PROHIBITED SUBSIDIES UNDER THE WTO AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES (SCM AGREEMENT): A COMPREHENSIVE LEGAL ANALYSIS

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Introduction

The multilateral trading system under the auspices of the World Trade Organization (WTO) is designed to ensure fair and open trade among member states. One of the central instruments in this framework is the Agreement on Subsidies and Countervailing Measures (SCM Agreement), which regulates the use of subsidies and the measures that may be taken to counteract their effects. The SCM Agreement divides subsidies into three principal categories: prohibited, actionable, and non-actionable. Among these, prohibited subsidies are considered the most harmful due to their inherently trade-distortive nature. This article provides a comprehensive legal analysis of prohibited subsidies under the SCM Agreement, with particular emphasis on the provisions of Article 3 and relevant jurisprudence.

This article provides a detailed understanding of the legal framework governing prohibited subsidies, the rationale behind their prohibition, and the interpretative approaches adopted by WTO adjudicative bodies. In doing so, it draws on relevant provisions of the SCM Agreement, and scholarly commentary to elucidate the scope, application, and implications of these rules.

Keywords: WTO, SCM Agreement, prohibited subsidies, export subsidies, import-substitution subsidies, de jure, de facto, international trade law, trade distortion.

The Agreement on Subsidies and Countervailing Measures (SCM Agreement), as a core component of the World Trade Organization (WTO) legal framework, establishes a comprehensive, rules-based approach to the regulation of government subsidies that may affect international trade. By introducing a structured legal regime, the SCM Agreement seeks to distinguish between subsidies that are permissible, those that are potentially harmful but tolerable under certain conditions, and those that are categorically prohibited.

At the heart of this regime lies Article 1 of the SCM Agreement, which provides a clear legal definition of a “subsidy”.[1] According to this provision, a subsidy exists when there is a financial contribution by a government or any public body within the territory of a member, and a benefit is thereby conferred. This foundational definition is critical, as it determines the scope of the entire Agreement.

[1] See article 1 of the SCM Agreement.

Codified in Article 3, prohibited subsidies are often referred to as "red light" subsidies,[2] symbolizing their inherent incompatibility with the principles of free and fair trade. These include, most notably, subsidies that are explicitly or implicitly contingent upon export performance (export subsidies) or upon the use of domestic goods over imported ones (import-substitution subsidies).

The strict prohibition of such subsidies is not merely a formal legal stance but is underpinned by compelling economic and normative justifications. First, these subsidies can severely distort competitive conditions in international markets, giving domestic producers an unfair edge over their foreign counterparts. Second, by artificially altering trade flows, they undermine the commitments that WTO members have made toward trade liberalization and market access. Finally, the outright ban on prohibited subsidies serves to preserve the integrity of the multilateral trading system, ensuring that government interventions do not erode the principle of a level playing field among nations.

Through the prohibition of certain subsidies, the SCM Agreement exemplifies the WTO's broader objective: to create a predictable, transparent, and equitable trading environment where no member gains an undue advantage through distortive domestic support measures.

Article 3.1 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement) represents a cornerstone provision in the WTO's framework for the regulation of subsidies.[3] It lays down, in clear and unequivocal terms, a categorical prohibition on certain types of subsidies that are considered inherently trade-distorting and incompatible with the foundational principles of the multilateral trading system. The text of Article 3.1 states that, except as otherwise provided in the Agreement on Agriculture, WTO members are strictly prohibited from granting or maintaining two particular categories of subsidies: a) Subsidies that are contingent, in law or in fact, whether solely or as one of several conditions, upon export performance, including the types of subsidies enumerated illustratively in Annex I of the SCM Agreement; b) Subsidies that are contingent, whether solely or as one of several conditions, upon the use of domestic over imported goods.

These two categories—export subsidies and import-substitution subsidies—constitute what are often referred to as "prohibited subsidies" or "red light subsidies" under WTO jurisprudence. The terminology "in law or in fact" (also known as de jure or de facto conditionality) is particularly significant because it expands the reach of the prohibition to cover not only measures that are explicitly linked to export or import-substitution objectives through legislative or regulatory texts but also those that, through their structure, design, or implementation, achieve the same effect in practice.

[2] See article 3 of the SCM Agreement
[3] See article 3.1 of the SCM Agreement.

The underlying rationale for such a stringent and uncompromising prohibition lies in the inherently trade-distorting nature of these two types of subsidies.

Export subsidies, by design, provide financial incentives or advantages that are linked to a firm's or sector's performance in foreign markets. This artificially enhances the international competitiveness of domestic producers, enabling them to capture foreign market share not through efficiency, innovation, or comparative advantage, but through government support. Such subsidies can depress international prices, displace foreign competitors, and undermine the commercial viability of unsubsidized producers in importing countries. This distortion is magnified in sectors with price-sensitive global markets, such as agriculture, manufacturing, and industrial goods.

Import-substitution subsidies, on the other hand, provide direct or indirect advantages to producers that use domestically sourced inputs instead of imported ones. The objective here is to promote domestic production and reduce reliance on foreign goods. While this may serve short-term economic or political objectives of self-sufficiency, such measures run contrary to the principles of open trade and non-discrimination. They introduce significant distortions by disincentivizing importation, thereby undermining the comparative advantage of foreign exporters and tilting the domestic market in favor of local producers—regardless of their efficiency or competitiveness.

These forms of government intervention not only skew the natural flow of international trade, but also have broader systemic implications. They may trigger retaliatory measures, trade disputes, or even lead to the escalation of protectionist policies. Therefore, the WTO Members—through the SCM Agreement—have agreed that prohibited subsidies must be eliminated or withdrawn without the need for demonstrating actual harm or adverse trade effects. This absolute prohibition reflects a legal and economic consensus that certain subsidy practices are so fundamentally at odds with the liberal international trading order that they warrant immediate cessation.

Export subsidies represent a specific and particularly trade-distorting category of subsidies that are expressly prohibited under the World Trade Organization's Agreement on Subsidies and Countervailing Measures (SCM Agreement). These are defined as financial contributions or benefits conferred by a government or public body that are made contingent upon export performance. In other words, the granting of the subsidy must be dependent—either directly or indirectly—on the act of exporting goods or services from the territory of the subsidizing country.

The concept of contingency is pivotal to the definition of export subsidies under Article 3.1(a) of the SCM Agreement. The term signifies a causal relationship—a "if-then" dynamic—where the availability or amount of the subsidy is linked to the recipient's actual or anticipated export activity. This contingency may take one of two legal forms: de jure (explicit in law) or de facto (implied through the structure or operation of the measure).

To help clarify what constitutes an export subsidy, Annex I of the SCM Agreement provides an illustrative—not exhaustive—list of practices that are presumed to fall within the category of prohibited export subsidies. These include, but are not limited to: Direct subsidies tied to export performance, such as financial grants awarded solely for goods destined for export markets; Retention schemes, under which exporters are allowed to retain foreign exchange earnings or receive favorable exchange rates; Tax exemptions, credits, or deferrals granted exclusively for export-related income or operations; Preferential access to goods or services (e.g., raw materials, utilities, logistics services) provided at favorable rates for producers engaged in export activity; Concessional financing or guarantees provided below market rates, contingent upon the export of goods.[4]

This list underscores the broad scope of measures that may fall within the definition of prohibited export subsidies, extending beyond simple cash payments to include more nuanced fiscal, regulatory, and administrative incentives that encourage or reward export behavior.

a) De Jure vs. De Facto Contingency

The SCM Agreement explicitly prohibits both de jure and de facto export subsidies. A de jure export subsidy is straightforward: it is one that is formally codified in the legal text—for instance, a government regulation that provides a tax rebate or exemption only for goods that are exported. The conditionality is spelled out clearly and requires no further interpretation.

De facto export subsidies, by contrast, are more complex and subtle in their operation. These do not contain an explicit export condition in law but nonetheless operate in such a way that export performance is an essential element in practice. In such cases, a careful examination of the design, structure, and practical implementation of the measure is required to assess whether the subsidy is effectively linked to export activity. This distinction is clarified in Footnote 4 of the SCM Agreement, which provides interpretative guidance for panels and the Appellate Body to investigate and consider a wide range of evidence, including statistical trends and the operational context of the subsidy.[5]

The prohibition of export subsidies under the SCM Agreement is not limited to formalistic legal definitions but extends to a thorough and evidence-based analysis of the economic realities behind governmental support measures. The WTO's evolving case law has ensured that countries cannot circumvent their obligations by simply avoiding explicit language in laws or regulations. Instead, the substance and effect of the measure, as much as its legal form, determine whether a subsidy is export-contingent and thus subject to prohibition. This

[4] See Annex I of the SCM Agreement.
[5] See also Peter Van den Bossche and Denise Prevost, Essentials of WTO Law (2nd edition; Cambridge University Press, 2021).

approach reinforces the commitment of WTO members to fair competition and undistorted trade, which are fundamental objectives of the multilateral trading system.

Import-substitution subsidies, as addressed under Article 3.1(b) of the Agreement on Subsidies and Countervailing Measures (SCM Agreement), are a specific type of prohibited subsidy.[6] These subsidies are conditioned upon the use of domestically produced goods in preference to imported alternatives. The underlying concern with such measures is that they discriminate against foreign goods and thereby distort international trade by altering competitive conditions in favor of domestic producers.

The prohibition of import-substitution subsidies under Article 3.1(b) reflects the broader WTO commitment to non-discrimination and market access, two foundational pillars of the multilateral trading system. By providing financial incentives contingent on domestic input usage, governments effectively undermine the principle of national treatment (as enshrined in Article III of the GATT 1994) and erect disguised barriers to trade, insulating domestic industries from foreign competition.

Although Article 3.1(b) does not expressly include the phrase “in law or in fact” (as does Article 3.1(a) concerning export subsidies), WTO jurisprudence has made it clear that both de jure (in law) and de facto (in fact) forms of contingency are covered within the scope of this provision. This clarification is vital for ensuring that the substantive objectives of the SCM Agreement are not circumvented through technical or linguistic formalities.

A de jure import-substitution subsidy is relatively easy to identify: it exists where a law or regulation explicitly conditions the granting of a subsidy on the use of domestic products. For instance, a government scheme that provides tax rebates or cash payments exclusively to firms that procure locally produced machinery or materials would clearly fall under this category.

However, de facto import-substitution subsidies present more complex legal and evidentiary challenges. These are cases where the subsidy program may not explicitly mandate the use of domestic goods, but in practice, the structure, design, or implementation of the program effectively induces or requires such usage.[7]

To determine whether a subsidy is de facto contingent upon the use of domestic goods, the Appellate Body emphasized the need for a comprehensive and contextual evaluation of how the measure operates in reality. This involves analyzing various factors, such as: The administrative practices of the agencies responsible for implementing and disbursing the subsidy; The behavioral patterns of the subsidy recipients, including whether they tend to favor domestic inputs as a result of the program; The economic effects of the measure, particularly the extent to which it disadvantages imported goods or incentivizes local production over foreign alternatives.

[6] See article 3.1 (b) of the SCM Agreement.

[7] See Peter Van den Bossche and Denise Prevost, Essentials of WTO Law (2nd edition; Cambridge University Press, 2021).

This functional and evidence-based approach ensures that the SCM Agreement remains effective in addressing policies that may not appear discriminatory on paper but have the practical effect of restricting trade and distorting market dynamics.

From an economic standpoint, the effect of import-substitution subsidies is to artificially insulate domestic producers from global competition. By lowering the relative cost of using domestic inputs, such subsidies disrupt market signals and create inefficiencies, shielding local industries from the need to innovate or compete on quality and price. This not only harms foreign exporters but can also lead to resource misallocation and reduced consumer welfare in the subsidizing country.

Under Article 4.7 of the SCM Agreement, once a subsidy is found to fall under the category of a prohibited subsidy—such as those described in Article 3.1(b)—the WTO Member providing the subsidy is required to withdraw it "without delay".[8] The language signals the urgency and gravity with which the WTO views such violations. Failure to comply with this obligation may result in the authorization of countermeasures, including retaliatory trade sanctions by the complaining Member, subject to WTO dispute settlement procedures.

Conclusion

Prohibited subsidies, as defined under Article 3 of the SCM Agreement, represent the most egregious forms of trade-distorting measures within the multilateral trading system. By banning export-contingent and import-substitution subsidies, the WTO aims to eliminate practices that give artificial advantages to domestic producers and undermine the principles of fair competition and non-discrimination.

Ultimately, the prohibition of such subsidies serves the broader objective of maintaining the integrity of the rules-based international trading system. For policymakers, legal practitioners, and scholars, understanding the legal contours of prohibited subsidies is essential for ensuring compliance with international obligations and promoting equitable global trade.

Bibliography

1. Agreement on Subsidies and Countervailing Measures (SCM Agreement)
2. General Agreement on Tariffs and Trade 1994 (GATT).
3. Peter Van den Bossche and Denise Prevost, Essentials of WTO Law (2nd edition; Cambridge University Press, 2021).

[8] See article 4.7 of the SCM Agreement.