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ARTICLE

Free Zone Incentives in MERCOSUR Countries and WTO Law

Gabriel Gari*

This article examines the consistency of the incentives offered by free zone regimes in Argentina, Brazil, Paraguay, and Uruguay with World Trade Organization (WTO) law. It suggests that some of the incentives offered to free zone users are inconsistent with the Agreement on Subsidies and Countervailing Measures (ASCM) because they constitute a 'subsidy' within the meaning of the ASCM, subject de iure *or de facto to export performance, most notably, exemptions of direct taxes, exemptions of custom duties on the import of capital goods, exemptions of payment of social welfare charges, unqualified exemptions on payment of indirect taxes, and the possibility to supply goods or services to free zone users at promotional rates. By contrast, this article suggests that there are no significant inconsistencies between free zone incentives and the General Agreement on Trade in Services (GATS) but warns that the situation could change in the future if, as a result of multilateral negotiations, MERCOSUR countries opt for extending their GATS commitments to new sectors and modes of supply.*

1. Introduction

On its most basic form, a free zone[1] simply consists of a special customs regime applicable to a part of the territory of a country where any goods introduced are generally regarded, insofar as import duties and taxes are concerned, as being outside the customs territory.[2] However, the type of incentives offered by free zones may go well beyond tariff incentives, depending on the specific purpose they aim to achieve. During the second half of the twentieth century, some countries began to use free zones to promote export-oriented manufacturing activities, offering not just custom duty exemptions but also exemptions on indirect taxes levied on inputs used for the manufacturing of exporting products, direct tax incentives for free zone users, a more liberal regulatory environment, and modern infrastructure.[3] Nowadays, free zones are used for a variety of purposes including the development of disadvantaged regions, generating income and employment, attracting investment (especially foreign direct investment), and promoting technology transfer.[4]

Competitive pressures have been pushing towards the standardization of the incentives offered by free zones across the world.[5] While some incentives such as exemptions, remissions, or deferrals of indirect taxes and import charges levied on goods and services that are consumed in the production of exported products are of interest only to manufacturing companies, free zones also typically offer other types of incentives that are of interest for service suppliers as well such as exemptions or remissions on corporate taxes, exemptions from most local and indirect taxes, no restrictions or taxes on capital and profits repatriation, exemption from foreign exchange controls, provision of public utilities at below market rates, and provision of state-of-the-art physical infrastructure.

Notes

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1 Contrary to 'free trade zone' or 'export processing zone' (EPZ), the term 'free zone' evokes in a more accurate way the essence of this trade policy instrument, being neutral as to its purpose, whether it pursues a purely trade objective or the development of an export-oriented manufacture sector.

2 International Convention on the Simplification and Harmonization of Customs Procedures, Revised Kyoto Convention, Annex D, Ch. 2.

3 See 'ILO Document (TMEPZ/1998), Labour and Social Issues Relating to Export Processing Zones, Report for Discussion at the Tripartite Meeting of Export Processing Zones – Operating Countries' (Geneva, 1998), 3.

4 Raúl A. Torres, 'Free Zones and the WTO Agreement on Subsidies and Countervailing Measures', *Global Trade and Customs Journal* 2, no. 5 (2007).

5 G. Akinci & J. Crittle, *Special Economic Zones: Performance, Lessons Learned, and Implications for Zone Development* (Washington, DC: The World Bank, 2008).

Not surprisingly, a clear tendency can be observed both in developed and developing countries towards widening the type of business hosted by free zones, increasingly incorporating different services, including data processing, call centres, management services, Internet gaming, education services, distribution services, technology services, production and distribution of films, sound recording, heath and veterinary services, banking and insurance, professional services, and retailing and merchandising.[6]

For World Trade Organization (WTO) members, the discretion to grant fiscal or financial incentives like those offered by free zones is not unfettered. Although the WTO agreements do not expressly refer to free zones, they include provisions both on trade in goods and on trade in services that discipline the offering of fiscal or financial incentives, particularly those that discriminate against foreign products or services or create trade distortions. Notwithstanding the fact that free zones have become an extremely popular trade policy instrument,[7] little research has been devoted to examine the consistency of free zone incentives with WTO disciplines.[8] Published studies so far are mainly focused on examining the implications of the Agreement on Subsidies and Countervailing Measures (ASCM) for free zones, overlooking the implications of the disciplines included in the General Agreement on Trade in Services (GATS), despite the growing number of service suppliers operating from free zones. The purpose of this article is to examine the consistency of the incentives offered by free zone regimes in MERCOSUR countries[9] with the ASCM and the GATS.[10] The remainder of this article is organized as follows: section 2 examines the incentives offered by free zone regimes in MERCOSUR countries; section 3 discusses the consistency of these incentives with the ASCM; section 4 discusses the consistency of these incentives with the GATS, and section 5 concludes.

2. Free Zone Incentives in MERCOSUR Countries

2.1. Argentina Free Zone Law

2.1.1. General Provisions

Argentinean free zone legislation can be traced back to the beginning of the twentieth century, but it was not until 1994 that a comprehensive legal framework for free zones was adopted. Law 24331 of 17 June 1994 stipulates the objectives of free zones, the mechanisms for their administration and control, and the fiscal and customs regime applicable to the activities carried out within their boundaries.[11] The statute authorizes the national government to create a free zone in each Argentine province and to establish up to four additional free zones in geographic regions whose critical economic situation and/or border status with other countries justify exceptional conditions.[12] The creation of the free zone requires an agreement between the national government and the provincial government, whereby the latter adheres *in totum* to the provisions of this statute.[13]

A free zone is defined as an area where the entrance and exit of merchandise is not subject to the usual

Notes

6 Luis Abugattas Majluf, 'State Support Measures for Services: An Explanatory Assessment with Scanty Data', *UNCTAD* (2005): 22. In the same vein, see Massimo Geloso Grosso, 'Analysis of Subsidies for Services. The Case of Export Services', OECD Trade Policy Working Paper No. 66 (2008), para. 71.

7 According to the ILO in 2006, there were 3,500 EPZs or similar types of zones distributed in 130 areas and employing 66 million people. See Jean-Pierre Singa Boyenge, 'ILO Database on Export Processing Zones (Revised)', ILO Working Paper (2007).

8 See Torres, *supra* n. 4; Jaime Granados, 'Export Processing Zones and Other Special Regimes in the Context of Multilateral and Regional Trade Negotiations', IADB INTAL-ITD Occasional Paper 20 (2003); Gokhan Akinici, *Special Economic Zones Performance, Lessons Learned and Implications for Zone Development* (World Bank, 2008); Stephen Creskoff & Peter Walkenhorst, 'Implications of WTO Disciplines for Special Economic Zones in Developing Countries', World Bank Policy Research Working Paper No. 4892 (2009); and Michael Engman, Osamu Onodera & Enrico Pinali, 'Export Processing Zones. Past and Future Role in Trade and Development', OECD Trade Policy Working Paper No. 53 (2007).

9 MERCOSUR stands for Mercado Comùn del Sur (Southern Common Market). The expression 'MERCOSUR countries' is used for ease of reference to the free zone regimes of Argentina, Brazil, Paraguay, and Uruguay. This article does not aim to discuss the consistency of each free zone regime with MERCOSUR disciplines but with WTO disciplines.

10 There are other WTO disciplines that impinge on members' discretion to grant incentives, albeit their practical implications are less relevant and, for reasons of space, are not covered here. That is the case, *inter alia,* of disciplines included in the Agreement on Trade Related Investment Measures and the GATT 1994 provisions on MFN Treatment (Art. I), National Treatment (Art. III), and Fees and Formalities (Art. VIII(I)).

11 The free zone regulatory framework is also governed by Law 5.142 of 22 Sep. 1907, 8.092 of 30 Sep. 1910, 24.756, O.J. of 2 Jan. 1997, 25.005, O.J. of 18 Aug. 1998, and 25.956, O.J. of 2 Dec. 2004; AFIP General Resolution No. 270/1998 and its Amendment No. 1879/2005; and MEP Resolution No. 42/2004. In addition, Law 19.640, O.J. of 2 Jun. 1972 established the Tierra del Fuego Special Customs Area; a different regime, not examined in this paper, which offers different benefits and it is subject to different regulations. The Tierra del Fuego Special Customs Area is allowed to operate until 2013 (WTO Trade Policy Review of Argentina (2007), WT/TPR/S/176/Rev.1, 76).

12 Law 24331/1994, Art. 2.

13 *Ibid.*, Art. 3.

customs controls, is exempted from payment of taxes other than fees for services rendered that could be established, and is not subject to prohibitions of an economic character.[14] The area must be fenced off in a manner that ensures its isolation from the national customs territory.[15]

According to the statute, the objective of free zones is to stimulate trade and industrial export activity, helping to extend the increase in efficiency and reduction in costs associated with the activities undertaken within such zones to investment and employment.[16] The statute further stipulates that free zones must function in accordance with national trade policy, they must contribute to the growth and competitiveness of the economy, and they must be fully incorporated into the regional integration process.[17] Moreover, it is expressly stated that free zones should become a development centre in those areas where they are established by employing human resources and using other resources available in those areas.[18] The types of business that can be undertaken in free zones include commercial activities, industrial activities, and the supply of services, including warehousing services.[19]

The free zone operator is the person, selected through a bidding process, responsible for running the free zone in accordance with a concession agreement.[20] It can be either an entirely private person or a public-private partnership. The free zone operator is responsible, among other things, for providing the basic infrastructure and services necessary for the normal operation of the free zone in accordance with the concession agreement.[21] Concessions for operating free zones are granted for a period of thirty years extendable for ten additional years. As of September 2009, the Executive Power had authorized the creation of twenty-two free zones.[22]

The direct free zone user is the natural or legal person, national or foreigner, that is entitled to run its business within the free zone in accordance with an agreement with the free zone operator, for an agreed price and during an agreed period of time.[23] The indirect free zone user is the natural or legal person, national or foreigner, that is entitled to run its business within the free zone in accordance to an agreement with the direct free zone user.[24]

2.1.2. Incentives

The entrance of merchandise into the free zone from the national customs territory or third countries is exempted from all import charges, existing or to be created, except for fees paid for services rendered.[25] The transfer of merchandise from the free zone to third countries is exempted from all import charges, existing or to be created, except for fees paid for services rendered.[26] The entrance of merchandise into the free zone from the national customs territory shall be considered as a suspended export.[27] The transfer of merchandise from the free zone to the national customs territory is regarded as an import.[28]

Merchandise exported from the national customs territory to a free zone and subsequently exported to third countries either in the same state or having undergone transformation, processing, combination, mixture, or any other enhancement within the free zone is covered by the general export duties regime. Nonetheless, the value added to the goods through processing or transformation in the free zone is exempted from such duties.[29]

The transfer of merchandise from the free zone to third countries is not eligible for any incentive other than the incentives established in accordance with international agreements subscribed by Argentina and the remission of taxes effectively paid provided that exporters domiciled in the national customs territory are entitled to such remissions.[30]

The provision of basic utilities (telecommunications, gas, electricity, mains water, sewerage, and

Notes

14 Argentinean Customs Code, Art. 590.
15 Law 24331/1994, Art. 38.
16 *Ibid.*, Art. 4.
17 *Ibid.*
18 *Ibid.*, Art. 5.
19 *Ibid.*, Art. 6.
20 *Ibid.*, Arts 18 and 19.
21 *Ibid.*, Art. 20.
22 See Argentina's notification pursuant to Art. XVI.1 of the GATT 1994 and Art. 25 of the ASCM of 28 Sep. 2009 (G/SCM/N/186/ARG).
23 Law 24331/1994, Art. 21 and AFIP General Resolution 270/1998 of 9 Dec. 1998, Annex II.
24 AFIP General Resolution 270/98 of 9 Dec. 1998, Annex II.
25 Law 24331/1994, Art. 24 and AFIP General Resolution 270/1998 of 9 Dec. 1998, Annex VI.I.1.
26 Law 24331/1994, Art. 25.
27 *Ibid.*, Art. 27.
28 *Ibid.*, Art. 28.
29 DGA/AFIP General Instruction No. 6/2004.
30 *Ibid.*, Art. 30.

drainage) within the free zone is exempted from national taxes.[31] Free zone users are not entitled to the benefits and fiscal incentives included in industrial promotion schemes and regional or sectoral schemes, existing or to be created in the national territory.[32] The statute stipulates that the agreement between the national and provincial governments for the creation of a free zone must include a commitment by the provincial government not to grant free zone users exemptions from provincial taxes except for fees paid for services rendered.[33]

The national customs authority must set up an office in each free zone able to deal with all the administrative procedures and documentation that free zone users need to comply with for clearing customs.[34] In addition, the statute exempts imports and exports from or into free zones from the economic restrictions or prior deposits that may be applicable for international trade transactions.[35] On the other hand, free zones are subject to the same labour law that is applicable in the national customs territory,[36] and the financial transactions within the free zone are subject to the same financial and exchange rate regulations applicable in the national customs territory.[37]

2.1.3. Conditions for Incentives

Free zone users can carry out industrial activities but with the sole purpose of exporting the manufactured goods to third countries.[38] When the merchandise is subject to a production process that involves manufacturing, mixing, or any other activity aimed at transforming and adding value to the merchandise, the statute determines that the merchandise must be exclusively destined for third countries.[39] In other words, the import of merchandise manufactured in the free zone into the national customs territory is prohibited.[40] The only exception to this rule consists of the manufacture of capital goods made with foreign inputs.[41] They can be imported into the national customs territory, provided they are not produced in the national customs territory or in the existing special customs areas and subject to payment of import charges and restrictions applicable to imports from third countries.[42]

Merchandise that remains in the same condition as it was when it was introduced into the free zone, or it has been subject to ordinary manipulations designed to improve their appearance or commercial value, can be transferred from the free zone into the national customs territory.[43] The transfer of merchandise from the free zone to the national customs territory is regarded as an import, subject to payment of import charges and restrictions applicable to imports from third countries.[44] The statute says nothing about the provision of services from the free zone into the national customs territory.

2.2. Brazil Export Processing Zone (EPZ) Law

2.2.1. General Provisions

Export Processing Zones (hereinafter EPZs) are industrial districts subject to a special regulatory regime that provides fiscal, foreign exchange, and administrative incentives to firms operating within them subject to the condition that at least 80% of their gross income is exported. The aim of EPZs is to boost exports, reduce regional imbalances, as well as strengthening the balance of payments, fostering technological transfers, and improving the nation's economic and social development.[45]

EPZs have a protracted history. Legislation authorizing their creations was first adopted in 1988.[46] However, the effective establishment of EPZs faced stiff resistance from the industrial sector, particularly from the Federação das Indústrias do Estado de São Paulo (FIESP) (Sao Paulo Industrial Association), in the South and from supporters of the Manaus Free

Notes

31 *Ibid.,* Art. 26.
32 Law 24331/1994, Art. 32.
33 *Ibid.,* Art. 31.
34 *Ibid.,* Art. 35.
35 *Ibid.,* Art. 8.
36 *Ibid.,* Art. 41.
37 *Ibid.,* Art. 36.
38 *Ibid.,* Art. 6.
39 *Ibid.,* Art. 7.
40 AFIP General Resolution 270/1998 of 9 Dec. 1998, Annex VI.II.2.
41 *Ibid.,* Annex VI.II.3.
42 Law 24331/1994, Art. 6.
43 *Ibid.*
44 *Ibid.,* Art. 28 and AFIP General Resolution 270/98 of 9 Dec. 1998, Annexes VI.II.1 and 2.
45 Law 11508/2008, Art. 1.
46 Law 2452/1988 of 29 Jul. 1988.

Trade Zone in the North, who feared fiscal incentives offered to companies operating within EPZs could leave them at a competitive disadvantage with EPZs' production. As a result, the fiscal incentives offered by the EPZs' legislation have been subject to various amendments.[47] The current regime is laid down by Law 11508/2007, of 20 July 2007, as amended by Law 11732/2008, of 20 July 2008.[48]

Proposals for the creation of EPZs are submitted by States or Municipalities, jointly or separately, to the National Council of EPZ (Conselho Nacional das Zonas de Processamento de Exportação, hereinafter CZPE). The proposal is first assessed by the CZPE and then forwarded to the Executive Power.[49] The final decision on the authorization of EPZs is made by a presidential decree that must strictly limit the physical area of the EPZ.[50] Among other requirements, the proposal for the creation of the EPZ must include evidence of availability of land, financial resources and minimum energy, communication, and transport infrastructures necessary for meeting the EPZ's demand.[51]

EPZs are monitored by the CZPE. The CZPE has authority, *inter alia*, to assess proposals for the creation of EPZs, authorize the establishment of companies in EPZs, approve industrial projects, and set out general policies on EPZs.[52]

EPZs are operated by a legal entity specifically created to this effect. EPZ operators must supply services to the EPZ users (that is, companies installed in the EPZ area) and must support and assist customs authorities. The EPZ area must be demarcated and closed to ensure fiscal control of the operations carried out there. The EPZ operator must comply with instructions from relevant government agencies regarding area enclosing, surveillance, and security devices.[53] It must also provide the facilities and equipment required for control, surveillance, and local customs management.[54]

To become an EPZ user, a company must be duly authorized by the CZPE.[55] There is no restriction in terms of nationality of the company. It can be a domestic or foreign company. According to the current legislation, EPZs are meant to host only companies dedicated to the manufacturing and export of goods.[56] However, Associação Brasileira de Zonas de Processamento de Exportação (ABRAZPE), the EPZs' industry association, is planning to lobby the Brazilian Congress for amending the current regime, in order to allow for the location of service companies in EPZs as well, in particular IT companies.[57]

2.2.2. *Incentives*

Payment of taxes levied on domestic purchases of goods and services by EPZ users is suspended for the following taxes and contributions:[58] Tax on Industrialized Products (Federal Excise Tax), Contribution to Social Security Financing (COFINS), and Contribution to the Social Integration Programme (PIS/PASEP).

Payment of taxes levied on imports of goods and services by EPZ users is suspended for the following taxes and contributions:[59] Import Duties, Tax on Industrialized Products (Federal Excise Tax), COFINS-Import, Contribution to the Social Integration Programme (PIS/PASEP-Importacao), and Import Freight Surcharge for the Renewal of the Merchant Navy on Goods Imported by Sea (AFRMM).

The suspension of tax payment covers domestic purchases or imports of machinery, equipment, and instruments necessary for industrial installation or

Notes

47 See Law 8396/1992 of 2 Jan. 1992 and Law 8924/1994 of 29 Jul. 1994, which prohibited the sale of goods manufactured in EPZs in the domestic market. Bill No. 146/1996 introduced a proposal to allow companies established in EPZs to sell up to 20% of their production to the domestic market, subject to the payment of taxes and duties applicable under normal circumstances. The amendments proposed by the 1996 Bill have been incorporated by the current law. Previous laws on EPZs have been totally or partially revoked by Art. 28 of Law 11508/2007.

48 The regulatory framework on EPZs is complemented by various administrative rules including, *inter alia,* Decree No. 6634, of 5 Nov. 2008, on the functioning and powers of the National Council of Export Processing Zones (hereinafter CZPE); Decree 6814, of 6 Apr. 2009, on the fiscal, foreign exchange and administrative regime applicable to companies operating in EPZs and Instrução Normativa RFB No. 952/2009, of 2 Jul. 2009, on the supervision and custom control of goods located in EPZs.

49 Decree 6634/2008, Art. 2.1.

50 Law 11508/2007, Art. 1.

51 *Ibid.*, Art. 2, s. 1 and Decree 6814, Art. 1, s. 1.

52 Law 11508/2007, Art. 3 and Decree 6634, Art. 2.

53 Law 11508/2007, Art. 2, s. 2.

54 *Ibid.*, Art. 2, s. 3.

55 Instrucao Normativa 952/2009, Art. 2, s. 1.

56 See, *inter alia*, Arts 1 and 8 of Law 11508/2007 and various provisions of Instrucao Normativa 952, which expressly refer to the manufacturing of goods.

57 Telephone interview with Dr Helson C. Braga, ABRAZPE President, on 23 Feb. 2010.

58 Law 11508/2007, Art. 6-A.

59 *Ibid.*

intended to integrate the production process of the company and raw materials, intermediate products, and packing materials necessary for the company's activities.[60] Machinery, equipment, and instruments, whether new or used goods, must be incorporated to the company's fixed assets and not resold.[61] The raw materials, intermediate products, and packaging materials, whether imported or purchased in the domestic market, must be fully used in the production process of the end product.[62]

The suspension of payment of import duties and the AFRMM is subject to the general export requirement[63] for a five-year period from the occurrence of the taxable event.[64] With respect to the importation of raw materials, intermediate products, and packing materials, the exemption of import duties and AFRMM is terminated in case of re-exportation or destruction of goods at the expense of interested parties or export of goods in the same state in which they were imported.[65]

Some free zone regimes stipulate that free zone users are not entitled to any fiscal incentives other than those offered by the free zone regime itself. The Brazilian EPZ regime, by contrast, allows for the accrual of EPZ incentives and other fiscal incentives offered by a specific list of statutes according to the conditions stipulated therein.[66] For example, EPZ users allowed to operate in EPZs located in the Superintendência do Desenvolvimento da Amazônia (SUDAM) or Superintendência do Desenvolvimento do Nordeste (SUDENE) areas are entitled to the fiscal incentives stipulated by the SUDAM/SUDENE programmes aimed at promoting the development of the Amazon and North East Regions.[67] Such programmes include a fiscal incentive consisting of a 75% reduction of income tax for a ten-year period.[68] Therefore, EPZ users operating in EPZs located in the SUDAM/SUDENE areas will be entitled to an exemption on income tax, albeit for a limited period of time.[69]

The EPZ statute also offers some regulatory advantages. Imports and exports by companies authorized to operate in an EPZ are exempted from licenses or authorizations from federal agencies, with the exception of sanitary, national security, and environmental controls.[70] Foreign currency earned by companies operating in EPZs as a result of their exports is not subject to the same legal and regulatory provisions related to foreign exchange applicable to other national companies. Law 11371/2006 allows exporting companies to hold a limited percentage of their foreign currency on overseas financial firms (the percentage is fixed by the National Monetary Council). That limit is not applicable to companies operating in EPZs,[71] who are allowed to keep abroad 100% of their foreign currency earned in exports. Thus, they are under no obligation to convert their foreign currencies into Brazilian Reais, which allows them to avoid foreign exchange risks.

2.2.3. Conditions for Incentives

To benefit from the incentives, companies located in EPZs must export at least 80% of the turnover related to the sales of goods and services.[72] This allows for a maximum 20% of the company's turnover to result from sales of goods and services to the domestic market. The domestic sale of products manufactured in EPZs, as well as the services and goods used as inputs in the production of those products, is subject to all taxes imposed on domestic acquisitions or importations.[73]

The CZPE may raise the percentage of the company's turnover that must result from exports or it may even prohibit altogether the sales of products manufactured

Notes

60 *Ibid.*, Arts 12.II and 13.
61 *Ibid.*, Art. 6-A, ss 1–4. This means that companies located in EPZs are not subject to the general restrictions on the import of used machinery and equipment.
62 *Ibid.*, Art. 6-A, s. 5, and Instrucao Normativa 952/2009, Art. 26, s. 1.
63 Law 11508/2007, Art. 18.
64 *Ibid.*, Art. 6-A, s. 5.
65 *Ibid.*, Art. 6-A, s. 8.
66 *Ibid.*, Art. 18, s. 4.
67 *Ibid.*, Art. 18, s. 4.II.
68 See Lei Complementar No. 124 of 3 Jan. 2007 and Lei Complementar No. 125 of 3 Jan. 2007.
69 It is interesting to note that Art. 11 of Bill 146/1996 on the fiscal, administrative, and currency regimes for EPZs included an exemption on income tax levied on EPZ users' profits during a five-year period to be extended for a ten-year period for those EPZ users operating in EPZs located in less developed regions of the country specifically determined by law. However, such incentive was later on vetoed by the President (Message from the Presidency No. 524, 20 Jul. 2007).
70 Law 11508/2007, Art. 12.I.
71 Article 15 of Law 11508 allows companies located in EPZs to enjoy fiscal benefits contemplated in other legislation under the conditions specified therein.
72 Law 11508/2007, Art. 18.
73 *Ibid.*, Art. 18.

in EPZs to the domestic market if it verifies that sales to the domestic market have a negative impact on the domestic industry.[74] The CZPE may also impose minimum total investment requirements on companies applying for authorization to operate in an EPZ, when so set forth by regulation.[75]

Companies located in EPZs are allowed to carry out only those activities related to the manufacturing of goods expressly authorized by the CZPE,[76] and they may not establish a branch or have interest in another legal entity located outside the EPZ regime.[77] The statute also prohibits the establishment of companies in EPZs, whose projects consist of the mere transfer into the EPZ of industrial plants already installed outside the EPZ.[78]

Incentives are time-limited. When authorizing the establishment of a company in an EPZ, the CZPE must limit the incentive regime for that company for a maximum of twenty years, renewable for an additional twenty-year period.[79] On exceptional circumstances, the CZPE can extend the incentive regime period to allow extra time for the amortization of big scale types of investments.[80]

2.3. Paraguay Free Zone Law

2.3.1. General Provisions

The free zone regime was introduced in 1995 by Law 523/95.[81] Free zones are defined as areas located outside the national customs territory, authorized by the Executive Power and subject to the fiscal, customs, and administrative control laid down by Law 523/95.[82] They must be established in a privately owned area that must be duly fenced to ensure their isolation from the national customs territory.[83]

The free zone operator is the legal person authorized by the Executive Power to run a free zone in accordance with a concession agreement. It must provide the infrastructure necessary to allow free zone users to run their undertakings. Concessions are granted for a maximum of thirty years, with a possibility of renewing the term for the same period once.[84] Free zones must be run by private operators only.[85] The Executive Power may authorize the free zone operator to set up a single undertaking exclusively for the purpose of manufacturing goods for exports. In this case, the free zone operator also becomes subject to the obligations applicable to free zone users.

The free zone user is the natural or legal person entitled to carry out activities within a free zone in accordance with the provisions stipulated by the statute, the regulations, and the contract between the free zone user and the free zone operator. The free zone user can carry out the following activities: (a) commercial activities such as warehousing, where goods enter into and leave the free zone without undergoing any type of transformation or modification; (b) industrial activities, that is, assemble activities and manufacturing goods for export by way of processing raw materials and/or semi-processed products, whether of domestic origin or imported; and (c) services, that is, repair and maintenance of equipment and machinery. Other services not specified in the statute that are intended for international markets may be authorized by the Executive, at the request of the National Council of Free Zones, in which case they too enjoy the fiscal incentives included in the statute.[86]

The statute establishes a National Council of Free Zones responsible, *inter alia*, for controlling and supervising the operation of the free zones. The Council is composed of representatives of the Ministries of Finance, Industry and Trade, Public Works and Communications, one representative of the free zone operators, and one representative of the free zone users.[87]

Notes

74 Decree 6634/2008, Art. 2.XV.
75 Law 11508/2007, Art. 3.V.
76 *Ibid.*, Art. 7 and Instrucao Normativa 952/2009, Art. 3.
77 Law 11508/2007, Art. 9 and Instrucao Normativa 952/2009, Art. 3.
78 Law 11508/2007, Art. 5.
79 Decree 6634/2008, Arts 2.VI and 2.VIII.
80 Decree 6634/2008, Arts 2.VII and 2.VIII.
81 See Law 523/1995 of 16 Jan. 1995, as amended by Law 2.421/2004, and regulated by Decree 15.554/1996 of 29 Nov. 1996, authorizing and establishing the regime, Decree 19.461/02 of 22 Nov. 2002, approving the rules of operation, Decree 20.395/2002, on administrative measures to broaden the regulations on imports from free zones, and Decree 21.309/2003 of 10 Jun. 2003, amending certain provisions of the earlier decrees in order to facilitate transit to free zones.
82 Law 523/1995, Art. 1.
83 *Ibid.*, Art. 2.
84 *Ibid.*, Art. 6.
85 The statute prohibits the State from operating free zones or becoming a free zone user, Art. 8 of Law 523/1995.
86 Law 523/1995, Art. 3.
87 *Ibid.*, Art. 37.

2.3.2. Incentives

Free zone users are exempted from any national, regional, or municipal taxes except for the single free zone tax.[88] The exemption includes any direct taxes levied on the income generated by free zone users; taxes levied on the commercial, industrial, and service activities carried out by free zone users; and taxes levied on payment of royalties, commissions, fees, interests, and any other payment for services, technical assistance, transfers of technology, loans, hiring of equipment, and any other service supplied from third countries to free zone users.[89] The establishment of free zone user companies and the remission of profits made by such companies to third countries are also exempted from any kind of tax.[90]

The introduction of goods into free zones, either from third countries or from the national customs territory, is exempted from all national, regional, or municipal taxes, except fees for services actually rendered.[91] The exemption includes the introduction of capital goods, even those subject to a leasing contract.[92] Capital goods introduced into the free zones in accordance with the tax exemptions granted by the statute cannot be sold, leased, or transferred under any title to persons resident in the national customs territory, without payment by the purchaser of import charges. The sale, lease, or transfer at any title of capital goods to other free zone users for their use within the free zone is exempted from all taxes.[93] The export or re-export of products and services from free zones to third countries, to the national customs territory, or to other free zones is exempted from all national, regional, or municipal taxes.[94] Free zone operators are exempted from Value-Added Tax (VAT) on the services that they provide to free zone users.[95]

2.3.3. Conditions for Incentives

Free zone users that carry out commercial, industrial, or service activities and are engaged exclusively in exports must pay a single free zone tax at a rate of 0.5% over the total value of gross revenues from exports.[96]

Free zone users that carry out commercial, industrial, or service activities and are engaged in both exports and sales to the national customs territory must pay a single free zone tax at a rate of 0.5% over the total value of gross revenues from exports provided that sales to the national customs territory do not exceed 10% of the enterprise's gross sales revenue.[97] If sales to the national customs territory exceed 10% of the enterprise's gross sales income, the free zone user must pay the single free zone tax at a rate of 0.5% over the total value of gross revenues from exports plus income tax over the total value of gross revenue from sales to the national customs territory, with the possibility of deducting its costs in the same proportion.[98]

Free zone users that carry out commercial activities and that in addition to exports to third countries do sales to the national customs territory must pay income tax on the commercial activities, taking into account their proportion over the total gross revenues and with the possibility of a proportional deduction of costs. This is without prejudice to payment of the single free zone tax on gross revenues generated by exports to third countries.[99]

All imports into the national customs territory from free zone users that carry out commercial, industrial, or service activities into the national customs territory are subject to all import charges, including tariffs, except for those products manufactured in the free zone that comply with the requirements of the rules of origin in force and hence are regarded as domestic products.[100] The statute allows the Executive Power to create tariff preferences for those products that are considered strategic for the country's development.[101]

Sales of any type of goods or services from the national customs territory to a free zone are regarded as exports, subject to payment of all taxes and duties

Notes

88 *Ibid.*, Art. 13.
89 *Ibid.*
90 *Ibid.*, Art. 13 and Decree 15554/1996, Art. 44.
91 Law 523/1995, Art. 23.
92 *Ibid.*, Art. 27.
93 *Ibid.*, Art. 28.
94 *Ibid.*, Art. 24.
95 *Ibid.*, Art. 12.
96 *Ibid.*, Art. 14.
97 *Ibid.*, Art. 16.
98 *Ibid.*, Art. 17. This reflects one of the two amendments to Law 523/1995 introduced by Law 2421/2004, since previously enterprises that sold more than 10% to the customs territory benefited from a 70% reduction in the income tax payable on their sales to the Paraguayan customs territory. The second amendment to Law 523/1995 eliminated Art. 18 that offered the possibility for enterprises to choose between paying the single free zone tax and paying income tax on their commercial, industrial, or service-related activities.
99 Law 523/1995, Art. 15.
100 *Ibid.*, Art. 20.
101 *Ibid.*

that may correspond and subject to customs and administrative procedures applicable to exports.[102]

2.4. Uruguay Free Zone Law

2.4.1. General Provisions

The free zone regime was adopted in 1987.[103] Free zones are public or private areas of the national territory, duly fenced in and efficiently isolated, designated by the government upon the advice of the Free Zones Honorary Advisory Committee, with the purpose of carrying out therein, under the tax exemptions and further benefits set forth by the law, any kind of industrial, commercial, or service activities such as: (a) commercialization of goods, storage, deposit, preparation, selection, sort, breakdown, assembly, handling, mixture of any foreign or domestic goods or raw materials; (b) establishment and operation of manufacturing industries; (c) supply of any kind of service, either within the free zone or from the free zone to third countries; (d) other activities that the Executive Power might deem convenient for the development of the domestic economy or for the economic and social integration of the countries.[104] The objective of free zones is to encourage investment, expand exports, increase the use of domestic labour, and foster international economic integration.[105]

Free zones must be operated either by the state or by duly authorized private persons known as free zone operators. In practice, there are three types of free zones: those belonging to and managed by the State; those owned by the State but managed privately; and private free zones.[106]

The free zone operator must supply the necessary and adequate infrastructure for the establishment and operation of a free zone in exchange for a price agreed upon with each free zone user.[107] Private persons willing to operate a free zone must submit an application for authorization to the Executive Power, enclosing an investment project whose economic feasibility must be duly evidenced together with the benefits that such project would bring to the country. The applicant must also either pay the government a lump sum or make periodic payments for the authorization, depending on what is agreed on each case.[108] The free zone operator must administrate the free zone in compliance with the terms of the corresponding authorization. In case of any breach of the terms of the authorization, the free zone operator can be subject to fines or their authorization can be withdrawn depending on the nature of the infringement.[109] In case of revocation of the authorization or any other serious situation liable to cause the said revocation, the Executive Power may, through the Free Zone Office, take any measure deemed necessary for the supply and maintenance of the infrastructure required for the due operation of the free zone.[110]

A free zone user is the natural or legal person, national or foreigner, that has acquired the right to carry out activities of a commercial, industrial, or service nature within a free zone. The free zone user may not perform any activity of a commercial, industrial, or service nature outside the free zone.[111] A direct free zone user is the natural or legal person that has acquired the right to carry out activities within the free zone by signing an agreement with the free zone operator.[112] An indirect free zone user is the natural or legal person that has acquired the right to carry out activities within the free zone by signing an agreement with the direct free zone user, using or taking advantage of its facilities.[113] Not only free zone users are allowed to operate within the free zone, but also any domestic or foreign company can perform commercial activities within these areas; however, they are not entitled to the free zone incentives.

2.4.2. Incentives

Free zone users are exempted from any national taxes, either existing or to be created in the future, including those whose exemption is specifically required by

Notes

102 *Ibid.*, Arts 12 and 22.
103 See Law 15921, 17 Dec. 1987, as amended by Law 17292, 25 Jan. 2001, and Decree 454/1988, 8 Jul. 1988. A complete list of rules applicable to free zones is available at <www.zfrancas.gub.uy/espanol/legislacion/>, 16 Apr. 2010.
104 Law 15921/1987, Art. 2 as amended by Law 17292/2001, Art. 65.
105 *Ibid.*, Art. 1.
106 For a full list of free zones, see <www.zfrancas.gub.uy/english/ftzuruguay/index.html>, 29 Oct. 2010.
107 Law 15921/1987, Art. 8.
108 *Ibid.*, Art. 10.
109 *Ibid.*, Art. 11.
110 *Ibid.*, Art. 12.
111 *Ibid.*, Art. 14.
112 *Ibid.*, Art. 15.
113 *Ibid.*, Art. 16.

law.[114] Exempted taxes include, among others: Gains Tax or Tax on Income from Economic Activity (IRAE, former Impuesto a la Renta de Industria y Comercio (IRIC)).[115] Net Worth Tax (Impuesto al Patrimonio),[116] and Tax on the Incorporation of Corporations and Capital Gains Tax (for free zone user corporations[117] and for free zone users who provide financial intermediary services exemption of tax on bank assets).[118] Social welfare charges are not exempted. However, foreign nationals working in a free zone may opt in writing not to benefit from the Uruguayan social security benefits and, therefore, be exempted from the payment of the corresponding contributions.[119] Salaries and any other income generated from activities performed in the free zone are subject to the Personal Income Tax (IRPF).

Any goods, services, merchandise, and raw materials that enter into the free zones, whatever their origin, are exempted from all import duties or charges applicable at the time of import, including those requiring by law a specific exemption, whatever the nature thereof.[120] The exemption is phrased in very broad terms, without restricting in any way the type of goods that may be imported into the free zone. In the absence of any specific limitation, one should assume that it includes, *inter alia*, inputs, machinery (new or used), productive assets, or merchandise destined for sale.[121] The exemption is not subject to any condition such as, for example, the need for the goods to be consumed in the production of the exported product. Finally, goods entering the free zone do not need to be re-exported within a certain period of time. They enjoy a right to unlimited stay. Similarly, any goods, services, merchandise, and raw materials imported into the free zones, as well as any products manufactured therein, may exit the free zone at any time, free from any present or future taxes or any other duties, encumbrances, and charges, including those requiring by law a specific exemption, whatever their nature.[122]

The circulation of goods and the supply of services within the free zones and the entry of goods from abroad into free zones are exempted from VAT and Specific Internal Excise Tax.[123] Public bodies that supply services to free zone users or provide them with inputs are allowed to charge promotional rates for their goods or services.[124] In addition, the National Telecommunications Administration must not establish differential rates for telecommunication services based on the distance between Montevideo and the location of the free zone, although other differentiated rates may be applicable, such as those based on volume or traffic.[125] The Uruguayan Port Authorities must collect fees for the services actually rendered to the goods coming from or going to the free zones, but the rate charged must not exceed the direct cost of the service involved. To this effect, the entry or exit of any goods and their transportation to/from the free zones shall be considered as international transit, but entry or exit duties must be charged only once.[126]

In addition to fiscal and financial incentives, the free zone regime confers a number of regulatory advantages. First, industrial and commercial state-owned monopoly suppliers must operate under a free competition regime within the free zone area.[127] Second, no local content requirements, created or to be created, shall apply to activities carried within the free zones.[128] Third, there shall be no restrictions to the entry and exit to the free zones of securities, national or foreign currency, and precious metals.[129] Fourth, corporate free zone users are entitled to a special regime for a quick approval of new legal entities and rapid changes to their articles of association.[130] Fifth, free zone users shall be able to introduce goods needed for their consumption, building construction, and repair of industrial equipment, buildings, and installations into the free trade zones, with the only requirement of having the invoice stamped by the

Notes

114 *Ibid.*, Art. 19.
115 Decree 4541/1988, Art. 35.
116 *Ibid.*, Art. 39.
117 *Ibid.*, Art. 41.
118 *Ibid.*, Art. 42.
119 Law 15921/1987, Art. 20.
120 *Ibid.*, Art. 21.
121 The Aguada Park website includes in the list of incentives offered by the Law on Free Zones the 'possibility to acquire equipment and supplies (new and used) without having to pay any taxes or customs duties'. See <www.aguadapark.com/index_en.html>, 12 Apr. 2010.
122 Law 15921/1987, Art. 22.
123 Decree 454/1988, Arts 43 and 46.
124 Law 15921/1987, Art. 24.
125 *Ibid.*, Art. 2.
126 *Ibid.*, Art. 23 and Decree 454/1988, Art. 49 as amended by Decree 920/1988, Art. 14.
127 Law 15291/1987, Art. 24.
128 *Ibid.*, Art. 40.
129 *Ibid.*, Art. 38.
130 *Ibid.*, Art. 17.

General Trade Authority – Free Zone Department.[131] In the specific case of services, the list of activities that have been considered export of services by the legislation, which includes services that are deemed necessary to be rendered within the free trade zone, must be taken into account.[132]

Finally, in order to provide additional security for free zone users and make the regime more stable, all tax exemptions, benefits, and rights stipulated by the free zone legislation are expressly guaranteed by the State. The statute stipulates that the State is obliged to compensate free zone users for any harms or losses caused by a modification in the free zones' regulatory framework.[133] Furthermore, the statute stipulates that should the free zone operator lose its operator status, then the Executive Power, through the Free Zone Office, may take any measure deemed necessary for the supply and maintenance of the infrastructure required for the due operation of the free zone.[134] An additional guarantee for free zone users provides that the land where the free trade zones are located is legally committed to that specific purpose during the term granted by the free zone operator, and it cannot be used for any other type of activities.[135]

2.4.3. Conditions for Incentives

From a customs point of view, the activities performed in a free zone are carried out outside of the national customs territory. As a result, the introduction of goods from the free zone into the national customs territory is regarded as an import, subject to payment of all customs duties and taxes that may correspond.[136] The introduction of goods from the free zone into the national customs territory is subject to payment of both VAT[137] and Special Internal Excise Tax.[138] Likewise, the introduction of goods from the national customs territory into the free zone is regarded as an export, subject to payment of all custom duties and taxes that may correspond.[139]

In principle, free zone users may not perform any industrial or commercial activities outside the free zone or supply services from the free zone into the national customs territory.[140] However, there are some exceptions to this rule. The statute authorizes free zone users to supply certain telephone and IT services from the free zone into the national customs including international call centres (excluding those that have as sole or principal destiny the national customs territory), e-mail services, e-learning, and issuance of electronic signature certificates.[141] Furthermore, the statute confers on the Executive Power the discretion to authorize the supply of new services from the free zone into the national customs territory.[142]

When free zone users supply services in the national customs territory, the provision of the service is subject to state monopolies, state exclusive regimes, and public concessions that apply therein.[143] With respect to the tax treatment of services supplied from the free zone into the national customs territory, the statute provides that such services will be taxed in the same way as those services provided from abroad either as regards to the supplier or to its deductibility by the consumer.[144] In addition, Decree 84/2006 stipulates that the tax exemptions provided by the statute will not be extended to the provision of services by free zone users into the national territory.[145] For such part of their activities, free zone users shall be subject to the tax regime in force at the time of the supply of the service.

As a condition for keeping their status and enjoying all tax exemptions, franchises, benefits, and rights offered by the statute, at least 75% of the workforce employed by a free zone user must consist of

Notes

131 Decree 454/1988, Art. 50.
132 Decree 220/1998, Art. 34.
133 *Ibid.*, Art. 25.
134 *Ibid.*, Art. 12.
135 Law 15291/1987, Art. 13.
136 *Ibid.*, Art. 22, s. 2.
137 Decree 454/1988, Art. 45.
138 *Ibid.*, Art. 48.
139 Law 15921/1987, Art. 21, s. 2.
140 *Ibid.*, Art. 14 and Decree 454/1988, Art. 9.
141 Law 15921/1987, Art. 2, literal (c).
142 *Ibid.*, Art. 2, literal (d). Since 2006, the Executive Power has exercised this power on three occasions. So far, the services that can be supplied from the free zone into the national custom territory in addition to those specified by the statute include software development services, IT consultancy services, and IT training services; management services, administration, accounting, and the like, provided by related entities engaged in providing logistics shipping services and logistics port services; film processing services, including digitalization and colour correction. Decree 84/2006, Art. 1, as amended by Decree 496/2007, Art. 1 and Decree 30 Nov. 2009, Art. 1.
143 Law 15921/1987, Art. 2, literal (c).
144 *Ibid.*
145 Decree 84/2006, Art. 2.

Uruguayan citizens. Under extraordinary conditions, the said percentage may be reduced upon authorization of the government, on account of special features of the activities to be performed and 'reasons of public interest'.[146]

3. Free Zone Incentives and the ASCM

3.1. Definition of Subsidy

According to the ASCM, for a measure to constitute a subsidy, it must: represent a *financial contribution or income support by a government*, which confers a *benefit* to a *specific* recipient. The Agreement distinguishes between direct and indirect financial contributions. A government or any public body provides a direct financial contribution when it makes a direct transfer of funds by way, for example, of grants, loans, or equity infusion; a potential direct transfer of funds by way, for example, of loan guarantees; when it forgoes government revenue that is otherwise due; or provides goods or services other than general infrastructure, or purchases goods. A government can also make indirect financial contributions by channelling payments through a private body.

To qualify as a subsidy, the financial contribution must confer a *benefit* to a specific recipient, that is, an advantage that it could not obtain in the marketplace.[147] In addition, to qualify as a subsidy, the financial contribution must be conferred to a *specific* recipient.[148] A subsidy is specific when the granting authority, or the legislation pursuant to which the granting authority operates, explicitly limits access to a subsidy to certain enterprises (*de iure* specificity).[149] By contrast, if the subsidy is granted subject to objective criteria or conditions, that is, generally applicable neutral criteria, which do not favour certain enterprises over others such as number of employees or size of enterprise, it must be considered as non-specific and thus not subject to the ASCM disciplines.[150] There may be circumstances where, despite an appearance of non-specificity, there may be reasons to believe that the subsidy may, in fact, be specific. In such circumstances, other factors may be considered such as the number of enterprises entitled to the subsidy, the amount of the subsidy, and the way the granting authority exercises its discretion to grant the subsidy.[151] The Agreement includes three cases where the specificity requirement is taken for granted: subsidies limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority;[152] local content subsidies;[153] and export subsidies.[154]

3.2. Classification of Subsidies

The ASCM distinguishes between prohibited forms of subsidies (that is, subsidies contingent to export performance or local content requirements) and actionable subsidies (defined by default, that is, any scheme that is a subsidy and is not a prohibited subsidy). Subsidies contingent, in law or in fact, upon export performance are prohibited.[155] Annex I of the Agreement includes an illustrative list of export subsidies. Any subsidy coming under the purview of the illustrative list is *ipso facto* prohibited, without any additional need to demonstrate that it is contingent upon export performance.[156] Subsidies not included in the illustrative list can only be branded as export subsidies upon demonstration of their contingency character, in law or in fact, upon export performance.

De facto export contingency operates when a member links benefits to exports without explicitly stating in the law that this has indeed been the case. The Agreement stipulates that the de facto export contingency 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'.[157] However, the Agreement also

Notes

146 Law 15921/1987, Art. 18.
147 As put by the Appellate Body: 'In our view, the marketplace provides an appropriate basis for comparison in determining whether a "benefit" has been "conferred", because the trade-distorting potential of a "financial contribution" can be identified by determining whether the recipient has received a "financial contribution" on terms more favourable than those available to the recipient in the market', *US – Lead and Bismuth II,* Appellate Body Report (WT/DS138/AB/R) (2000), para. 67.
148 ASCM, Arts 1.2 and 2.
149 *Ibid.,* Art. 2.1(a).
150 *Ibid.,* Art. 2.1(b).
151 *Ibid.,* Art. 2(1)(c).
152 *Ibid.,* Art. 2(2).
153 *Ibid.,* Art. 2(3).
154 *Ibid.*
155 *Ibid.,* Art. 3.1(a).
156 *Brazil – Aircraft (Article 21.5 – Canada)* (2000), Appellate Body Report (WT/DS46/AB/RW).
157 ASCM, Art. 3(1)(a), n. 4.

stipulates that the mere fact that a subsidy is granted to enterprises that export shall not for that reason alone be considered to be an export subsidy within the meaning of Article 3(1)(a).

The Agreement exempts the following WTO members from the prohibition on export subsidies:

(a) members designated as least developed countries by the United Nations;

(b) members listed by Annex VII(b) until their GNP per capita reaches USD 1,000 in constant 1990 dollars for three consecutive years.

Developing countries other than Annex VII(b) countries (including those that have graduated from Annex VII(b)) were required by Article 27.4 to phase out their export subsidies within an eight-year period ending on 31 December 2002. However, a mechanism for an extension beyond that date is provided by the same provision, based upon a timely application to and agreement by the Committee on Subsidies and Countervailing Measures (hereinafter Committee). If the Committee does not affirmatively determine that an extension is justified, the export subsidy at issue must be phased out within two years from the end of the last authorized period.[158]

In 2001, a special procedure was implemented to address the concerns of certain small developing country members.[159] The purpose of the 2001 special procedure was to grant extensions over a period of five years to certain members for certain programmes that met agreed-upon qualifications.[160] Members that met all the qualifications were eligible for a five-year extension of the transition period (that is, until 31 December 2007) plus the additional two-year phase-out period provided for in Article 27.4 (that is, until 31 December 2009). Following a request for a further extension, in July 2007, the WTO General Council approved an extension of these procedures through 31 December 2013, with the final two-year phase-out period ending not later than 31 December 2015.[161]

It is interesting to note that a significant number of the notified programmes under Article 27.4 relate to free zones.[162] According to Article 25.7, members recognize that notification of a measure does not prejudge on the nature of the measure and, therefore, does not constitute an admission that these programmes are, in fact, export subsidies prohibited by the ASCM. However, the fact that a significant number of members who relied on Article 27.4 requested extra time for phasing out their free zone regimes at least suggests a degree of concern about the consistency of their free zones regimes with WTO law. None of the MERCOSUR countries have relied on Article 27.4 to request extra time to phase out their free zone legislation.

Any incentive that meets the three requirements necessary to constitute a 'subsidy' within the meaning of the Agreement and is not a prohibited subsidy is an actionable subsidy. Actionable subsidies may be maintained, provided they do not cause adverse effects to the interests of other members, that is, injury to the domestic industry of another member; nullification or impairment of benefits accruing directly or indirectly to other members under General Agreement on Tariffs and Trade (GATT) 1994; or serious prejudice to the interests of another member (including threats of serious prejudice).[163] Any WTO member that considers itself adversely affected by an actionable subsidy may request consultations with the member that maintains it and could eventually refer the matter to the Dispute Settlement Body.[164] Developing countries are not exempted from actionable subsidy rules, except for some *de minimis* cases.

Notes

158 ASCM, Art. 27.4.

159 WTO Document (WT/MIN(01)/17), Ministerial Conference Decision on Implementation-Related Issues and Concerns (14 Nov. 2001), para. 10.6; and WTO Document (G/SCM/39), Procedures for Extensions under Article 27.4 for Certain Developing Country Members (20 Nov. 2001).

160 Full or partial exemptions from import duties and internal taxes, which came into existence not later than 1 Sep. 2001 and which were provided by developing country members whose share of world merchandise export trade was not greater than 0.1%; whose total Gross National Income ('GNI') for the year 2000 as published by the World Bank was at or below USD 20 billion; that were otherwise eligible to request an extension pursuant to Art. 27.4, and that followed the procedures prescribed by the Subsidies and Countervailing Measures (SCM) Committee in WTO Document G/SCM/39.

161 WTO Document (WT/L/691), General Council Decision of 31 Jul. 2007. The 'last authorised period' referred to in the last sentence of Art. 27.4 SCM shall not extend beyond 31 Dec. 2013, and the final two-year phase-out period provided for in the last sentence of Art. 27.4 SCM shall end not later than 31 Dec. 2015.

162 At least thirty of the forty programmes for which an extension of the transition period was requested were legislative measures establishing free zone schemes. For instance, Antigua and Barbuda notified its 'Free Trade/Processing Zones' programme. Belize notified its 'Export Processing Zone Act and Commercial Free Zone Act'. Costa Rica notified its 'Duty Free Zone regime'. The Dominican Republic notified 'Law 8-90, to Promote the Establishment of Free Trade Zones'. Fiji notified its 'Export Processing Factories/Zones Scheme'. Guatemala notified 'Free Zones' and 'Industrial and Free Trade Zones (ZOLIC)'. Jamaica notified its 'Jamaica Export Free Zone Act'. Mauritius notified its 'Freeport Scheme'. Panama notified its 'Export Processing Zone'. Lastly, St. Lucia notified its 'Free Zone Act'.

163 ASCM, Art. 5.

164 *Ibid.*, Art. 7.

3.3. Implications for Free Zones in MERCOSUR Countries

The consistency of MERCOSUR countries' free zone incentives with the disciplines stipulated by the ASCM depends on whether the incentives in question constitute a 'subsidy' within the meaning of the Agreement and, if so, whether they are contingent in law or in fact on export performance.

3.3.1. Free Zone Incentives that Constitute a 'Subsidy' within the Meaning of the ASCM

Fiscal incentives offered by MERCOSUR free zones meet the three requirements necessary to constitute a 'subsidy' within the meaning of the ASCM. First, they constitute a 'financial contribution by a government' by way of expressly surrendering to collect government revenue that is otherwise due.[165] By definition, only governments can forgo fiscal incentives and even when the free zone is operated by a private entity, the fiscal incentives granted to free zone users remain a governmental measure. Second, the fiscal incentives confer a 'benefit' to free zone users within the meaning of the Agreement, by way of exempting them from paying taxes otherwise due and, therefore, placing them at an advantage when compared to like enterprises operating in the national customs territory.[166] Finally, the fiscal incentives are 'specific' because they are limited to certain enterprises located within a designated geographical region within the jurisdiction of the granting authority.[167] The specificity is also implied by the requirements and conditions for the establishment and operation of free zones.[168]

It must be noted, however, that the ASCM excludes from the definition of 'subsidy' the core fiscal incentives typically provided by free zones, namely:

(a) exemptions or remissions of indirect taxes levied on the production and distribution of exported products, provided they are not in excess of the indirect taxes levied on the production and distribution of like products when sold for domestic consumption;[169]

(b) exemptions, remissions, or deferrals of prior-stage cumulative indirect taxes levied on goods and services that are 'consumed'[170] in the production of exported products, provided they are not in excess of prior-stage cumulative indirect taxes levied on goods and services used in the production of like products when sold for domestic consumption;[171] and

(c) remissions or drawbacks of import charges levied on inputs that are 'consumed'[172] in the production of the exported product, provided they are not in excess of those actually levied on inputs that are actually consumed in the production of the exported product.[173]

Any fiscal incentive that is not expressly excluded falls within the definition of 'subsidy'. In fact, there are several incentives offered by MERCOSUR countries' free zone laws that are not covered by these exclusions and, hence, fall within the ASCM definition of 'subsidy', namely:

– The Brazilian EPZ statute provides for the suspension of payment of indirect taxes and import charges levied on the domestic purchases and imports of machinery, equipment, and instruments, whether new or used, necessary for industrial installation or intended to integrate the production process of the company.[174] The statute further provides that machinery, equipment, and instruments, whether new or used, must be incorporated to the company's fixed assets and must not be resold.[175] However, it is still plausible to argue that this requirement is not sufficiently restrictive to satisfy the 'consumption' requirement provided by the ASCM to exclude the incentive from the meaning of 'subsidy'. Capital goods cannot be 'consumed' in the production of the

Notes

165 *Ibid.*, Art. 1(a)(1).
166 *Ibid.*, Art. 1(a)(2).
167 *Ibid.*, Art. 2.2. All free zone statutes stipulate that free zones are specifically designated areas, clearly demarcated and isolated from the national customs territory.
168 The right to operate a free zone is far from automatic. Applications are considered on a case-by-case basis, looking, *inter alia*, at the investment project proposed by the applicant. See Law 15921/1987, Arts 7 and 10 and Decree 454/1988, Arts 13–16.
169 ASCM, n. 1 and Annex I (g).
170 *Ibid.*, Annex II and n. 61, which provide that inputs consumed in the production process are those that are physically incorporated into the exported product, as well as energy, fuels, oils, and catalysts.
171 ASCM, n. 1 and Annex I (h).
172 *Ibid.*, Annex II and n. 61.
173 *Ibid.*, n. 1 and Annex I(i).
174 Law 11508/2007, Arts 6-A, 12.II, and 13.
175 *Ibid.*, Art. 6-A, ss 1–4. This means that companies located in EPZs are not subject to the general restrictions on the import of used machinery and equipment.

exported product in such a way that satisfies the requirements of Annex II and footnote 61 of the ASCM, and therefore, tax incentives on domestic purchase and imports of machinery, equipment, and instruments constitute a 'subsidy' within the meaning of the Agreement.[176]

– The Brazilian EPZ statute also provides for the suspension of payments of contributions to social security financing levied on domestic purchases or imports of goods or services (COFINS/COFINS-Imports).[177] According to the ASCM, the full or partial exemption, remission, or deferral, specifically related to exports of social welfare charges paid or payable by industrial or commercial enterprises, constitutes an export subsidy.[178]

– Finally, the Brazilian EPZ statute allows for the accumulation of incentives offered by the EPZ regime with other incentives.[179] The SUDAM/SUDENE programmes offer a 75% reduction of income tax for a ten-year period.[180] Hence, EPZ users operating from EPZs located in the SUDAM/SUDENE areas are entitled to direct tax incentives. According to the ASCM, the full or partial exemption, remission, or deferral, specifically related to exports of direct tax incentives paid or payable by industrial or commercial enterprises, constitutes an export subsidy.[181]

– The Paraguayan Law on Free Zones exempts free zone users and the activities carried by them from any national, regional, or municipal taxes except for the single free zone tax.[182] The exemption is quite broad including, *inter alia*, direct taxes levied on the income generated by free zone users; taxes levied on the commercial, industrial, and service activities carried out by free zone users; and taxes levied on payment of royalties, commissions, fees, interests, and any other payment for services, technical assistance, transfer of technology, loans, hiring of equipment, and any other service supplied from third countries to free zone users.[183] Considering its scope, there is no doubt that this exemption constitutes a 'subsidy' within the meaning of the ASCM.

– The Paraguayan Law on Free Zones also exempts the introduction of goods into free zones, either from third countries or from the national customs territory from all national, regional, or municipal taxes, except fees for services actually rendered.[184] The exemption expressly includes the introduction of capital goods.[185] As mentioned, capital goods cannot be 'consumed' in the production of the exported product in such a way that satisfies the requirements of Annex II and footnote 61 of the ASCM, and therefore, tax incentives on imports of capital goods constitute a 'subsidy' within the meaning of the Agreement.[186]

– The Uruguayan Law on Free Zones exempts free zone users from any national taxes, either existing or to be created in the future,[187] including, among others, direct taxes such as Gains Tax or Tax on Income from Economic Activity (IRAE,

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176 Some scholars suggest a broader interpretation of the ASCM's exclusions from the meaning of subsidy, which should also cover indirect taxes and import charges on capital goods and production equipment. This interpretation, influenced by the long-established status of free zones in international law as areas outside the national customs territory and their wide use in both developed and developing countries around the world, is based on the following considerations: (1) all goods stored in free zones are duty and tax free; (2) duty and tax exemptions for production equipment are not specifically listed as a prohibited subsidy in ASCM, Annex I; and (3) at the end of its useful life in the free zone, production equipment will either be exported duty and tax free; entered into domestic commerce upon payment of applicable duties and taxes; or discarded as scrap (see Creskoff & Walkenhorst, *supra* n. 8). The counterarguments to this position are as follows: (a) the purpose of capital goods and production equipment is not to be 'stored' in the free zone to be re-exported, but to be used for the production of goods to be exported; (b) while production equipment is not specifically listed as a prohibited subsidy by Annex I, there is Annex II and n. 61 whose purpose is to specify when an input is consumed during the production process. These provisions make it clear that capital goods and production equipment are not 'consumed' during the production process because they are not 'physically incorporated into the exported product'. There is a consensus among members of the ASCM Committee about this interpretation; (c) when the capital goods or production equipment is exported at the end of its useful life it would be at a much lower value than that paid at the time of their importation precisely because they have reached their useful life. The product being exported is not the same or identical product as the one that has been imported on a duty-free basis (see Torres, *supra* n. 4 and Engman et al., *supra* n. 8, 46).

177 Law 11508/2007, Art. 6-A.

178 ASCM, Annex I, literal (e).

179 Law 11508/2007, Art. 18, s. 4.II.

180 See Lei Complementar No. 124 of 3 Jan. 2007 and Lei Complementar No. 125 of 3 Jan. 2007.

181 ASCM, Annex I, literal (e).

182 Law 523/1995, Art. 13.

183 *Ibid.*

184 *Ibid.*, Art. 23.

185 *Ibid.*, Art. 27.

186 It must be noted that Stephen Creskoff and Peter Walkenhorst hold a different opinion about the consistency of tax incentives on capital goods with the ASCM. *See supra* n. 176.

187 Law 15921/1987, Art. 19.

former IRIC),[188] and Capital Gains Tax (for free zone user corporations).[189] As mentioned, exemptions of direct taxes constitute a 'subsidy' within the meaning of the ASCM, which does not fall within the Agreement's exclusion.

– The Uruguayan Law on Free Zones also exempts imports of goods entering the free zones from payment of import duties and other charges to imports of goods entering the free zones. The statute stipulates that 'any goods, services, merchandise and raw materials that enter into the free zones, whatever their origin, shall be exempted from all import duties or charges applicable at the time of import, including those requiring by law a specific exemption, whatever the nature thereof'. [190] The exemption is phrased in very broad terms, without restricting in any way the type of goods that may be introduced into the free zone on a duty-free basis. In the absence of any specific limitation, one should assume that it includes, *inter alia*, inputs, machinery (new or used), productive assets, or merchandise destined for sale.[191] Furthermore, the exemption is not subject to any condition such as, for example, the need for the goods to be consumed in the production of the exported product. By contrast, the ASCM allows for the non-excessive remission of duties levied on imported inputs that are consumed in the production of the exported product (emphasis added).[192] As mentioned above, duty-free treatment of inputs that are not consumed in the production of the exported product such as capital goods and production equipment falls within the Agreement's definition of 'subsidy'.

3.3.2. Contingency of Those Free Zone Incentives that Constitute a 'Subsidy' upon Export Performance

The contingency of the incentives offered by the Brazilian EPZ statute upon export performance is clear. The statute expressly requests EPZ users to export at least 80% of the turnover related to the sales of goods and services.[193] In its turn, the ASCM prohibits members to grant or maintain subsidies that are contingent in law or in fact to export performance.[194] Hence, those incentives offered by the EPZ that fall within the meaning of subsidy are inconsistent with ASCM prohibition on export incentives.

The Paraguayan statute stipulates that free zone users must pay a single free zone tax at a rate of 0.5% over the total value of gross revenues from exports, provided they are engaged exclusively in exports[195] or are engaged in both exports and sales to the national customs territory, but the sales to the national customs territory do not exceed 10% of the enterprise's gross sales revenue. [196] If sales to the national customs territory exceed 10% of the enterprise's gross sales income, the free zone user must pay the single free zone tax at a rate of 0.5% over the total value of gross revenues from exports plus income tax over the total value of gross revenue from sales to the national customs territory, with the possibility of deducting its costs in the same proportion.[197] The statute does not prohibit free zone users from selling their goods to domestic consumers, but the fiscal incentives are not extended to revenues from domestic sales, creating a strong incentive in favour of exports. In other words, the fiscal incentive reaches its maximum value when the free zone user consigns all of its sales or at least 90% of them to third countries, which clearly constitutes a *de iure* export performance requirement. As a result, those incentives offered by the Paraguayan free zone regime that fall within the meaning of subsidy are inconsistent with ASCM prohibition on export incentives.

The Uruguayan Free Zone statute does not include a specific provision conditioning the fiscal incentives to a specific export performance requirement. However, the statute stipulates that the introduction of goods from the free zone into the national customs territory is regarded as an 'import'[198] and, therefore, subject to payment of all custom duties and taxes that

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188 Decree 454/1988, Art. 35, provides that free zone users are exempted from IRAE (former IRIC) with respect to the activities performed in the free zone.
189 *Ibid.*, Art. 41.
190 Law 15921/1987, Art. 21.
191 The Aguada Park website includes in the list of incentives offered by the Law on Free Zones the 'possibility to acquire equipment and supplies (new and used) without having to pay any taxes or customs duties'. <www.aguadapark.com/index_en.html>, 12 Apr. 2010.
192 ASCM, Annex I, literal (i).
193 Law 11508/2007, Art. 18.
194 ASCM, Art. 3.
195 *Ibid.*, Art. 14.
196 *Ibid.*, Art. 16.
197 *Ibid.*, Art. 17. This reflects one of the two amendments to Law 523/1995 introduced by Law 2421/2004, since previously enterprises that sold more than 10% to the customs territory benefited from a 70% reduction in the income tax payable on their sales to the Paraguayan customs territory. The second amendment to Law 523/1995 eliminated Art. 18 that offered the possibility for enterprises to choose between paying the single free zone tax and paying income tax on their commercial, industrial, or service-related activities.
198 Law 15921/1987, Art. 22, second paragraph.

may correspond. It could be argued that conditioning access to the domestic market to payment of all duties and taxes that may correspond constitutes a de facto incentive for free zone users to export their production (on a tax-free basis) rather than sell it in the domestic market (on a taxed basis).[199] By accepting this argument, it follows that those incentives offered by the Uruguayan free zone regime that fall within the meaning of subsidy are inconsistent with ASCM prohibition to grant or maintain subsidies that are contingent in fact to export performance. Even if the argument suggesting the existence of a de facto export performance requirement is not accepted, the fiscal incentives that fall within the definition of subsidy remain 'actionable' within the meaning of the ASCM,[200] that is, they can be maintained provided they do not cause adverse effects to the interests of other WTO members.[201]

3.3.3. Free Zone Incentives that Do Not Constitute a 'Subsidy' within the Meaning of the ASCM

In addition to fiscal incentives, most free zones also offer incentives of an infrastructural nature such as access to improved telecom networks, broadband, power supply, roads, and ports. According to the ASCM, the provision by a government of general infrastructure does not constitute a subsidy, but the provision of goods or services other than general infrastructure does.[202] It is further specified that the provision of services by a government shall not be considered as conferring a benefit unless the provision is made for less than adequate remuneration.[203] Moreover, the Agreement prohibits governments from providing goods or services for use in the production of exported products on terms or conditions more favourable than those provided for the production of like products for domestic consumption.[204]

The Uruguayan Free Zone Law allows public bodies that supply goods or services to free zone users to charge promotional rates for them.[205] Should public bodies decide to supply goods or provide services at promotional rates (for example, the provision by the state-owned telecom company of telecommunication services to firms operating within the free zone area at a rate significantly lower than that charged to consumers outside the free zone), they could be challenged as a prohibited subsidy, since the ASCM expressly prohibits the provision by governments or their agencies of services for use in the production of exported goods on terms or conditions more favourable than those provided for use in the production of goods for domestic consumption.[206]

The Brazilian EPZ Law and the Uruguayan Free Zone Law offer regulatory incentives such as trade facilitation measures, more liberal foreign exchange regimes (except for currency retention schemes which involve a bonus on exports), exemption from national monopolies, and so forth, which do not constitute 'subsidies' within the meaning of the ASCM and, thus, are not caught by the Agreement's disciplines.

4. Free Zone Incentives and the GATS

4.1. Mandate to Negotiate Disciplines on Subsidies

The GATS does not include disciplines on subsidies but mandates WTO members to negotiate them.[207] Negotiations on subsidies have been carried out by the Working Party on GATS Rules (hereinafter WPGR), established on 30 March 1995 by the Council for Trade in Services but faced significant obstacles from the very beginning. With over fifteen years of work, the WPGR has not made any significant progress in advancing an agreement on disciplines for trade-distortive subsidies. One of the main reasons for this lack of progress is the negotiators' failure to clearly identify the problem that needs to be addressed. The Agreement recognizes that, in certain circumstances, subsidies may have distortive effects on trade in services, but no one exactly knows which those circumstances are. The impact of subsides on trade in services is heavily under-researched and there is limited information about the type and scale of support

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199 See Torres, *supra,* 219. It is important to state that this is a doctrinal interpretation. As in any 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 interpretative and dispute settlement procedures stipulated by the WTO agreements. So far, there have not been WTO cases dealing with this issue nor any official interpretation about it.
200 *Ibid.,* Art. 5.
201 ASCM, Art. 7.
202 *Ibid.,* Art. 1.1(a)(1)(iii).
203 *Ibid.,* Art. 14(d).
204 *Ibid.,* Annex I(c).
205 Law 15921/1987, Art. 24.
206 ASCM, Annex I, literal (d).
207 Article XV GATS.

measures provided by members to their service suppliers.[208] No member has so far put on the negotiating table concrete evidence about the distortive effects of any specific governmental support measures adopted by another member, let alone, complaints about the trade-distorting effects of specific export incentives given to the offshore industry.[209]

The chairman of the WPGR has recently stressed that unless inputs were received from delegations on the nature of the problem to be addressed and the means for doing so, little progress could be expected.[210] He urged delegations wishing to intensify work in this area to submit their inputs specifying how the trade-distortive effects of subsidies might be addressed.[211] In connection to this, the US Representative complained about the difficulty to design disciplines in circumstances where the nature and extent of the problem that those disciplines are meant to address is far from being clear. He also reminded delegations that WTO members are meant to address significant trade problems and not hypothetical ones.[212]

In conclusion, the multilateral negotiations on disciplines for subsidies on services place no immediate risk for the incentives given by members to their service suppliers. At least for the short to medium terms, it is not reasonable to expect a negotiating outcome that could force members to dismantle incentives for service suppliers such as those offered by MERCOSUR countries' free zone laws.

4.2. National Treatment

There is a common misconception about the GATS that associates the absence of disciplines on subsidies for trade in services with an unfettered discretion to grant fiscal or financial incentives for the supply or consumption of services. However, the GATS is concerned with any measure that affects trade in services and includes a number of disciplines that limit members' discretion to grant fiscal or financial incentives, most notably, the national treatment and the Most Favoured Nation (MFN) standards.[213]

The national treatment discipline compels members to accord services and service suppliers of any other member treatment no less favourable than that accorded to its own 'like' services and service suppliers in respect of all measures affecting the supply of services.[214] The provision clearly states that treatment shall be considered to be less favourable if it modifies the conditions of competition in favour of services or service suppliers of the member compared to like services or service suppliers of any other member.[215] Therefore, the discipline catches not only measures that formally accord to domestic services and service suppliers a treatment more favourable than that accorded to foreign suppliers (that is, de jure discrimination) but also measures that despite formally according an identical treatment to both domestic and foreign services and service suppliers, in practice, discriminate against the latter because they face greater difficulties to comply with them (that is, de facto discrimination).[216]

In principle, the obligation not to discriminate that stems from the national treatment discipline refers to all measures affecting the supply of services, including, *inter alia,* fiscal incentives, financial contributions, transfers of funds, or any other form of financial assistance. Unlike GATT 1994, the GATS does not include a specific carve-out for the payment of subsidies exclusively to domestic producers.[217] However, on the other hand, the GATS calls members to enter into negotiations with a view to developing multilateral disciplines on subsidies.[218] Distinguished scholars have argued that the mere fact that there is a provision calling for the negotiation on multilateral disciplines on subsidies leave them completely

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208 The title of a United Nations Trade and Development (UNCTAD) paper published in 2005 speaks for itself: 'State support measures for services: an exploratory assessment with scanty data' (Luis Abugattas Majulf, UNCTAD Document for Discussion). While the paper provides robust evidence confirming the widespread use of state support measures for services worldwide, it falls short to shed light on the scale and effects of such measures due to the lack of reliable information on this matter.

209 Pursuant to Art. XV.2 GATS, '[a]ny Member which considers that it is adversely affected by a subsidy of another Member may request consultations with that Member on such matters. Such requests shall be accorded sympathetic consideration'. However, members have not yet made use of this instrument.

210 WTO Document (S/WPGR/M/65), WPRG – Report of the Meeting of 6 Oct. 2009, para. 2.

211 *Ibid.*

212 *Ibid.*

213 Other provisions that may also affect the legality of subsidies for services are the provisions on transparency (Art. III), domestic regulation (Art. XI), monopolies and exclusive service suppliers (Art. VIII), and non-violation nullification or impairment (Art. XXIII).

214 Article XVII GATS.

215 Article XVII.3 GATS.

216 *Canada – Autos,* Appellate Body Report (WT/DS139/AB/R and WT/DS142/AB/R) (2000), paras 10.307 and 10.308.

217 Article III(8)(b) GATT 1994.

218 Article XV GATS.

unregulated under GATS until the negotiations come to a fruitful end.[219]

By contrast, there are good reasons for supporting the idea that the payment of subsidies is not completely excluded from the scope of application of Article XVII. First, the 2001 Scheduling Guidelines expressly state that Article XVII applies to subsidies in the same way that it applies to all other measures.[220] The Appellate Body has recognized that, although not part of the treaty itself, the scheduling guidelines do shape the interpretation of treaty provisions as a supplementary means of interpretation.[221] In addition, members' practice in scheduling specific commitments suggests that there is an understanding, at least among some members, that subsidies are covered by Article XVII.[222] For instance, Switzerland's schedule of specific commitments includes a 'horizontal limitation' (that is, a limitation applicable to all sectors included in its schedule) expressly excluding subsidies, tax incentives, and tax credits from its national treatment commitments on modes 1 (cross-border supply) and 2 (consumption abroad). A similar horizontal limitation is included in Korea's schedule of specific commitments for mode 3 (commercial presence). The schedule expressly reserves Korea's right to limit eligibility for subsidies, including tax benefits, to companies that are established in Korea according to the pertinent laws. It also excludes research and development subsidies from its national treatment commitments. Armenia provides an example of one of the broadest carve-outs for subsidies. The schedule of specific commitments specifies that Armenia's national treatment commitments are unbound for all service sectors and modes of supply with respect to subsidies. Only legal entities constituted under Armenian legislation are eligible for subsidization, irrespective of their capital ownership.[223]

More importantly, the words used to define the scope of application of Article XVII have been interpreted broadly by WTO adjudicatory bodies. In its relevant part, Article XVII provides '… each Member shall accord to services and service suppliers of any other Member, in respect of all measures *affecting* the supply of services …'[224] (emphasis added). Likewise, Article I provides that the agreement applies to measures by members *affecting* trade in services.[225] Both panels and the Appellate Body have indicated that the word 'affecting' suggests that no measures are excluded *a priori* from the scope of the GATS. For instance, in *EC-Bananas* the panel indicated the following:

> The scope of the GATS encompasses any measure of a Member to the extent it affects the supply of a service regardless of whether such measure directly governs the supply of a service or whether it regulates other matters but nevertheless affects trade in services.[226]

The Appellate Body, confirming the panel's interpretation, added:

> In our view, the use of the term 'affecting' reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word 'affecting' implies a measure that has 'an effect on', which indicates a broad scope of application. This interpretation is further reinforced by the conclusions of previous panels that the term 'affecting' in the context of Article III of the GATT is wider in scope than such terms as 'regulating' or 'governing'.[227]

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219 Juan Alberto Marchetti & Petros C. Mavroidis make the following point: if Art. XVII includes subsidies, and thus, subsidies are to be granted on a national treatment basis, how could they be distortive? If one were to accept that Art. XVII suffices to discipline subsidies, what is the point of Art. XV.1 calling for negotiations with a view to develop multilateral disciplines to avoid the trade-distorting effects of subsidies? The only way to justify subsidies negotiations, they argue, is to accept that subsidies are by definition discriminatory and, therefore, outside the scope of Art. XVII. See Juan Alberto Marchetti & Petros C. Mavroidis, 'Walking the Tightrope. Between Domestic Policy and Globalization: Market Access, Discrimination and Regulatory Intervention under the GATS', Mimeo (2006), cited in Mitsu Matsushita, Thomas Schoenbaum & Petros Mavroidis, *The World Trade Organization Law, Practice, and Policy*, 2nd edn (OUP, 2005), 661.

220 In the relevant part, the guidelines provide as follows: Art. XVII applies to subsidies in the same way that it applies to all other measures. Art. XV (Subsidies) merely obliges members to 'enter into negotiations with a view to developing the necessary multilateral disciplines' to counter the distortive effects caused by subsidies and does not contain a definition of subsidy. Therefore, any subsidy that is a discriminatory measure within the meaning of Art. XVII would have to be either scheduled as a limitation on national treatment or brought into conformity with that article. Subsidies are also not excluded from the scope of Art. II (MFN). In line with the paragraph *supra*, a binding under Art. XVII with respect to the granting of a subsidy does not require a member to offer such a subsidy to a services supplier located in the territory of another member. See WTO Document (S/L/92), Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services, 23 Mar. 2001, para. 16.

221 US – Gambling (2005), Appellate Body Report (WT/DS285/AB/R), para. 196.

222 See Note by WTO Secretariat, 'Limitations in Members' Schedules Relating to Subsidies', S/WPGR/W/13 of 22 May 1996. Subsequently updated by S/WPGR/W/13/Add.1 of 14 Jun. 2000 and S/WPGR/W/13/Add.2 of 30 Aug. 2004.

223 See Armenia (GATS/SC/137, 3).

224 Article XVII.1 GATS.

225 Article I.1 GATS.

226 Panel Reports (WT/DS27/R/ECU, WT/DS27/R/MEX, and WT/DS27/R/USA), para. 7.285.

227 *EC – Bananas* (9 Sep. 1997), Appellate Body Report (WT/DS27/AB/R), para. 220.

The implications stemming from the application of the national treatment standard on fiscal or financial incentives are significant. Like any other measure affecting trade in services, Article XVII forces members to grant them in a non-discriminatory way. In other words, the National Treatment (NT) standard outlaws financial or fiscal incentives given to domestic service suppliers, which results in less favourable conditions for the supply of a service by like foreign suppliers.

There are, however, important caveats that limit the scope of application of the national treatment discipline. First, it applies only to services inscribed in a member's schedule.[228] A country retains full discretion to discriminate against foreign services and service suppliers by refraining from inscribing a given service sector in its schedule of specific commitments. Second, members may qualify their specific commitments by inscribing in the schedule measures incompatible with the NT obligation that they nevertheless wish to maintain.[229] Third, both the GATT Document Scheduling of Initial Commitments in Trade in Services: Explanatory Note[230] and the Guidelines for the Scheduling of Specific Commitments under the GATS[231] limit the territorial applicability of the NT obligation, although the text of the agreement does not expressly address this issue.

4.3. MFN Treatment

The MFN, a principle known as 'favour one, favour all', forbids WTO members from discriminating between trading partners. Article II of GATT 1994 stipulates that with respect to 'any measure covered by the Agreement', members must extend immediately and unconditionally to services or service suppliers of all other members 'treatment no less favourable than that accorded to like services and service suppliers of any other country'. Since the payment of incentives to service suppliers are 'measures' within the meaning of the GATS, they are covered by the MFN discipline. In other words, a member cannot grant a fiscal or financial incentive to a foreign service supplier from country A but refrain from extending the same treatment to like service suppliers from any other WTO member.[232]

The scope of application of the MFN standard is defined broadly. Unlike the national treatment standard, it applies to all sectors and modes of supply, regardless of members' specific commitments.[233] However, the MFN provision gives members the opportunity to maintain measures inconsistent with the MFN Treatment, provided that such measures are listed in and meet the conditions of the Annex on Article II Exemptions.[234]

The MFN obligation has direct implications for free zone regimes. First, free zones that host service suppliers must be open for any foreign service supplier with a commercial presence in the territory of the member where the free zone is located, regardless of their origin. Second, custom duty exemptions granted by free zone regimes on the import of goods necessary for the supply of services must be extended to like goods originating in any WTO member.

4.4. Implications for Free Zones in MERCOSUR Countries

Fiscal incentives included in the Uruguayan Law on Free Zones are available for natural or legal persons, national or foreigners, and therefore, on their face, they are not discriminatory. However, the statute authorizes free zone users to supply certain type of services from the free zone into the national customs territory.[235] At present, there are a number of services that can be supplied from the free zone into the national customs territory, including, *inter alia*, software development services, IT consultancy services, and IT training services. In its turn, Uruguay's GATS schedule includes a full commitment to national treatment on computer and related services for modes

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228 Article XVII.1 GATS.

229 See, for example, the horizontal limitations inscribed in the Swiss, Korean, and Armenian schedules of specific commitments mentioned *supra*.

230 The Explanatory Note states that '... there is no obligation in the GATS which requires a Member to take measures outside its territorial jurisdiction. It therefore follows that the national treatment obligation in Article XVII does not require a Member to extend such treatment to a service provider located outside the territory of another Member'. WTO Document (MTN.GNS/W/164), 'GATT Document Scheduling of Initial Commitments in Trade in Services: Explanatory Note', 3 Sep. 1993, para. 10.

231 Paragraph 16 of the Guidelines stipulate that a binding under Art. XVII with respect to the granting of a subsidy does not require a member to offer such a subsidy to a services supplier located in the territory of another member.

232 Paragraph 9 of WTO Document (S/L/92), Guidelines for the Scheduling of Specific Commitments under the General Agreement on Trade in Services, 23 Mar. 2001, stipulates that subsidy-type measures are [...] not excluded from the scope of Art. II MFN.

233 The wider scope of application of the MFN standard also derives from the way the provision is drafted. Whereas Art. XVII.1 refers to 'all measures affecting the supply of services', Art. II refers to 'any measure covered by this Agreement'.

234 Article II.2 GATS.

235 See *supra* n. 142 and n. 143.

1, 2, and 3. As long as the free zone users supply the services into the national customs territory under the same conditions applicable to the supply of services by 'like' foreign service suppliers with a commercial presence in the Uruguayan territory but operating outside the free zone, there is no risk of inconsistencies with Uruguay's national treatment obligations.[236] However, if free zone users were allowed to take advantage of any of the incentives offered by the free zone regime, while competing with 'like' foreign service suppliers not entitled to such incentives, there could be a risk of discriminatory treatment in breach of the NT standard.

Similar concerns can be raised with respect to the incentives offered by the Paraguayan free zone regime. This statute also allows free zone users to direct part of their sales to customers located in the national customs territory provided certain conditions are met. Allowing a narrow group of service suppliers to access the domestic market under a tax regime more beneficial than that applicable to like foreign service suppliers established in the Paraguayan territory, but outside the free zone, could be regarded as a discriminatory behaviour inconsistent with national treatment obligations on service sectors where specific commitments have been undertaken. However, so far, given the fact that Paraguayan specific GATS commitments are almost non-existent, these concerns remain at a purely speculative level.

Brazilian EPZs are open only for companies dedicated to the manufacturing and export of goods, although the situation could change in the future.[237] Again, even if this occurs, the chances for inconsistencies are minimal since Brazil's GATS commitments are quite modest.

Argentina's free zone incentives are offered to natural or legal persons, national or foreigners.[238] There is no *de iure* discrimination against foreign service providers and there is no apparent reason to infer a de facto discriminatory situation. However, the Argentinean law stipulates that free zones should become a development centre in those areas where they are established by employing human resources and using other resources available in those areas in accordance to the provisions of the statute and subordinated legislation.[239] Imposing a specific requirement on free zone users to use, for example, local service suppliers available in the area where the free zone is located is clearly discriminatory against like foreign service suppliers that are not located in that area and, depending on the specific commitments undertaken, could be inconsistent with the NT obligation. So far, however, there is no evidence that subordinated legislation has imposed specific local content requirements in such a way.

In summary, save for the minor concerns expressed above, MERCOSUR countries' free zone incentives are not inconsistent with GATS disciplines. The main reason for this is that MERCOSUR countries' GATS commitments, which determine the scope of application of existing disciplines, are limited to only a very narrow number of service sectors and modes of supply. The situation could change in the future if, as a result of multilateral negotiations, MERCOSUR countries opt for extending their GATS commitments to new sectors and modes of supply. GATS disciplines on subsidies, which are currently being negotiated, could eventually outlaw some of the current incentives offered by free zone regimes, but no meaningful results are expected from these negotiations for the short to medium terms.

5. Conclusions

This article examined the consistency of the incentives offered by free zone regimes in Argentina, Brazil, Paraguay, and Uruguay with WTO law. There is no reference to free zones in the WTO agreements. However, that does not mean that free zone incentives fall outside the scope of application of WTO disciplines. WTO members' discretion to grant fiscal or financial incentives is constrained, among others, by disciplines on non-discrimination, subsidies, and trade-related investment measures.

Some of the incentives offered by MERCOSUR countries' free zone regimes constitute a 'subsidy' within the meaning of the ASCM, most notably, the exemptions of direct taxes otherwise due by free zone users, exemptions of custom duties on the import of capital goods, exemptions of payment of social welfare charges, unqualified exemptions on payment of indirect taxes, and the possibility to supply goods or services to free

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236 Decree 84/2006 stipulates that the tax exemptions provided by the Uruguayan Law on Free Zones will not be extended to the provision of services by free zone users into the national territory. The Decree provides that for such part of their activities, free zone users shall be subject to the tax regime in force at the time of the supply of the service. In its turn, Art. 2, literal (c) of the Free Zone statute provides that services supplied from the free zone into the national customs territory will receive the same tax treatment to those services provided from abroad either as regards to the supplier and to its deductibility by the consumer.

237 See *supra* n. 57.

238 Law 24331/1994, Art. 21.

239 Article 5, Law 24331.

zone users at promotional rates. Incentives offered by the Brazilian and Paraguayan free zone regimes are contingent in law to export performance, which is expressly prohibited by the ASCM. Although the Uruguayan free zone regime does not include a specific provision conditioning access to fiscal incentives to a specific export performance requirement, it could be argued that conditioning access to the domestic market to payment of all duties and taxes that may correspond constitutes a de facto incentive for free zone users to export their production (on a tax-free basis) rather than sell it in the domestic market (on a taxed basis), which is also prohibited by the ASCM. Even if the argument suggesting the existence of a de facto export performance requirement is not accepted, the fiscal incentives that fall within the definition of subsidy remain 'actionable' within the meaning of the ASCM.

To bring inconsistent fiscal incentives into conformity with the ASCM requires a reform of free zone laws. One possibility could be to eliminate the export performance requirement by allowing free zone products full access to the domestic market. By removing the export performance requirement, the fiscal incentive is no longer prohibited by the ASCM but remains an 'actionable subsidy', that is, any other member that considers itself adversely affected by it may trigger an investigation to determine the existence, degree, and effect of any alleged subsidy, which may end up with the imposition of countervailing duties.[240] An actionable subsidy can be converted into a non-specific subsidy by extending the incentive to all firms subject to objective criteria or conditions irrespective of location and not just to firms allowed to operate within a designated geographical enclave. Non-specific subsidies fall outside the scope of the ASCM. A more radical option could be to remove the fiscal incentives altogether. However, if this option is chosen, members should be particularly careful with the rights of existing free zone users that are already benefiting from such incentives.[241]

In any case, there are no reasons to suggest an immediate need for reform. First, it is worth noting that, so far, the consistency of free zone incentives with WTO law has not been subject to litigation. Moreover, although the ASCM confers members the right to make, at any time, a written request for information on the nature and extent of any subsidy granted or maintained by another member,[242] so far no member has exercised this right to enquire about fiscal incentives offered by free zone regimes. Of course, the absence of claims or enquiries does not in itself guarantees the legality of these incentives but at least indicates some level of tolerance by WTO members with respect to measures that have been in place for many years now. In addition, the ASCM contains provisions on special and differential treatment for developing country members that must be borne in mind. None of the MERCOSUR countries notified their free zone regimes under the mechanism provided by the Agreement for developing countries to extend the phase-out period for export subsidies. Yet, the Agreement does contain other provisions that make it more difficult for other WTO members to challenge measures allegedly inconsistent with the ASCM, when such measures are maintained by developing country members.[243] Furthermore, the Ministerial Conference Decision on Implementation-Related Issues and Concerns urges members to exercise due restraint with respect to challenging measures implemented by developing countries with a view to achieving legitimate development goals, such as regional growth, technology research and development funding, production diversification and development, and implementation of environmentally sound methods of production.[244]

By contrast, no significant inconsistencies between free zone incentives and the GATS have been found. The main reason for this is that the GATS commitments of MERCOSUR countries, which determine the scope of application of market access and national treatment disciplines, are limited to only a very narrow number of service sectors and modes of supply. The situation could change in the future if, as a result of multilateral negotiations, MERCOSUR countries opt for extending their GATS commitments to new sectors and modes of supply. GATS disciplines on subsidies, which are currently being negotiated, could eventually outlaw some of the current incentives offered by free zone regimes, but no meaningful results are expected from these negotiations for the short to medium terms.

Notes

240 ASCM, Arts 10 to 23.

241 Creskoff et al. (2009, *supra* n. 8). Note, for example, that after Special Economic Zone (SEZ) incentive measures were repealed in Ukraine in 2005, subsequent court decisions continued the fiscal measures for certain investors.

242 ASCM, Art. 25.8.

243 See, for example, ASCM, Art. 27, paras 8–10.

244 WTO Document (WT/MIN(01)/17), Ministerial Conference Decision on Implementation-Related Issues and Concerns (14 Nov. 2001), para. 10.2.

GUIDE TO AUTHORS

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