement on Trade in Services.

### Achieving WTO Compliance

There are four principal elements in a program to achieve WTO compliance regarding government measures employed in connection with SEZ programs. These are (i) a thorough review of all applicable measures and identification of possible inconsistent measures; (ii) prompt reporting of possible WTO-inconsistent measures; (iii) development of a plan to phase out WTO-inconsistent measures; and (iv) implementation of the phase-out plan. These are summarized below.

**Review and identification.** All members, and in particular middle-income countries, should review their SEZ programs in detail to assure compliance with the SCM Agreement and other WTO disciplines. This is best accomplished using independent advisors and not government officials or local experts that may have a vested interest in defending the existing measures. It may be appropriate to request technical assistance from experts at the WTO, international financial institutions, and other donors in connection with such a review. Upon request, the WTO Secretariat staff routinely provide confidential advice and in-depth technical assistance to individual members about their programs, including bringing these into conformity with WTO disciplines.

SEZ programs in middle-income countries are examined by the WTO as part of regularly scheduled trade policy reviews (TPRs). Middle-income countries are normally reviewed every six years. Preparation for scheduled TPRs should include a thorough review of all measures relating to SEZs.

**Notification.** Changes with regards to export subsidy exemptions and other measures that are specific subsidies should be notified to the WTO Committee on Subsidies and Countervailing Measures by 30 June of each year. The notifications must contain sufficient detail to enable an understanding of the operation of the subsidy programs and an understanding of their trade effects. Progress made in the removal of export subsidies and other subsidy measures should also be notified to the Committee. Countries entitled to a phase-out period for export subsidies and WTO decisions must also meet annual notification requirements regarding these subsidies.

**Compliance plan.** Following notification, the next step is development of a compliance plan to change prohibited subsidies and other WTO-prohibited measures into WTO non-prohibited measures or to remove the measure. In this connection, it is important to consult with SEZ businesses and investors. In some instances, SEZ incentive measures cannot be modified or repealed without the consent of existing businesses and investors that have made financial commitments in reliance on these incentives. For example, after SEZ incentive measures were repealed in Ukraine in 2005, subsequent court decisions continued the fiscal measures for certain investors.

In many instances, prohibited export subsidies can be converted into actionable subsidies by removing any de jure or de facto obligation to export goods produced in an SEZ and allowing zone enterprises full access to the domestic market on a duty- and tax-paid basis. In addition, specific but allowed subsidies can be converted into nonspecific subsidies by, for example, extending benefits such as tax reductions to all businesses irrespective of location or sector. This would move them outside the scope of the SCM Agreement's provisions.

**Implementation.** Members that do not have the benefit of SDT treatment for export subsidies should remove illegal export subsidies and other measures that are WTO inconsistent as soon as possible.

Currently, pursuant to SDT treatment, 18 countries can maintain export subsidies because their per capita GNP is under US\$1,000 in 1990 dollars (see appendix table A.1) and 16 middle-income countries can maintain “grandfathered” export subsidies through 2015 (see appendix table A.2). Both categories of exempt countries should plan to phase out all export subsidies by 2015 at the latest since it is quite possible that the countries in the first category will “graduate” by then (that is, per capita GNP will exceed US\$1,000 in 1990 dollars for three consecutive years) and that further extensions will not be granted for “grandfathered” programs. In view of the likelihood that the legal rights of SEZ investors may prevent the termination of fiscal incentives without compensation, the phase-out of export subsidies should begin as soon as possible and not be deferred until near the end of the extension period.

### Further Reading

- Akinci, G., and J. Crittle. 2008. *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development*. Washington DC: The World Bank.
- Creskoff, S., and P. Walkenhorst. 2009. “Implications of WTO Disciplines for Special Economic Zones in Developing Countries.” Policy Research Working Paper 4892. World Bank, Washington, DC.
- Engman, M., O. Onodera, and E. Pinali. 2007. “Export Processing Zones: Past and Future Role in Trade and Development.” OECD Trade Policy Working Paper No. 53. OECD, Paris.

## APPENDIX

**Table A.1: Countries Exempted from the Prohibition of Export Subsidies in the WTO SCM Agreement**

Least-developed country WTO members* (SCM Art. 27.2(a) and Annex VII(a))	Members with a per capita GNP<\$1,000** (SCM Art. 27.2(a) and Annex VII(b))
Angola	Bolivia
Bangladesh	Cameroon
Benin	Congo
Burkina Faso	Cote d'Ivoire
Burundi	Egypt
Cambodia	Ghana
Cape Verde	Guyana
Central African Republic	Honduras
Chad	India
Democratic Republic of the Congo	Indonesia
Djibouti	Kenya
Gambia	Nicaragua
Guinea	Nigeria
Guinea-Bissau	Pakistan
Haiti	Philippines
Lesotho	Senegal
Madagascar	Sri Lanka
Malawi	Zimbabwe
Maldives	
Mali	
Mauritania	
Mozambique	
Myanmar	
Nepal	
Niger	
Rwanda	
Senegal	
Sierra Leone	
Solomon Islands	
Togo	
Uganda	
United Republic of Tanzania	
Zambia	

Source: WTO Website, Document G/SCM/110/Add.4 (December 21, 2007).

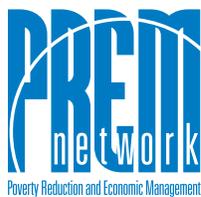
\* As of 28 July 2008. In addition, 12 least-developed countries are in the process of WTO accession: Afghanistan, Bhutan, Comoros, Equatorial Guinea, Ethiopia, the Lao People's Democratic Republic, Liberia, Samoa, São Tomé and Príncipe, Sudan, Vanuatu, and Yemen.

\*\* In 1990 U.S. dollars.

**Table A.2. Countries with a Further Extension of the Transition Period for Export Subsidies (SCM Art. 27.4)**

WTO member	Notified programs (bolded if concerning SEZs)	WTO action
Antigua & Barbuda	<b>Free Trade/Processing Zones.</b> Fiscal Incentives Act	Extensions granted
Barbados	Fiscal Incentive Program. Export Allowance. Research & Development Allowance. International Business Incentives. Societies with Restricted Liability. Export Re-discount Facility. Export Credit Insurance Scheme. Export Finance Guarantee Scheme. Export Grant & Incentive Scheme.	Extensions granted
Belize	<b>Export Processing Zone Act. Commercial Free Zone Act.</b> Fiscal Incentives Program. Conditional Duty Exemption Facility.	Extensions granted
Bolivia (Annex VII(b))	<b>Free Zone.</b> Temporary Admission Regime for Inward Processing.	Reservation of rights
Costa Rica	<b>Duty Free Zone Regime.</b> Inward Processing Regime. Fiscal Incentives Program.	Extension granted
Dominica	Fiscal Incentives Program.	Extension granted
Dominican Republic	<b>Law to Promote the Establishment of Free Trade Zones.</b>	Extension granted
El Salvador	<b>Export Processing Zones &amp; Marketing Act.</b>	Extension granted
Fiji	<b>Export Processing Factories/Zones Scheme.</b> Short-Term Export Profit Deduction.	Extension granted
Grenada	Fiscal Incentives Act. Qualified Enterprise Act. Statutory Rules and Orders.	Extension granted
Guatemala	<b>Free Zones. Industrial and Free Trade Zones (ZOLIC).</b> Special Customs Regimes.	Extension granted
Honduras (Annex VII(b))	<b>Free Trade Zone of Puerto Cortes. Export Processing Zones.</b> Temporary Import Regime.	Reservation of rights
Jamaica	<b>Export Free Zone Act.</b> Export Industry Encouragement Act. Foreign Sales Corporation Act. Industrial Incentives Act.	Extension granted
Jordan	Income Tax Law of 1985, amended.	Extension granted
Kenya (Annex VII(b))	<b>Export Processing Zones.</b> Export Promotion Program. Customs & Excise Regulation.	Reservation of rights
Mauritius	<b>Freeport Scheme.</b> Export Enterprise Scheme. Pioneer Status Enterprise Scheme. Export Promotion.	Extension granted
Panama	<b>Export Processing Zones.</b> Official Industry Register.	Extension granted
Papua New Guinea	Income Tax Act.	Extension granted
Sri Lanka (Annex VII(b))	Income Tax Concessions. Tax Holidays & Profits Generated. Concessionary Tax on Dividends. Indirect Tax Concessions-Internal Tax Exemptions. Export Development Investment Support Scheme. Import Duty Exemption. Exemption from Exchange Control.	Reservation of rights
St. Kitts & Nevis	Fiscal Incentives Act.	Extension granted
St. Lucia	<b>Free Zone Act.</b> Fiscal Incentives Act. Micro & Small Scale Business Enterprise Act.	Extension granted
St. Vincent and the Grenadines	Fiscal Incentives Act.	Extension granted
Uruguay	Automotive Industry Export Promotion Regime.	Extension granted

Sources: Subsidies Enforcement Annual Report to the U.S. Congress (February 2008); WTO notifications.



This note series is intended to summarize good practices and key policy findings on PREM-related topics. The views expressed in the notes are those of the authors and do not necessarily reflect those of the World Bank. *PREMnotes* are widely distributed to Bank staff and are also available on the PREM Web site (<http://www.worldbank.org/prem>). If you are interested in writing a *PREMnote*, email your idea to Madjiguene Seck at [mseck@worldbank.org](mailto:mseck@worldbank.org). For additional copies of this *PREMnote* please contact the PREM Advisory Service at x87736. *PREMnotes* are edited and laid out by Grammarians, Inc.

Prepared for World Bank staff