

Sinha, Sagnik

Article

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Indian Exports at Crossroads: Why the European Community is Subjecting Indian Goods to Countervailing Duties

Sagnik Sinha*

Gujarat National Law University, Gandhinagar, Gujarat, India

The European Community represents one of the primary destinations for Indian goods accounting for one fifth of Indian exports. Indian goods have been at the receiving end of a significant majority of anti subsidy investigations initiated by the European Commission. Such goods have been alleged to be benefiting from subsidies inconsistent with Council Regulation 2026/97 which forms the legal basis for anti subsidy investigations initiated by the Commission. The paper puts forth an analysis of India's export incentive schemes including old schemes already subjected to challenge as well as new schemes vulnerable to challenge in future investigations with regard to the Council Regulation 2026/97 and the WTO Agreement on Subsidies and Countervailing Measures.

Key Words: WTO, India, EU, international trade, countervailing measures.

Jel-Codes: K 29, K 39, F 19.

1 Introduction

Exports represent a key vehicle of development for a nation, being as it is one of the principal modes of foreign exchange income. It is therefore not surprising that the state as institutions, in particular the ones in a comparatively infant stage of development, would invariably seek to lend a helping hand to manufacturers and traders – exporters who seek to export their goods or services. Such supports often are by way of grant of subsidies contingent on export performance or export subsidies.

India is exempted from the general prohibition of grant of export subsidies as defined in the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures¹ (SCM) by virtue of being an Annex VII Member of the agreement, which exempts from the prohibition such na-

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1 Art 3.1(a), Agreement on Subsidies and Countervailing Measures.

tions which have a net per capita income of less than \$1000 provided they have not reached more than 3.25% world market share in the product in question². However, they remain subject to countervailing duties in the event they cause material injury to the domestic industry of importing states. The European Communities (EC) a primary destination for Indian products, accounting for one fifth of Indian exports³ have, repeatedly subjected Indian goods to countervailing duties on the ground that they receive export subsidies which are in violation of the Council Regulation (EC) NO 2026/97 of 6 October 1997 on protection against subsidised imports from countries not members of the European Community⁴ which governs EC law on import of subsidised goods, with Indian companies involved in a significant majority of anti subsidy investigations initiated by the Community.

India's controversial schemes like the Duty Entitlement Pass Book scheme (DEPB) a scheme repeatedly deemed actionable by the European Communities, to the relatively new schemes like the Special Economic Zones (SEZ) and the Focus Product and Market scheme (FPS/FMS) represent subsidies vulnerable to challenge and hence countervailing duties. The fundamental focal point, however, remains the Agreement on Subsidies and Countervailing Measures, the WTO regime's agreement regulating the use of subsidies by its member states, from which the European Communities as also India borrow heavily in respect of their domestic regulation on subsidies and remain accountable to in respect of their WTO obligations. The article covers some of India's controversial schemes and the ground on which they have been challenged by the European Communities as also the new schemes and why they could be targeted by the investigating authorities of the European Communities in anti subsidy investigations.

2 Law of the European Communities Governing the Import of Subsidised Products

The legal basis for imposition of countervailing duties imposed against subsidised goods in the European Community is the Council Regulation (EC) NO 2026/97 referred to as the basic regulation on subsidies. The need for a separate EC regulation in regard to subsidies arose in light of requirement of greater transparency and effectiveness in the application of the Agree-

2 Annex VII. Agreement on Subsidies and Countervailing Measures.

3 EU-India Trade: Facts & Figures. Helsinki, 12 October 2006. Internet: <http://trade.ec.europa.eu/doclib/html/130593.htm> (as of 15 October 2007).

4 Official Journal of the European Community 288, 21 October 1997, pp 1-33.

ment on Subsidies and Countervailing Measures⁵. In light of the similarity of the text of the basic regulation with that of the subsidies agreement the jurisprudence of the WTO Dispute Settlement Body gives an invaluable insight into the interpretation of such texts.

Three factors are essential for Indian goods to be subject to countervailing duties under the EC law.

1. A subsidy as defined in the basic regulation⁶ must be deemed to exist. Such a subsidy exists when there is a financial contribution⁷ including by way of revenue foregone⁸ accompanied by the conferral of a benefit⁹.
2. The subsidy must be specific or directed at certain enterprises *de jure* by explicit provision of law or *de facto* if the subsidy is such that only certain enterprises can make use of it¹⁰. It is to be noted, however, that if the subsidy in question is captured by the definition of an export subsidy as defined in the regulation¹¹ then it is automatically deemed to be specific; therefore the same needs not be established by the domestic industry or the investigating authority.
3. The subsidy so granted must cause injury¹² to the domestic industry requiring thereby in addition a degree of causality between the subsidy and the injury.

Indian schemes have, as discussed above, repeatedly been deemed to constitute export subsidies and when material injury and causality are established they have been subjected to countervailing duties. While the establishment of injury and causality would essentially depend on facts and circumstances the focus of this paper is to determine whether Indian schemes are actually on the wrong side of the EC domestic law on subsidies with due reference to the WTO agreement on subsidies.

5 Preamble, Regulation 2026//97.

6 Art 2, Regulation 2026//97.

7 Art 2.1(a), Regulation 2026//97.

8 Art 2.1(a)(ii), Regulation 2026//97.

9 Art 2.2, Regulation 2026//97.

10 Art 3.3, Regulation 2026//97.

11 Art 3.4, Annexure I, Regulation 2026//97.

12 Art 1.1, Regulation 2026//97.

3 Operation of Indian Schemes

India's export incentive regime is broadly covered by two principal documents. Post 2004, the schemes derive their origin in the Foreign Trade Policy 2004-09 which lays down the various export incentives granted by the Government of India (GOI) to its exporters. The Handbook of Procedures (HOP) lays down the procedures to be complied with for the efficient regulation of foreign trade.

3.1 The Duty Entitlement Pass Book Scheme

Covered by chapter 7 of the Indian Foreign Trade Policy 2004-09 the Duty Entitlement Passbook scheme represents one of the most controversial yet domestically one of the most popular schemes. The scheme has been extended to 31 March 2008 by the 2007 Annual Supplement to the Foreign Trade Policy 2004-09.

The objective of the DEPB scheme is to neutralise the incidence of customs duty on import content of the exported product¹³ by provision of a duty credit against the exported product. Credits are determined by calculation of the deemed import content of the said export product in accordance with the Standard Input Output Norms (SION) used by the Government of India which determines the input per manufactured unit and the basic customs duty payable on such imports. The Director General of Foreign Trade notifies a definite rate for export products. All inputs are deemed to have been imported and to have suffered customs duty. Offset of duty on inputs used in goods bound for exports is deemed a world trade law consistent policy as acknowledged in the WTO subsidies agreement¹⁴ as also the basic regulation¹⁵. The exception so carved out however has to be in accordance with Annex I to III¹⁶.

The Illustrative List of Export Subsidies¹⁷ identifies as an export subsidy the remission or drawback of imported inputs in excess of that consumed in the exported product, provided that in particular cases a quantity of home market inputs equal to and having the same quality and characteristics as

13 Handbook on Duty Entitlement Passbook scheme (NABHI 2002), 1.

14 Footnote 1 to the Annex I (i), SCM.

15 Art 2.1(ii), Annex I(i), Regulation 2026/97.

16 Art 2.1(ii), Annex I(i), Regulation 2026/97.

17 Annex I (i), Regulation 2026/97.

imported units that may be substitutes for them. The condition is that the import and the corresponding export operations both occur within a reasonable time period not to exceed two years¹⁸. As discussed, the schemes have to adhere to the guidelines laid down in Annex I and II respectively¹⁹ which seek to prevent excess remission or withdrawal.

The basic regulation provides that when there is an allegation of excess remission or withdrawal in respect of input consumption in production process or substitution drawback the commission must normally first determine whether the government of the exporting country has in place a verification mechanism²⁰. This would ensure that the goods on which duty is exempted are actually used in the production process²¹ or enable the government to demonstrate in the case of substitution drawback that the quantity of inputs for which drawback is claimed does not exceed the quantity of similar products exported²². In respect of substitution drawbacks the commission had even pointed out that since imported goods do not need to be of the same quantity and characteristics as the domestically sourced inputs that were used for export production under the DEPB scheme as required by Annex III of the basic regulation guidelines on substitution drawbacks they did not constitute a valid substitution drawback scheme²³.

When no such verification procedure exists or the one in question is not reasonable or effective a further examination by the exporting country based on the actual inputs involved would need to be carried out²⁴ to determine whether a subsidy arises by way of excess remission or drawback.

The European Commission has taken the position that the DEPB constitutes a subsidy within the meaning of article 2(1) (a) (ii) and article 2(2) of the basic regulation²⁵. DEPB credit was deemed to be a financial contribution of the GOI as the duty credit would ultimately be used to offset the import duties decreasing thereby the GOI's duty revenue which would

18 Ibid.

19 Id.

20 Annex II(4); Annex III(2), Regulation 2026/97.

21 Annex II(4), Regulation 2026/97.

22 Annex III (2), Regulation 2026/97.

23 Commission Regulation (EC) No 1338/2002, 22 July 2002, imposing a definitive countervailing duty and collecting definitively the provisional countervailing duty imposed on imports of Sulphanilic Acid originating in India, Official Journal of the European Community, 196, 25 July 2002, pp 1-8.

24 Annex II (5), Annex III (3), Regulation 2026/97.

25 Commission Regulation (EC) NO 367/2006, 27 February 2006, imposing a definite countervailing duty on import of polyethylene terephthalate (PET) film originating in India following an expiry review pursuant to article 18 of Regulation (EC) NO 2026/97, Official Journal of the European Community 68, 8 March, 2006, pp 15-36.

otherwise be due accompanied by the conferral of a benefit in light of heightened liquidity of the company which otherwise would not be available. Export contingency requirement, as provided in article 3(4) of the basic regulation, is met as credits can be obtained only on exports. In a prior EC regulation in respect of certain graphite electrode systems originating in India²⁶ the European Communities had objected to the provision in the DEPB whereby the DEPB credits could be sold in the open market deeming it to be a financial contribution by way of grant as it involved a direct transfer of funds as the credits could be sold in the market for cash.

On the question that offset of duty in inputs used in the production process and substitution drawback were acknowledged by the WTO subsidies agreement and the EC's basic regulation itself, the European Communities took the position that if such a measure was to be deemed consistent with the basic regulation, and a permissible duty drawback or substitution drawback system it would have to adhere to the textual guidelines of the regulation put forth in Annex II and III as discussed above²⁷.

It stated that an exporter was under no obligation to actually consume the goods imported duty free in the production process and that the amount of credit was not calculated in relation to actual inputs used. The commission did not address the question of whether excess remission or offset was actually taking place. Absence of a verification mechanism or other system or procedure to ensure that the inputs on which duty was offset, as discussed above, was actually consumed in the production process was held to be a ground for which the scheme could not be deemed a permissible duty drawback mechanism²⁸. Annex II (5) and Annex III (3) allow for the commission itself to carry out an examination to determine whether there was excess withdrawal or remission, something which the commission has refused to do in respect of the DEPB scheme. The commission has clearly proceeded on a literal interpretation of provisions. It may be noted that a specific mechanism of duty drawback is not specified in the subsidies agreement or the basic regulation²⁹. Under such circumstances the position of the European Commission holding goods benefiting from the DEPB scheme as recipients

26 Commission Regulation (EC) No 1008/2004, 19 May 2004, imposing a provisional anti subsidy duty on imports of certain graphite electrode systems originating in India Official Journal of the European Community 183, 20 May 2004, pp 35-60.

27 Supra Note 24.

28 Supra Note 26.

29 basic regulation, Annex II (5). Also see JONATHAN BRANTON (1999), When is a duty drawback not a duty drawback? Case study on the operation of the E.C. Anti-subsidy Regulation, 5(4) International Trade Law Reporter 93-96, At 94.

of EC law inconsistent subsidies may be defeating the very rationale with which the drafters of the SCM designated duty drawback mechanism as a permissible subsidy.

3.2 Export Promotion Capital Goods Scheme

Export Promotion Capital Goods (EPCG) scheme is provided for in chapter 5 of the Foreign Trade Policy 2004-09 and in chapter 5 of the Hand Book of Procedures, 2004-09. It is essentially a scheme by virtue of which capital goods to be used in the production or manufacture of the resultant export product specified in the EPCG license is permitted at a concessional rate of customs duty. Import of capital goods may be for pre production, production, and post production stage and is fixed at 5% customs duty³⁰. In respect of the scheme by virtue of the Annual Supplement 2007 of the Foreign Trade Policy, certain modifications and additions have been made. These include raising to 12 years the export obligation for tiny and cottage sector, allowing issue of import of spares, tools, and spare refractory for existing plant and machinery, and the abolition of the block wise export obligation, as discussed below, keeping in mind the avoidance of unnecessary cost and paper work. Present policy in turn would be that in case of export obligations fresh EPCG certificate would be issued only to such applicant who has fulfilled proportionate export obligations by that time.

The crucial point of consideration is that unlike the offset of duties on inputs actually consumed in the production process, the offset of duties in capital goods is not viewed as a permissible subsidy, on the simple premise that a capital good, for instance plant and machinery, is not actually consumed in the production process in accordance with the text of Annex II and III of the basic regulation. Therefore such exemption is not deemed a permissible duty drawback or substitution drawback scheme. In the Commission Regulation (EC) No 193/2007 of 22 February 2007 imposing a definite countervailing duty in imports of PET originating in India following an expiry review pursuant to article 18 of Regulation NO 2026/97³¹, in what reflects the latest position of the Community in respect of the scheme the commission reiterated the position of prior EC regulations namely, Commission Regulation 1008/2004 as also Commission Regulation 367/2006 that by virtue of the EPCG scheme there was a provision of a subsidy within the meaning of

30 Chapter 5, Foreign Trade Policy, 2004-09.

31 Official Journal of the European Community 59, 27 February 2007, pp 34-59.

article 2(1)(a)(ii) and article 2(2) of the basic regulation. Revenue it was argued was being foregone as a result of offset of such import duty and the subsequent benefit as a result of the heightened liquidity of the benefiting corporation. A commitment to export which preceded such license makes the subsidy export contingent, hence, specific and countervailable. This gives rise to an interesting proposition. It may be noted that the subsidy need not be pertaining to exports alone. Capital goods so imported may be used for domestic production as well. However, the fact nevertheless remains that the subsidy is *de jure* dependent on export performance with an explicit requirement in the foreign trade policy and its 2007 supplement requiring export performance.

India, in its first submission to the Negotiating Group on Subsidies and Countervailing Measures way back in 1989 prior to the subsidies agreement coming into force, had criticised the physical incorporation test describing it as bad from the point of view of equity and economic efficiency, placing multi stage cumulative tax systems at a disadvantage in respect to countries with value added tax systems where it argues that there is no impediment to an exporter collecting full credit for prior stage tax paid on inputs³². WTO jurisprudence today does not acknowledge that a determination of what is a prohibited export subsidy should be decided based on whether the measure at issue merely serves to offset advantages bestowed on competing products from another Member country³³. India's argument in crux was that irrespective of whether some inputs are physically incorporated, tax on them should be allowed for remission given that all inputs have a price raising effect. Such a proposition does not however reflect in the present day SCM.

On 15 December 2002 the General Council adopted a decision that mandates the SCM Committee to examine as an important part of its work the issues of aggregate and generalised rates of remission of import duties and the definition of 'inputs consumed in the production process', taking into account the particular needs of developing country members on 15 December 2002³⁴ which in turn facilitated a debate in this area of WTO law. A specific amendment, however, is yet to be made to such effect in the subsidies agreement.

32 Submission by India to the Negotiating Group on Subsidies and Countervailing Measures, MTN.GNG/NG10/W/33, 30 November 1989.

33 Panel Report, Brazil – Export Financing Programme for Aircrafts, WT/DS46/R., Para 7.25.

34 Paragraph 6.3 of the General Council Decision of 15 December 2000, WT/L/384.

The Government of India has taken the position before the WTO Negotiating Group on Rules (Agreement on Subsidies and Countervailing Measures) that capital goods should not be left out of the ambit of permissible drawbacks as laid down in Annex II and III as they could be deemed to be used to the extent of their depreciation and actual consumption.³⁵ India has criticised the exclusion of capital goods as hitting at the basis of General Agreement on Tariff and Trade (GATT) 1947 that no product must be subject to countervailing duty 'by reason of the exemption of such product from duties or taxes borne by the like product when destined for consumption in the country of origin or exportation, or by reason of the refund of such duties or taxes'.³⁶ It argues that the basis of this was the destination principle of indirect taxation³⁷ from which the SCM has deviated, a deviation which could be suitably amended by an amendment to footnote 61 of the SCM which specifies the ambit of the physical incorporation requirement³⁸. However, in the absence of such a proposal taking the concrete shape of WTO law, India's EPCG scheme shall continue to be deemed a countervailable export subsidy.

3.3 Export Oriented Units/Special Economic Zones

3.3.1 *Export Oriented Units*

The export Oriented Units (EOU) scheme finds mention in chapter 6 of the Foreign Trade Policy, 2004-09. Benefits of such a scheme extend to units undertaking to export the entire production of goods or services except permissible sale to the Domestic Tariff Area³⁹ (DTA), i.e., the domestic market. An EOU Unit may import and/or procure from the DTA/international exhibition held in India without payment of duty of all types of all kinds of goods and services including capital goods required for its activities⁴⁰ as also reimbursement of central sales tax on goods procured from DTA,⁴¹ and exemption from excise duty⁴². Such an exemption extends to second hand capital goods as well⁴³. EOU is also a beneficiary of certain income tax con-

35 Third Submission by India to the Negotiating Group on Rules (Agreement on Subsidies and Countervailing Measures). TN/RL/W/120, 16 June 2003.

36 Ibid.

37 Id.

38 Id.

39 Para 6.1, Foreign Trade Policy.

40 Para 6.2(b), Foreign Trade Policy.

41 Ibid. 6.11 (c) (i).

42 Id. 6.11 (c) (ii).

43 Id. 6.3.

cessions⁴⁴ by virtue of section 10 (A) and section 10 (B) of the Indian Income Tax Act, 1961.

The EOU scheme has been deemed to be a countervailable subsidy by the European Communities in the Commission Regulation 367/2006 of 27 February, 2006⁴⁵. Point of objection to the EOU scheme by the Community remains on the Commissions' view that the exemption from import duty, i.e., basic customs duty, special additional customs duty, and the reimbursement of sales tax are financial contributions of the GOI within the meaning of article 2(2) of the basic regulation, by way of revenue foregone by the GOI which enhances the liquidity position of the beneficiary enterprise. Exemption on excise duty and additional customs duty, usually equivalent of the excise duty was however deemed not to be a financial contribution, by way of revenue foregone otherwise due, as such duty paid could be used as a credit for its own future duty liabilities, under the then Central Value Added Tax (CENVAT) credit system, which made these duties not definite⁴⁶. By the means of CENVAT credit only an added value bears a definite duty, not the input materials⁴⁷. The issue was whether offset on duty for inputs could also be challenged, or whether it would be a tantamount to a permissible duty drawback mechanism as envisaged by the SCM and basic regulation. The European Commission, while noting that exporters were legally obliged to maintain proper accounts of all imported material and of the exports made in accordance with chapter 6.11.1. of the Handbook of Procedures, 2004-09 which had to be submitted periodically to the competent authorities through quarterly and annual progress reports, objected to the provision that at no point of time shall an EOU be required to correlate every export consignments with its exports, transfer to other units, sales in DTA, or stocks as provided in chapter 6.11.2. of Handbook of Procedures, 2004-09. The provision it opined would hinder the abilities of Indian authorities to obtain information about the final destination of inputs so as to ensure that the duty/sales tax exemptions do not exceed duty actually charged on inputs for export production⁴⁸. This way there could be a possibility of excess remission of sales tax⁴⁹ and import charges⁵⁰. Moreover, the fact that fifty percent of the annual turnover could be sold on the domestic market and no legal obligation existed to export the entire product, with domestic trans-

44 *Id.*, 6.12(b).

45 *Supra* Note 25.

46 *Ibid.*

47 *Id.*

48 *Id.*

49 See Annex I (h), Regulation 2026/97.

50 See Annex I (i), Regulation 2026/97.

action taking place without the supervision of a government official, subject only to a self certification process, did not go well with the investigating authorities. The provision it pointed out increased the need for a control over the duty free inputs and resultant export product to ensure that duty or tax offset was actually on inputs incorporated in exports.

It affirmed that the EOU scheme could not constitute in respect of offset of duty on inputs a permissible duty drawback mechanism as they did not confirm to the guidelines laid down in Annex I to III of the regulation. Lack of a proper verification system or a further examination based on actual inputs involve has become a serious impediment in India's attempt to subsidise inputs, *a prima facie* legal measure under WTO law. Monthly tax returns filed for domestic sales on a self assessment basis periodically assessed by the Indian authorities was also deemed not to be adequate by the commission as the purpose of such was not to control the destination of inputs but to monitor excise duty. India in its third submission to the WTO Negotiating Group on Rules⁵¹ has submitted that the verification of inputs that are actually consumed in the production process in each transaction for every unit is not practical and places an onerous burden due to the prevalence of a large number of small and medium enterprises which are not concentrated in and around certain areas but are dispersed all over the country including remote areas. The administrative machinery required for such verification, India has pointed out may not be commensurate to the extent of duty concessions extended by the GOI⁵². India has suggested that one manner of addressing the problem is to have a reasonable verification mechanism wherever standard input-output norms or similar averaging procedures are developed fairly and systematically for determining the average amount of various inputs required for the manufacture of one unit of the final product. The same in turn is used to determine the amount payable to the exporter on account of remission of indirect tax or import duties. Such suggestion, however, is yet to be incorporated in the law on subsidies of the WTO. In the absence of such, investigating authorities in the European Communities have sufficient leeway to apply the literal rule in interpretation of their domestic law on subsidies. It, however, makes sense to note that the object of WTO law is to avoid excess remission of duties. Guidelines are framed in pursuance of that objective. An overemphasis on the procedure at the expense of the end it seeks to achieve may be self defeating for world trade. It is worthy to note that while on a broader scale, it is the state

51 Third Submission by India to the Negotiating Group on Rules, TN/RL/W/120, 16 June 2003.

52 Ibid.

which may suffer; the immediate victims are individual companies in anti subsidy investigations. Therefore a company using the scheme in a perfectly legitimate manner may find itself on the wrong side of the community law. The community law itself authorises the commission to carry out a further examination of its own to determine excess remittance or drawback of indirect taxes⁵³. The European Commission did not use such discretion opining instead that the scheme was not a valid duty drawback mechanism, just as it did in the case of the DEPB scheme.

EOUs are entitled to a deduction of such profits and gains from their total income as are derived by a hundred percent export oriented undertaking from the export of articles or things or computer software for a period of ten consecutive years beginning with the assessment year relevant to the previous year in which the undertaking begins to manufacture or produce articles or things or computer software⁵⁴.

The measure could easily be captured by item(f) of the illustrative list of export subsidies⁵⁵ which prohibits the allowance of special deductions directly related to exports or export performance over and above those granted in respect of production for domestic consumption, in the calculation of the base on which the direct tax are charged. Since the condition of exports is a prerequisite for the establishment of such EOU, such relation to exports, as envisaged by the said provision, already exists. Tax concessions would invariably be a financial contribution in the form of revenue foregone otherwise due, as a legitimate source of revenue in the form of direct taxes, is foregone, which no doubt confers a benefit on terms more favourable than that available in the market. Income tax exemptions therefore could be tantamount to a countervailable subsidy.

3.3.2 *Special Economic Zone*

A Special Economic Zone is a designated duty free enclave to be treated as a foreign territory only for trade operations and duties and tariffs. SEZs are now regulated by the Indian Special Economic Zones Act, 2005 and the subsequent Special Economic Zones Rules, 2006. SEZ Act provides that

53 Annex II (5), Regulation 2026/97 Also see JONATHAN BRANTON, When is a duty drawback not a duty drawback? Case study on the operation of the E.C. Anti-subsidy Regulation, Int. T.L.R. 1999, 5(4), 93-96, At 95.

54 Section 10 A (1) Indian Income Tax Act, 1961.

55 Annex I (f), Regulation 2026/97.

developers of SEZ and entrepreneurs shall be exempt from certain exemptions, drawbacks, and concessions including duty of exemption from customs and excise tax⁵⁶ on all goods freely importable which would include capital goods. The issues of concern in respect of the compatibility of SEZ scheme are essentially on two counts. (1) The exemption of capital goods and inputs from payment of duty (2) income tax concessions granted to the developers and entrepreneurs in SEZ.

Production in an SEZ is bound for exports and only under conditions specified in the Act and the SEZ Rules could such production be sold in the Domestic Tariff Area⁵⁷ or in the home territory of the state in question. Law of the SEZ does not take into consideration concerns on duty exemption of capital goods as they are, unlike inputs consumed in the production process not acknowledged as a permissible subsidy under the WTO or community regime. To the extent an exporter benefits from import of capital goods, his goods remain subject to countervailing duty.

A closer study, however, is important to determine whether the offset of duties on inputs in the SEZ takes into account the concerns over the lack of a verification mechanism or examination of accounts by the GOI felt in respect of the Duty Entitlement Pass Book scheme and the EOU scheme. The primary test is laid down in Annex I to III to determine whether in respect of the SEZ scheme, India has a proper verification mechanism in place to determine whether the goods are consumed in the production process and in what amounts.

It is to be observed that it is indeed unusual for a manufacturer to import certain goods and not make use of it either in the production process itself or otherwise. A manufacturer has certain options available to it. (1) He could use it for goods destined for exports as it is supposed to do. (2) He could sell it in the DTA either as part of the final product or directly. (3) Sell it within the SEZ. (4) Keep it idle or alternatively (5) it could be stolen and in such way defeat the purpose of the exemption. If these practical problems are sufficiently addressed by the Indian laws on SEZ, then it could ensure the purpose of the exemption is met.

We could proceed with the help of an illustration: X imports 100 tones of inputs. He utilises 60 tones which are actually incorporated into the final pro-

56 Section 26, Indian Special Economic Zones Act, 2005.

57 Section 30, Indian SEZ Act; Rule 47, Indian Special Economic Zones Rules.

duct. He remains with 40 tones of duty free imports which he could sell in the domestic market and make a profit thereof. Such an advantage shall no doubt be undue.

The SEZ is a physically separate territory. Any sale which entails removal of the product from the SEZ is highly regulated and removal from SEZ to DTA would attract customs duty and other duties as may be applicable by virtue of SEZ Act and Rules⁵⁸. This keeps the manufacturer in a definite dilemma. In line of our illustration: if X imports 100 tones and incorporates only 60, he would nevertheless like to get return in some form from the remaining forty. No manufacturer would like to keep his inputs idle as the same shall not be a sound business decision irrespective of how much duty is saved on such transaction. Neither would such be permitted by the SEZ Rules⁵⁹ which would require that the entrepreneur refund an amount equal to the exemption, drawback, cess or concession availed in respect of duty free import or goods in the event of non utilisation of the same in the manufacturing process. Of course there remains the possibility of sale within the SEZ but the same would not serve any beneficial purpose as such goods are anyway available duty free and in light of an additional condition of maintaining accounts of imports consumed as discussed below, more difficult as well. The SEZ Rules⁶⁰ provides that grant of exemption, drawbacks, and concessions to the entrepreneur or developer shall be subject to the condition that the unit shall execute a bond *cum legal* undertaking in form H with regard to proper utilisation and accounting of goods including capital goods, raw materials, and other inputs. The Unit in question shall be obliged to maintain accounts on all goods imported or procured from the Domestic Tariff Area or consumed and utilised in proper form including those that remain in stock and those sent temporarily outside the SEZ in the DTA would be under the obligations of the Units and accounts for such would be produced for inspection of the Specified Officer or Authorised Officer⁶¹. Rule 22(2) of the SEZ Rules, 2006 stipulates that every unit and developer shall maintain proper accounts, financial year wise and such accounts shall indicate in clear value terms, the goods imported or procured from the DTA, consumption or utilisation of goods, production of goods including by products, waste or scrap or remnant, disposal of goods manufactured, or produced by way of exports, sales or supplies to the DTA or transfer to SEZs and other Export Oriented Units.

58 Supra Note 57.

59 Rule 22(1), Indian SEZ Rules, 2006.

60 Rule 22(1) (i) SEZ Rules, 2006, Rule 22(1) (i).

61 Form H, Point (5), SEZ Rules, 2006.

Bond H provides that in the event of theft the Unit in question shall be responsible for payment of customs duty for such amount or unit stolen.

The sale to a DTA is to be considered as an import and customs duty is to be levied. The SEZ Act, 2005 states that subject to the Rules made by central government any goods removed by the central government any goods removed from the SEZ to the DTA shall be chargeable to duties of customs including anti dumping, countervailing, and safeguard duties⁶², a position reiterated by the SEZ Rules⁶³. Therefore any benefit that may have accrued from prior duty exemption is automatically negated. The whole position may be summed up with the help of a simple illustration.

100 Units are imported into the SEZ. Let us assume 1 Unit of input is required per one resultant end product. 70 Units of input/end product are exported. The manufacturer is left with 30 Units. The manufacturer will have to make good the duty or exemption in respect of the 30 Units if only 70 Units are manufactured in accordance with Rule 25 cited above.

On the alternative: If X has utilised the entire production of 100 Units but could only export 70 units, he has the option to sell it into the DTA. In that case the good in question would be subject to import duty negating any benefit of duty free inputs.

All the concerns raised above are sufficiently met by the Indian laws pertaining to SEZ. This gives rise to a conclusion that duty free inputs are bound to be utilised for production for primary exports as not only is it legally required to do so but also because the uniqueness of the SEZ scheme ensures that it has no visible choice. In the cases that it does sell in the domestic market the benefit is negated. Thereby an adequate check and balance is present which should adequately meet the requirement for a verification mechanism or examination of accounts by the government, and more importantly ensure that the possibility of excess remission is negated.

Chapter VI, section 27 of the SEZ Act provides for the modified application of the Indian Income Tax Act, 1961 in relation to the developer or entrepreneur in respect of authorised operations in an SEZ or unit subject to the modifications specified in the second schedule of the SEZ Act. The special provisions in respect of newly established units in SEZ⁶⁴ provide for a de-

62 Section 30(b), Indian SEZ Act, 2005.

63 Ibid.

64 Section 10 AA, Indian Income Tax Act, 1961.

duction of hundred percent of profits and gains derived from the export of articles or things as also from services for a period of five consecutive assessment years beginning with the assessment year in which the units starts manufacturing such articles or providing services⁶⁵. For the next five consecutive assessment years which follow fifty percent of the profit is debited to the profit and loss account of the previous year in respect of which the deduction is allowed⁶⁶. Such amount is then credited to a Special Economic Zone Re-investment Reserve Account⁶⁷ which is to be utilised as per the direction laid down in clause (2) of section 10 AA which includes purposes like purchase of plant and machinery. Failure to such mandate means that tax shall be charged accordingly⁶⁸ negating thereby any benefit which could possibly have accrued.

As discussed in light of the EOU scheme, the extension of concessions would be tantamount to an export subsidy as covered by item (f) and the general provisions laid down in article 3(4) of the basic regulation. Such benefits being directed towards units in SEZ, which in turn as discussed above is export oriented making the scheme countervailable.

3.4 Focus Product/ Market Scheme

Introduced by the Annual Supplement, 2006 to the Foreign Trade Policy, the scheme aims at increasing India's share in world trade. As the names itself suggest, while the objective of the Focus Product scheme is to give impetus to certain sectors, the Focus Market scheme seeks to enhance India's share in respect of certain notified markets⁶⁹.

3.4.1 Focus Product Scheme

The scheme provides incentives for export of products which have a high employment potential in rural and semi urban areas in order to offset the inherent infrastructure bottlenecks and other associated costs involved in marketing of such products. FPS scheme allows duty credit facility at 2.5% of the free on board (FOB) value of exports to fifty percent of the exports

65 Section 10 AA (1) (i), Indian Income Tax Act, 1961.

66 Section 10 AA (1) (ii), Indian Income Tax Act, 1961.

67 Ibid.

68 Section 10AA (3), Indian Income Tax Act, 1961.

69 Appendix 37(c), Handbook of Procedures.

turnover of notified products such as value added fish and leather products, stationery items, product bearing handloom and handicraft items⁷⁰.

Duty credit so obtained may be used for import of inputs or goods including capital goods provided that the same is freely transferable. The scrip and the items imported against it are freely transferable⁷¹.

It is worth noting that such scheme could constitute easily an export subsidy. A financial contribution arises as the duty scrip is finally to be used to offset duty due to the GOI in the form of customs duty⁷². Since the GOI foregoes revenue it would constitute a financial contribution. Transferability of the duty scrip further ensures that the seller of such scrip is in a position to enhance its liquidity position. Both these would result in a benefit⁷³, as these are available on terms more favourable than that available in the market⁷⁴. Subsidy so granted is export contingent making it that much closer to inconsistency with EC and also WTO law. India could not possibly argue that the subsequent offset of duty on input and capital goods could constitute a legitimate duty drawback mechanism as envisaged in Annex (i) of the basic regulation as the purpose of the scheme is in no way to exempt duty on goods actually consumed in the production process bound for exports, but such is only a benefit subsequent. In addition there is no verification mechanism, nor is duty offset on capital goods as discussed above legitimate.

For such reason there remains the definite possibility that India's Focus Product scheme shall constitute an export subsidy.

3.4.2 *Focus Market Scheme*

The Focus Market scheme was introduced with a view to offsetting the high freight cost and other disabilities faced in accessing international markets⁷⁵. The initiative shall enhance India's export competitiveness in the region. FMS scheme allows duty credit facility at 2.5% FOB value of exports of all products to the notified country. The Annual Supplement of 2007 has ex-

70 Annual Supplement, 2006 to the Foreign Trade Policy.

71 *Supra* Note 70.

72 Art 2.1(a) (ii), Regulation 2026//97.

73 Art 2.2, Regulation 2026//97.

74 European Communities – Countervailing Duties on DRAMS Chips from Korea, WT/DS299, Para 7.175. Also see United States – Imposition of Countervailing Duties on Certain Hot Rolled Lead and Bismuth Carbon Steel Products Originating in the United Kingdom, WT/DS138/R. Para 67.

75 Annual Supplement 2006 to the Foreign Trade Policy 2004-09.

panded the scope of such notified countries by including Commonwealth of Independent States countries in addition to countries notified in the prior year from African and Latin American States.

While such a duty offset on freight could be captured by item (c) of the basic regulation which defines as an export subsidy, the provision of freight charges on terms more favourable than on domestic shipments, since the target destination is not the European Communities, it may *prima facie* seem that it may not be an area of concern for the community. However, we need to bear in mind that the fact that since such duty credit could very well be used to subsidised exports to the community, countervailing investigations against such scheme remains a definite possibility. An illustration could further clarify.

'X' is an exporter of iron and steel who exports both to a notified Latin American State as also the European Communities. On exports bound for Latin America he receives a duty credit along the lines specified above. The same duty credit is utilised in offsetting customs duty on imported capital goods. Since the line of production will not be any different, such capital goods shall be used for manufacture of goods destined for the Community.

Alternatively X could sell such duty credit to a manufacturer or import capital goods for a manufacturer who exports to the Community, in light of the freely transferable provision of such duty scrip.

In such an event there is a transfer of benefits from the focus market intended to another market. That would be tantamount to a financial contribution in way of revenue foregone which confers a subsequent benefit. The provision being on exports, such subsidy would constitute an export subsidy by virtue of which it could be subjected to countervailing duty investigations under article 3 of Regulation 2026/97.

3.5 Export Credit Scheme of the Reserve Bank of India

Export Credit scheme of the Reserve Bank of India (RBI) operates through two related schemes. One of them is the Rupee Export Credit scheme and the Export Credit scheme of the RBI in respect of foreign currency. Both these schemes are granted at a pre shipment as well as on a post shipment stage. The pre shipment packing credit scheme means any loan or advance granted or any other credit provided by a bank to an exporter for financing

the purchasing, processing, manufacturing, or packing of goods or services on the basis of a letter of credit opened in favour of some other person on the production of evidence reflecting an intent to export. Post shipment credit on the other hand means any loan or advance granted or any other credit provided by a bank to an exporter of goods/services from India from the date of extending credit after shipment of goods/rendering of serving of goods or services to the date of realisation of export proceeds and includes any loan or advance granted to an exporter in consideration of or on the security of any drawback duty. The same may be in Indian rupees or foreign currency as stated above with the latter seeking to make available foreign currency to Indian exporters at internationally competitive prices in respect of exports. The Export Credit scheme has been deemed to be a counter-vailing subsidy in the Commission Regulation 193/2007. The position of the investigating authorities was that by virtue of these schemes, a maximum ceiling was imposed by the RBI as to the rate of interest which could be charged. As a result commercial banks were bound to a reduced lower rate of interest on credit given to exporters than it could have charged under normal market conditions. Such, was determined, would constitute a subsidy within the meaning of article 2(1) (a) (IV) of Regulation 2026/97 in *pari materia* with article 1.1(iv) of the SCM. The relevant provision in essence deems a subsidy to exist when a government makes a payment to a funding mechanism or entrusts or directs a private body to carry out one or more of the types of functions illustrated in points i, ii and iii which pertain to direct transfer of funds, foregoing of revenue otherwise due or the provision of goods and services other than general infrastructure and the subsequent conferral of benefit as stipulated in article 2.2.

Direct inconsistency of the scheme is on three principal grounds. (1) The scheme is brought into operation by the RBI, which constitutes a public body for the purpose of Regulation 2026/97, and by virtue of article 1(3) would be deemed to be a government for the purpose of EC law as it is owned hundred percent by the GOI and pursues policy objectives. (2) There exists a financial contribution by the commercial banks in the form of provision of credits for export at preferential rates which constitute a direct transfer of funds within the meaning of article 2.1(a) (i) of the basic regulation which takes place under the directions of the RBI, deemed as discussed above to be the government. Benefit is conferred on the recipient as the terms of interest are more advantageous than that otherwise available in the market. (3) Such a scheme is available only for exports and is therefore an export subsidy within the meaning of article 3(4) of the SCM and

more important for our purpose the basic regulation⁷⁶. Annex I (k) of the basic regulation and SCM defines as an export subsidy

The grant by governments (or special institutions controlled by and/or acting under the authority of governments) of export credits at rates below those which they actually have to pay for the funds so employed (or would have to pay if they borrowed on international capital markets in order to obtain funds of the same maturity and other credit terms and denominated in the same currency as the export credit), or the payment by them of all or part of the costs incurred by exporters of financial institutions in obtaining credits, in so far as they are used to secure a material advantage in the field of export credit terms.

There are therefore three prerequisites which have to be met:

First, grant of export credits are at rates below the market rate. Second, the grant should be from the government or some special institution controlled by or acting under the authority of the government. Third, there should be some form of material advantage. WTO jurisprudence establishes that in identifying an appropriate benchmark for determination of the market rate a WTO Member must show that the benchmark on which it relies is based on evidence from relevant, comparable transactions in the market place⁷⁷. Under the Rupee Export Credit System the appropriate benchmark could be the prime lending rate as it forms a universal lending rate prescribed by the RBI irrespective of whether the industry exports or sells domestically. Since the rate is below the market rate there is the possibility of a payment. In respect of the foreign currency credit scheme the question is more complicated. RBI by notification has fixed the ceiling at 100 basic point or 1% over the London Inter Bank Offering Rate (LIBOR) which is the reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale money market and the Euro Inter Bank Offered Rate (EURIBOR) that is the daily reference rate based on the averaged interest rates at which banks offer to lend unsecured funds to other banks in the Euro wholesale money market. This gives rise to the question of which would be the appropriate benchmark. If the LIBOR or EURIBOR rates are taken into consideration there may be no supposed grant as the rates are above the market rate but if the Indian banking market in respect of the foreign currency is taken there is a

⁷⁶ Art 3.4(a), Regulation 2026/97.

⁷⁷ Brazil -Export Financing Programme for Aircrafts, Report of the Appellate Body (article 21.5 of the DSU) WT/DS/46/AB.

possibility of a grant or payment as the rate is ceiled and the commercial banks may not be able to charge more than the specified rate. Therefore there is no commercial consideration in respect of the transaction. The EU seems to have relied on the latter in determining the existence of a financial contribution in respect of this scheme.

Second, the question is whether there is a grant by a government or special institution controlled or acting under the authority of the government. Here it may be noted that the actual credit reduction is given by the commercial banks though they act under the supervision of the RBI which could be deemed to meet the definition of government by being a public body along the lines envisaged in the SCM⁷⁸ or the basic regulation⁷⁹. Since it is the RBI which directs the commercial banks to make such payments, the parameters of financial contribution as provided in article 2(1) IV of the basic regulation are met.

Third, we come to the question of material advantage. In Brazil-Aircraft the Appellate Body took the position that Brazil could prove that its interest equalisation scheme did not secure a material advantage if it could prove that the rates granted were above the benchmark market rates or that there is an alternative benchmark more suitable for such examination. In the facts of this instant case the rates are below the market rate in respect of rupee export credit and also below rates in respect of foreign currency if the domestic banking market rate for foreign currency is taken into consideration. The argument in respect of LIBOR/EURIBOR as the alternate benchmark would depend on whether domestic exporters actually avail of foreign currency from such London or European banks determined on the basis of transactions of the exporters as stipulated above. The position in 2007 in respect of the scheme was that by virtue of the notification dated, 12 April 2007 the ceiling on export credit scheme up to 180 days and post shipment credit up to 90 days was stipulated at 2.5 percent below prime lending interest rate available valid up to 31 October 2007. In respect of foreign currency the notification dated, 18 April 2006 stipulates the interest rate at which foreign currency shall be made available. Legal arguments kept aside the fact remain that an exporter who benefits or continues to benefit from the same shall find himself at the receiving end of countervailing duty investigations in the Community.

78 Art 1.1(a) (1), SCM.

79 Art 1(3), Regulation 2026/97.

4 Conclusion

A WTO consistent approach to subsidies remains essential to ensuring that Indian exporters are not at the receiving of countervailing duty investigations in the European Community, one of its most important markets. Innovation in means in respect of permissible subsidies, as observed in respect of the DEPB scheme for instance makes it clear that, innovation has its own share of risk. Nevertheless it may make sense for the Community to base their investigations with due respect to the market. The essential focus of world trade is on restricting unfair trade practices such as export subsidies. To focus unduly on the procedure may in some cases run contrary to the very end it seeks to meet. Trade law cannot be interpreted in clinical isolation from the market for it is indeed the market where all aspects of trade, domestic and international are decided.

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Indian Exports at Crossroads: Why the European Community is Subjecting Indian Goods to Countervailing Duties

Sagnik Sinha

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The European Community represents one of the primary destinations for Indian goods accounting for one fifth of Indian exports. Indian goods have been at the receiving end of a significant majority of anti subsidy investigations initiated by the European Commission. Such goods have been alleged to be benefiting from subsidies inconsistent with Council Regulation 2026/97 which forms the legal basis for anti subsidy investigations initiated by the Commission. The paper puts forth an analysis of India's export incentive schemes including old schemes already subjected to challenge as well as new schemes vulnerable to challenges in future investigations with regard to the Council Regulation 2026/97 and the WTO Agreement on Subsidies and Countervailing Measures.

Die Europäische Union ist eines der wichtigsten Ziele der indischen Exportgüter. Rund ein Fünftel der indischen Exporte gehen in die Europäische Union. Diese Güter waren in letzter Zeit einem Grossteil der Antisubventionsverfahren, welche von der Europäischen Kommission initiiert wurden, ausgesetzt. Die Güter sollen angeblich von Subventionen profitieren, die der Verordnung Nr. 2026/97 des Rates widersprechen. Diese bildet die Rechtsgrundlage für jene von der Kommission initiierten Antisubventionsverfahren. Der Artikel präsentiert eine Analyse der indischen Exportförderung, sowohl von alten Massnahmen, die bereits angefochten wurden, als auch von neuen Massnahmen, welche wohl auch künftigen Untersuchungen mit Bezug auf die Verordnung Nr. 2026/97 des Rates und das WTO-Übereinkommen über Subventionen und Ausgleichsmassnahmen ausgesetzt sein werden.

Buchbesprechung – Book Review

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