

# ACHIEVING WORLD TRADE ORGANIZATION COMPLIANCE FOR EXPORT PROCESSING ZONES WHILE MAINTAINING ECONOMIC COMPETITIVENESS FOR DEVELOPING COUNTRIES

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## ABSTRACT

*Export processing zones (EPZs) are statutorily created investment parks that developing countries establish to attract foreign investment in exchange for government-granted fiscal incentives. At their core, EPZs are a quid pro quo between host governments and investor companies: in exchange for the promise of job creation, technological transfer, economic development, and compliance with export performance requirements, investor companies receive substantial fiscal incentives, such as tax and tariff exemptions.*

*Most EPZ statutes are inconsistent with Article 3.1(a) of the World Trade Organization's Agreement on Subsidies and Countervailing Measures (SCM Agreement) because EPZ incentives qualify as prohibited export subsidies. Fortunately, many developing countries have received exemptions from this prohibition to maintain their EPZ systems. The exemptions, however, are set to permanently expire for many countries on December 31, 2015, spurring the need for EPZ reform.*

*This Note proposes a framework for achieving WTO-compliance for EPZ statutes by conditioning EPZ incentives on an investor company's implementation of standards of corporate social responsibility. This proposal will permit developing countries to*

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*maintain fiscal incentives—thus helping preserve their economic competitiveness as attractive destinations for foreign investment—while also offsetting potential harm that the mandatory elimination of EPZ export requirements may cause to developing-country industries.*

## INTRODUCTION

Just after takeoff, attentive passengers flying out of Managua, Nicaragua's international airport can catch a glimpse of Las Mercedes Industrial Park, a foreign investment park where companies have established operations that employ about twenty four thousand workers.<sup>1</sup> A walk through the investment park's streets will reveal a surprisingly bustling batch of merchants catering to workers and passersby. With such a dynamic pedestrian culture, it may seem as if Las Mercedes were its own city of economic activity, providing employment opportunities for workers and an economic stimulus for the surrounding communities.

Las Mercedes is a quintessential example of an export processing zone (EPZ). EPZs are geographically delimited areas that developing countries establish to attract foreign investment in exchange for fiscal incentives granted by the host government.<sup>2</sup> EPZs, which "range in size from single factories to large cities,"<sup>3</sup> have been called "vehicles of globalization"<sup>4</sup> and "essential tools" of economic growth for developing countries.<sup>5</sup> EPZs employ sixty eight million people worldwide, or about 3 percent of the global workforce,<sup>6</sup> and exist in

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1. CONSULADO GENERAL DE NICAR. EN MIAMI, FLA., NICARAGUA'S EXPORT PROCESSING ZONES 1, available at <http://www.consuladonicamiami.com/pdf/exportprocessingzones.pdf>.

2. Stephen Creskoff & Peter Walkenhorst, *Implications of WTO Disciplines for Special Economic Zones in Developing Countries 7-8* (World Bank, Policy Research Working Paper No. 4892, 2009), available at <http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-4892>. Countries refer to EPZs by varying names, including industrial free zones, export free zones, foreign trade zones, free zones, and investment promotion zones, among others. *Id.*

3. *Id.* at 7.

4. Jamie K. McCallum, *Export Processing Zones: Comparative Data from China, Honduras, Nicaragua and South Africa 1* (Geneva Int'l Labour Office, Working Paper No. 21, 2011), available at [http://www.ilo.org/ifpdial/information-resources/publications/WCMS\\_158364/lang-en/index.htm](http://www.ilo.org/ifpdial/information-resources/publications/WCMS_158364/lang-en/index.htm) (quotation marks omitted).

5. Telephone Interview with Carlos Zúñiga, Dir., Nat'l Comm'n of Free Zones of Nicar. (Nov. 9, 2012).

6. McCallum, *supra* note 4, at 2.

over 119 countries<sup>7</sup> across Asia, Latin America, Eastern Europe, the Middle East, and sub-Saharan Africa.<sup>8</sup>

EPZs bring substantial investment to developing countries. In Costa Rica, for example, EPZs account for about half of all foreign direct investment in the country.<sup>9</sup> In Haiti, former U.S. President Bill Clinton and then-Secretary of State Hillary Clinton helped launch a new EPZ in October 2012 as part of U.S. efforts to help put Haiti on a path toward “sustainable economic growth” and “long-term prosperity.”<sup>10</sup> This EPZ is expected to create twenty thousand jobs and provide homes for five thousand families.<sup>11</sup>

Despite the important role that EPZs play in sustainable economic development, it is not widely known that most EPZs are inconsistent with the World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM Agreement).<sup>12</sup> Article 3.1(a) of the SCM Agreement prohibits “subsidies contingent, in law or in fact . . . upon export performance.”<sup>13</sup> As explained later in this Note, EPZ fiscal incentives qualify as subsidies conditioned on export performance<sup>14</sup> because most EPZ statutes require companies to export most or all of their products as a condition of receiving the statutorily enumerated incentives.<sup>15</sup> Thus, all WTO members that maintain EPZs with fiscal incentives and de jure or de facto export requirements are in prima facie breach of their WTO obligations.

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7. FOREIGN INV. ADVISORY SERV., WORLD BANK GRP., SPECIAL ECONOMIC ZONES: PERFORMANCE, LESSONS LEARNED, AND IMPLICATIONS FOR ZONE DEVELOPMENT 23 (2008), available at <https://www.wbginvestmentclimate.org/uploads/SEZs%20-%20Performance,%20Lessons%20Learned%20and%20Implications%20for%20Zone%20Development.pdf>.

8. *See id.* at 26 tbl.13 (listing the number of EPZs in each region of the world).

9. RICARDO MONGE GONZÁLEZ, JULIO ROSALES TIJERINO & GILBERTO ARCE ALPÍZAR, ORGANIZACIÓN DE LOS ESTADOS AMERICANOS, ANÁLISIS COSTO-BENEFICIO DEL RÉGIMEN DE ZONAS FRANCAS: IMPACTOS DE LA INVERSIÓN EXTRANJERA DIRECTA EN COSTA RICA 2 (2005), available at <http://www.iadb.org/intal/intalcdi/PE/2011/09337.pdf>.

10.  *Clintons Open Haiti Industry Park*, BBC (Oct. 22, 2012, 7:04 PM), <http://www.bbc.co.uk/news/world-latin-america-20037360> (quoting Hillary Clinton, Secretary of State of the United States).

11. *Id.*

12. Agreement on Subsidies and Countervailing Measures, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1A, 1869 U.N.T.S. 14 [hereinafter SCM Agreement].

13. *Id.* art. 3.1(a).

14. *See infra* Part II.

15. *See, e.g.*, Export Processing Zone Act, ch. 280, art. 8.3 (2000) (Belize) (prohibiting the sale of EPZ products in Belize).

Fortunately, Article 27 of the SCM Agreement grants certain developing nations an exemption from Article 3.1(a) by specifying that countries listed in Annex VII of the SCM Agreement are exempt from Article 3.1(a)'s prohibition on export subsidies.<sup>16</sup> Annex VII states that countries identified as either a least-developed country (LDC) by the United Nations or countries with a Gross National Product (GNP) per capita of less than \$1,000<sup>17</sup> are exempt from Article 3.1(a)'s prohibition on export subsidies.<sup>18</sup> When a non-LDC's Gross National Income (GNI) per capita<sup>19</sup> surpasses the \$1,000 threshold for three consecutive years, however, it "graduates" from the list and must comply with Article 3.1(a).<sup>20</sup>

Until recently, this exemption protected many EPZs that would otherwise have violated the SCM Agreement. Even when a developing country neither held LDC status nor had a GNI per capita of less than \$1,000, the WTO Committee on Subsidies and Countervailing Measures (SCM Committee) often granted ad hoc extensions to EPZs,<sup>21</sup> perhaps recognizing how hard developing countries had fought for the exemption during the negotiation of the SCM Agreement.<sup>22</sup>

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16. See SCM Agreement art. 27.2(a) ("The prohibition of paragraph 1(a) of Article 3 shall not apply to . . . developing country Members referred to in Annex VII.").

17. See World Trade Organization, Implementation-Related Issues and Concerns, ¶ 10.1, WT/MIN(01)/17, 41 I.L.M 757, 761–62 (2002). The \$1,000 threshold is in terms of 1990 dollars. *Id.* The peg to 1990 dollars acts as a mathematical hedge against the risk that a country will surpass the threshold solely due to exchange rate fluctuations. For instance, even if the dollar were to depreciate heavily against a foreign currency, the per capita income of the country in 1990 dollars would not change.

18. SCM Agreement Annex VII.

19. The World Bank data series previously published as GNP is now published as GNI. The difference in terminology between GNP and GNI reflects the implementation of the 1993 System of National Accounts. See INTER-SECRETARIAT WORKING GRP. ON NAT'L ACCOUNTS, SYSTEM OF NATIONAL ACCOUNTS 1993 (1993), at 55, 650 (defining GNI). This Note refers to the measure as GNI.

20. SCM Agreement Annex VII. In this Note, those countries that no longer meet either exemption of Annex VII are referred to as graduating countries. As explained, these are the countries that must implement EPZ reform no later than December 31, 2015. See *infra* note 94 and accompanying text.

21. See OFFICE OF THE U.S. TRADE REPRESENTATIVE & U.S. DEP'T OF COMMERCE, SUBSIDIES ENFORCEMENT ANNUAL REPORT TO THE CONGRESS 25 (2010), available at <http://ia.ita.doc.gov/esel/reports/seo2010/seo-annual-report-2010.pdf> ("[In 2009], the Subsidies Committee conducted a detailed review of more than 40 export subsidy programs. At the end of the process, all of the extension requests were granted.").

22. See *infra* Part II.A.

In 2007, the SCM Committee decided to phase out its practice of granting extensions to developing countries that did not meet either condition for the exemption and set a final deadline of December 31, 2015, for making EPZ statutes in these countries WTO-compliant.<sup>23</sup> A 2012 WTO report lists the five countries that have graduated from both conditions and are thus subject to the December 31, 2015, deadline.<sup>24</sup> More importantly, multiple countries that are not on Annex VII's list but have been continuing EPZ regimes with ad hoc extensions<sup>25</sup> must also comply with the 2015 deadline.

Some developing countries subject to the 2015 deadline have tried unsuccessfully to reform their EPZ statutes.<sup>26</sup> Others have succeeded in promulgating EPZ reforms, but their full compliance with Article 3.1(a) is questionable.<sup>27</sup> This Note formulates a strategy for developing countries to use in effectively modifying their EPZ statutes to comply fully with Article 3.1(a)'s prohibition on export subsidies while also maintaining their economic competitiveness and encouraging corporate social responsibility (CSR) by foreign investors.

Both objectives are critical components of EPZ reform. Maintaining economic competitiveness is essential because foreign firms have the ability and resources to relocate easily to another

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23. Report (2007) of the Committee on Subsidies and Countervailing Measures, Oct. 27, 2006–Oct. 25, 2007, ¶ 18 n.6., G/L/840 (Nov. 12, 2007); see OFFICE OF THE U.S. TRADE REPRESENTATIVE & U.S. DEP'T OF COMMERCE, *supra* note 21, at 25 (“An important outcome of these negotiations, insisted upon by the United States and other developed and developing countries, was that [developing countries] have no further recourse to extensions beyond 2015.”). LDCs and countries with GNI per capita of less than \$1,000, however, will continue to enjoy the exemption until they no longer meet either condition because it is only the *extensions* that are discontinued past 2015. *Id.*; see SCM Agreement Annex VII.

24. Committee on Subsidies and Countervailing Measures, *Note by the Secretariat: Updating GNP Per Capita for Members Listed in Annex VII(b) as Foreseen in Paragraph 10.1 of the Doha Ministerial Decision and in Accordance with the Methodology in G/SCM/38*, ¶ 3, G/SCM/110/Add.9 (June 20, 2012). Countries that have reached the \$1,000 threshold include the Dominican Republic, Egypt, Guatemala, Morocco, and the Philippines. *Id.* Several other countries, including the Congo, Cameroon, Guyana, Honduras, India, Indonesia, Senegal, and Sri Lanka have a GNI per capita that is within only a few hundred dollars of the \$1,000 threshold. *Id.*

25. For example, Barbados, Belize, Costa Rica, Dominica, El Salvador, Fiji, Jamaica, Jordan, Mauritius, Panama, St. Kitts and Nevis, and St. Lucia are operating their EPZ regimes based on ad hoc extensions. See Report (2007) of the Committee on Subsidies and Countervailing Measures, *supra* note 23, ¶ 18 n.6. (listing countries that were granted extensions for the 2008 calendar year).

26. See *infra* notes 146–49 and accompanying text.

27. See *infra* Part III.B.1.

country that offers a more attractive legal framework for investment.<sup>28</sup> Developing countries should also reform their EPZs as soon as possible because foreign investors crave legal certainty.<sup>29</sup>

CSR is also an important goal of EPZ reform. CSR is a corporation's commitment to advance positive social change by improving worker conditions, increasing environmental protections, and facilitating community involvement and development.<sup>30</sup> For example, a corporation dedicated to CSR might implement progressive policies such as permitting worker unionization, taking extra precautions to protect the environment, and offering scholarships for higher education to students in the local community. As described later in this Note, conditioning EPZ incentives upon objective standards of CSR will enable countries to comply fully with Article 3.1(a) of the SCM Agreement while maintaining the economic competitiveness of a country's EPZ system.<sup>31</sup> In contrast to other attempted reforms, an EPZ system based on CSR conditions will offer investors much-needed legal certainty that is often a prerequisite to attracting investment.

In addition to providing an economically feasible path to WTO compliance for EPZ systems, CSR can help address cases of inadequate working conditions and the prevention of worker

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28. See Ingrid Franco, *Adozona Espera que Impacto No Sea para el Sector*, LISTIN DIARIO (Nov. 1, 2012, 11:57 AM), <http://www.listin.com.do/economia-y-negocios/2012/10/31/253317/Adozona-espera-que-impacto-no-sea-para-el-sector> (“[A new tax on dividends] may put [the Dominican Republic] at a competitive disadvantage and would be an important factor for the investor to consider . . . .” (quoting Aquiles Bermúdez, President of the Dominican Association of Free Trade Zones) (author's translation)); Kelssin Iván Vásquez, *Inseguridad Promueve Fuga de Maquilas Hacia Nicaragua*, EL HERALDO (July 22, 2012, 6:50 PM), <http://www.elheraldo.hn/Secciones-Principales/Economia/Inseguridad-promueve-fuga-de-maquilas-hacia-Nicaragua> (explaining that investment is flowing from Honduras to Nicaragua because “[t]he government of Nicaragua has a lower minimum wage than [Honduras] and it offers [investors] land to build industrial facilities for free” (quoting Arturo Chávez, Executive Director of the Foundation of Investments and Exports) (author's translation)).

29. Legal certainty is “the ability of people or legal entities to plan their future activities taking the potential legal consequences of their conduct into consideration.” Camilo A. Rodríguez Yong, *Enhancing Legal Certainty in Colombia: The Role of the Andean Community*, 17 MICH. ST. J. INT'L L. 407, 411–12 (2009). For EPZ investors, legal certainty includes knowing whether an EPZ statute is consistent with WTO law. See, e.g., Guadalupe Hernández, *Una Ley Obsoleta No Permitirá Más Inversiones en las Zonas Francas*, EL SALVADOR (Aug. 11, 2011), [http://www.elsalvador.com/mwedh/nota/nota\\_completa.asp?idCat=6374&idArt=6085440](http://www.elsalvador.com/mwedh/nota/nota_completa.asp?idCat=6374&idArt=6085440) (“[I]t is important to define [new EPZ legislation] as soon as possible so [EPZ] investments have legal certainty.” (author's translation)); Vásquez, *supra* note 28 (considering lack of “legal certainty” as a disincentive for EPZ investors (author's translation)).

30. See Part IV.A.

31. See *infra* Part IV.B.

unionization, among other labor issues, that remain significant problems in the global trading system.<sup>32</sup> CSR can do so by harnessing competitive market forces to give all actors in EPZ systems—the WTO, host governments, and private companies—an interest in working toward social improvement.<sup>33</sup>

This Note chooses depth over breadth in focusing on one aspect of EPZ reform: compliance with Article 3.1(a)'s prohibition of de jure and de facto export subsidization. Though other issues regarding EPZ reform exist,<sup>34</sup> compliance with Article 3.1(a) is among the most pressing issues confronting developing countries. This Note analyzes compliance with Article 3.1(a) using sources such as EPZ statutes and the SCM Agreement, Inter-American Development Bank reports, WTO panel and Appellate Body decisions, and interviews with a government official and an economist in Nicaragua.

Although some scholars have discussed how EPZs are inconsistent with WTO law and have even proposed potential solutions for achieving WTO compliance,<sup>35</sup> the existing literature has yet to formulate a full defense for conditioning EPZ incentives on CSR that ensures legal compliance while also taking into account the potential policy repercussions of EPZ reform. In contrast with existing literature, this Note addresses both the legal *and* policy implications of EPZ reform at a time in which developing countries must act to meet a fast-approaching deadline.

This Note proceeds in four parts. Part I explains the functions that EPZs perform in developing countries, focusing on the creation and expansion of export industries. In setting forth the most relevant components of an EPZ legal framework, Part I also briefly

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32. See THOMAS FAROLE, SPECIAL ECONOMIC ZONES IN AFRICA: COMPARING PERFORMANCE AND LEARNING FROM GLOBAL EXPERIENCES 100 (2011) (“Perhaps the single biggest concern identified across the zones is poor enforcement of agreed-upon labor standards, working conditions, and pay and benefits. Although most zone programs have made significant progress in the past decade . . . enforcement lags considerably in many programs.”); McCallum, *supra* note 4, at 3–5 (describing international problems with inadequate labor conditions and the prevention of worker unionization in various countries).

33. See *infra* Part IV.B.

34. For example, countries must also eliminate domestic-content requirements to comply with Article 3.1(b) of the SCM Agreement. See SCM Agreement art. 3.1(b).

35. See generally JAIME GRANADOS, INTER-AM. DEV. BANK, EXPORT PROCESSING ZONES AND OTHER SPECIAL REGIMES IN THE CONTEXT OF MULTILATERAL AND REGIONAL TRADE NEGOTIATIONS (2003) (explaining the interaction of WTO law and EPZ statutes); Creskoff & Walkenhorst, *supra* note 2 (noting the many ways in which EPZ statutes can be inconsistent with WTO law and offering potential reforms).

summarizes relevant provisions in Guatemala's EPZ statute, a typical example of an EPZ statute. Part II details relevant WTO law applicable to EPZs, including provisions of the SCM Agreement as well as WTO case law that sets forth the legal tests for de facto export subsidization with which graduating countries must comply by 2015. Part II concludes by synthesizing the key elements of WTO law relevant to EPZ reform. Part III discusses potential policy implications that governments must consider before embarking on reform and explains the inadequacies of past EPZ reform attempts. Part IV sets forth a legal framework that allows graduating countries to maintain fiscal incentives while conditioning such incentives on standards of CSR. Part IV also addresses potential counterarguments that opponents may make regarding EPZ reform based upon CSR conditionality. The Note concludes by encouraging timely EPZ reforms based upon CSR as a path toward WTO compliance, economic competitiveness, improved labor standards, and legal certainty for investors.

### I. EPZS AS SUSTAINABLE DEVELOPMENT TOOLS

Before discussing proposals for EPZ reform, it is necessary to examine the substance of EPZ statutes and their role in sustainable economic development. Understanding the mechanics of EPZ statutes will illustrate the economic importance of EPZs, particularly their export-increasing potential.<sup>36</sup> Given that EPZs also play a large role in the infrastructural development of developing countries,<sup>37</sup>

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36. The exports generated by EPZs are economically beneficial to developing countries. Evidence shows that "[t]here is a clear positive relationship between export growth and GDP growth" for developing countries. WILLIAM R. CLINE, *TRADE POLICY AND GLOBAL POVERTY* 42 (2004). Empirical models have demonstrated that export growth is "highly significant" when regressed against GDP growth, with each percentage point of export growth being associated with a rise of 0.15 percentage points in GDP. *Id.* Although exports have potential benefits for economic growth in developing countries, significant potential disadvantages also exist that countries must consider. Developing countries that rely on primary products exports can experience "a high degree of exposure to risk and uncertainty" when prices fluctuate in world markets. JUAN FELIPE MEJA, *EXPORT DIVERSIFICATION AND ECONOMIC GROWTH: AN ANALYSIS OF COLOMBIA'S EXPORT COMPETITIVENESS IN THE EUROPEAN UNION'S MARKET* 31 (2011). Countries can mitigate this risk through export diversification. *See id.* ("[E]xport diversification has been proposed as a policy mechanism seeking to stabilize export earnings . . ."). Other commentators have hypothesized that exports do not cause but are rather merely correlated with economic growth. *Id.* at 29.

37. EPZs bring well-developed infrastructure such as electricity services, water services, telecommunications services, and transportation infrastructure for the exportation of products. *See infra* Part I.B. Weaknesses in this infrastructure are "major constraints on investment and



understanding their statutory mechanics will demonstrate the prominence of EPZs in economic development generally.<sup>38</sup>

This Part introduces the concept of an EPZ in two sections. Section A gives a general overview of the legal frameworks of EPZs and their operation in developing countries. Section B provides a specific example of an EPZ statute: the Guatemalan EPZ statute.

#### A. An Overview of EPZs

EPZs are key tools that developing countries use to attract foreign investment. National legislatures establish EPZs to accomplish policy goals such as generating employment, promoting the acquisition of technology, encouraging foreign investment, and increasing a country's exports.<sup>39</sup> EPZ statutes offer attractive incentives to companies, including an exemption from income tax for a statutorily specified term of years, tax-free importation of production equipment, a waiver of administrative and property taxes, and a reprieve from value-added taxes for goods transferred between EPZs.<sup>40</sup> Savings can be significant; for instance, companies can accrue over \$20 million in income-tax savings alone.<sup>41</sup> In short, EPZs are a quid pro quo: in exchange for the promise of job creation, technological transfer, and economic development, investor companies receive substantial fiscal incentives.

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operations in many developing countries." Chris Milner, *Constraints to Export Development in the Developing Countries*, in THE WTO AND DEVELOPING COUNTRIES 213, 229 (Homi Katrak & Roger Strange eds., 2004). Relatively high levels of "water supply interruptions, power breakdowns, or voltage fluctuations" can lead to "export-oriented investment . . . [being] diverted from the affected countries." *Id.* at 230. Hence, the fiscal incentives for both public and private development of EPZs offer a developing country much-needed infrastructure that will help them compete in the global marketplace as investment destinations.

38. Especially important for economic development is that exports from EPZs provide a type of economic insurance for developing countries because the exports of EPZs remain strong even when other sectors of the economy fail. *See, e.g.*, Press Release, World Trade Org., Economic Reforms Take Hold in the Dominican Republic: But Obstacles for Export Sectors Remain (Feb. 2, 1996), available at [http://www.wto.org/english/tratop\\_e/tp\\_r\\_e/tp25\\_e.htm](http://www.wto.org/english/tratop_e/tp_r_e/tp25_e.htm) ("Exports from [EPZs] . . . increased continuously at times when other exports [had] decreased."). EPZs have been called "one of the most important and dynamic sectors" in the Dominican Republic. *Id.*

39. *See, e.g.*, Ley que Establece un Régimen Especial, Integral y Simplificado para el Establecimiento y Operación de Zonas Francas y Dicta Otras Disposiciones [Law To Establish a Special, Integrated and Simplified Regime for the Establishment and Operation of Free Zones and Other Dispositions], Ley No. 32, 5 Apr. 2011, ch. I, art. 1, GACETA OFICIAL No. 26757-B (Panama) (listing the objectives of Panama's Free Zone System).

40. Creskoff & Walkenhorst, *supra* note 2, at 29.

41. FAROLE, *supra* note 32, at 147.

Competition among developing countries to attract foreign investment is fierce. In considering a location, companies investigate not only a country's EPZ incentives but also a country's political stability, infrastructure, and general economic climate.<sup>42</sup> In Central America, for example, some companies have moved from Honduras to Nicaragua, in part because production costs were 20 percent lower in Nicaragua.<sup>43</sup> Nonetheless, the availability of attractive economic incentives remains one of the "most important criteria" for investors.<sup>44</sup>

EPZs can convey enormous benefits to developing countries. For example, in Nicaragua, EPZs generate an estimated one hundred thousand direct jobs and three hundred thousand indirect jobs, both substantial figures in a country of six million people.<sup>45</sup> Because EPZ employees pay income and social security taxes to the government, Nicaraguan EPZs create roughly one hundred thousand new taxpayers in the country.<sup>46</sup>

Many investor companies also contribute to philanthropic programs in the communities of which they are a part. Some companies in Nicaragua's EPZ system, for instance, have donated computers to schools and helped organize a cycling marathon for the community.<sup>47</sup> Additionally, other companies have participated in Nicaragua's "Food for the People Program," a nutritional program whereby companies distribute food to their workers.<sup>48</sup> Overall, while it may seem at first that EPZ companies receive overly favorable

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42. See *id.* at 129 ("[W]e find clear evidence suggesting that investment climate matters for [EPZ] performance.").

43. Vásquez, *supra* note 28.

44. See FAROLE, *supra* note 32, at 147 (listing the "level of corporate taxes" as one of the "most important criteria" for investors).

45. Telephone Interview with Carlos Zúñiga, *supra* note 5. An EPZ generates a direct job when an EPZ company employs individual workers, whereas an EPZ generates indirect jobs when EPZ companies consistently buy goods, such as lumber, from local companies, which can then in turn employ more workers.

46. *Id.* The number of new taxpayers generated by EPZs could likely be above one hundred thousand if at least some of the indirect jobs created also required the payment of income and social security taxes.

47. *II Free Zone's Cycling Marathon*, COMISIÓN NACIONAL DE ZONAS FRANCAS, <http://www.cnzf.gob.ni/?q=en/news/ii-free-zones-cycling-marathon> (last visited Sept. 23, 2013); *Donation to the Hogar Zacarias Guerra*, COMISIÓN NACIONAL DE ZONAS FRANCAS, <http://www.cnzf.gob.ni/?q=en/news/donation-hogar-zacarias-guerra> (last visited Sept. 23, 2013).

48. See "Food for the People" Program for Workers at Free Zones, COMISIÓN NACIONAL DE ZONAS FRANCAS, <http://www.cnzf.gob.ni/?q=en/news/food-people%E2%80%9D-program-workers-free-zones> (last visited Sept. 23, 2013).

concessions from host governments in exchange for investment, the companies contribute substantially to the economic and societal welfare of their host communities.

*B. The EPZ Statute of Guatemala: A Typical Example of an EPZ System*

Guatemala's administrative framework for developing and implementing EPZs provides a representative example of EPZ statutes in other developing countries. Guatemala is thus a useful example with which to illustrate the dynamics of an EPZ system.

Under Guatemala's EPZ statute, private developers apply to the Political Industrial Committee, a public agency, for permission to operate an EPZ.<sup>49</sup> The developers also set rental rates for production space.<sup>50</sup> Once a company applies to operate within the EPZ, the developer will seek permission from the Political Industrial Committee to allow that company to operate.<sup>51</sup> Once approved, the company begins producing goods or services<sup>52</sup> and begins accruing benefits from the fiscal incentives of the EPZ.

Both developers and investor companies receive fiscal incentives. For example, developers receive a total exemption from importation taxes on all machines and materials used to construct the infrastructure, buildings, and installations of the EPZ. Among other benefits, developers also pocket the rental income earned by leasing operating space to companies; this rental income is tax exempt for fifteen years.<sup>53</sup> Investor companies import, free of taxes, all machines, equipment, tools, and raw materials.<sup>54</sup> Companies also receive income

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49. Ley de Zonas Francas [Law of Free Zones], Decreto No. 65-89, 14 Nov. 1989, ch. III, art. 11 (Guatemala), *as amended* by Decreto No. 25-91, 19 Mar. 1991.

50. *Id.* ch. IV, art. 16.

51. *Id.* art. 17.

52. Examples of common EPZ goods include textile products, automotive parts, and electrical devices. Examples of common EPZ services include call center services and financial services. Vietnam, for example, has attracted several high-profile investors including Canon, Samsung, Panasonic, and Intel. FAROLE, *supra* note 32, at 207. Honduras has attracted apparel companies such as Sara Lee Knit Products, which manufactures the Champion and Hanes brands. *Id.*

53. *See* Law of Free Zones, ch. V, art. 21(a)–(b). Developers are also exempt from administrative taxes and receive tax-free importation and consumption of fuel, oil, gas, and propane strictly necessary for the generation of electric energy used in operating the EPZ. *Id.* art. 21(g).

54. *Id.* art. 22.

tax exemptions for twelve years and are exempt from several administrative taxes.<sup>55</sup>

In exchange for these incentives, both developers and investor companies undertake a range of obligations. First, developers must install and manage the services of the EPZ.<sup>56</sup> Second, companies must export at least 80 percent of their products.<sup>57</sup> Companies cannot sell locally without governmental permission, and when permission is granted to sell locally, the minimum sales contract amount is \$5,000.<sup>58</sup> Additionally, companies must pay import and income taxes on locally sold products.<sup>59</sup>

## II. WTO LAW APPLICABLE TO EPZ STATUTES

The WTO is a supranational organization of 159 members<sup>60</sup> tasked with developing an “integrated, more viable and durable multilateral trading system.”<sup>61</sup> To this end, WTO members negotiate and implement agreements<sup>62</sup> to improve the world trading system. This Note will focus on the SCM Agreement, which governs the use of export subsidies.<sup>63</sup> All WTO members have a duty to carry out their obligations under the SCM Agreement in good faith.<sup>64</sup> In addition, members must take WTO tribunals’ interpretations of the SCM Agreement into account.<sup>65</sup>

This Part introduces WTO law applicable to EPZs in four sections. Section A discusses the negotiating history of the SCM Agreement and its relationship to export subsidization. Section B discusses the issue of export subsidization in the context of the SCM

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55. *Id.*

56. *Id.* ch. VI, art. 36.

57. *Id.* ch. V, art. 25.

58. *Id.*

59. *Id.*

60. *The WTO*, WORLD TRADE ORG., [http://www.wto.org/english/thewto\\_e/thewto\\_e.htm](http://www.wto.org/english/thewto_e/thewto_e.htm) (last visited Sept. 23, 2013).

61. Marrakesh Agreement Establishing the World Trade Organization pmb., Apr. 15, 1994, 1867 U.N.T.S. 154, 155.

62. For a list of all WTO agreements, see *WTO Legal Texts*, WORLD TRADE ORG., [http://www.wto.org/english/docs\\_e/legal\\_e/legal\\_e.htm](http://www.wto.org/english/docs_e/legal_e/legal_e.htm) (last visited Sept. 23, 2013).

63. See SCM Agreement art. 3.1(a) (declaring a general prohibition on export subsidies).

64. See Appellate Body Report, *European Communities—Trade Description of Sardines*, ¶ 278, WT/DS231/AB/R (Sept. 26, 2002) (noting that members should be presumed to carry out WTO obligations in good faith as “required by the principle of *pacta sunt servanda* articulated in Article 26 of the *Vienna Convention*”).

65. See *infra* Part II.C.

Agreement. Section C sets forth the legal standards of de jure and de facto export subsidization, which are of particular importance for making EPZ statutes WTO-compliant. Lastly, Section D summarizes the key implications of WTO law for EPZ reform.

A. *The SCM Agreement and Its Negotiating History with Respect to Export Subsidies*

The SCM Agreement governs the use of subsidies and countervailing measures by WTO members. Of relevance to this Note, it defines a subsidy as (1) a financial contribution<sup>66</sup> (2) by a government or any public body<sup>67</sup> (3) that confers a benefit on the recipient.<sup>68</sup> Examples of subsidies include when “government revenue . . . is foregone or not collected,” “a government provides goods or services other than general infrastructure,” or a government makes “loan guarantees.”<sup>69</sup> The SCM Agreement establishes rules and procedures for utilizing subsidies to provide stability to the global trading system.

Export subsidies are government practices that “increase the profitability of export sales without similarly increasing the profitability of domestic sales.”<sup>70</sup> Examples include income tax exemptions for profits earned on exported products and transport charges for export shipments with terms more favorable than those of domestic shipments.<sup>71</sup> Export subsidies can be de jure or de facto: de jure refers to a law or practice that favors exports on its face, whereas de facto requires an examination of all facts and circumstances.

The prohibition in Article 3.1(a) on de facto export subsidies generated sharp disagreement among countries negotiating the SCM Agreement. Countries supporting the de facto export subsidy prohibition wanted to “provide a way of dealing with the situation where the administration of a subsidy programme allows the disbursement of funds to favour exports.”<sup>72</sup> In contrast, other countries proposed deleting all references to the ban on de facto

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66. SCM Agreement art. 1.1(a)(1).

67. *Id.*

68. *Id.* art. 1.1(b).

69. *Id.* art. 1.1(a)(1)(i)–(iii).

70. MICHAEL J. TREBILCOCK, ROBERT HOWSE & ANTONIA ELIASON, *THE REGULATION OF INTERNATIONAL TRADE* 299 (3d ed. 2005).

71. *See* SCM Agreement Annex I.

72. Panel Report, *Australia—Subsidies Provided to Producers and Exporters of Automotive Leather*, ¶ 7.132, WT/DS126/R (May 25, 1999).

export subsidies in the text and footnotes of the SCM Agreement;<sup>73</sup> they expressed “concerns” about “the approach taken to establish . . . different categories of developing countries” that would be subject to different phase-out periods for the controversial prohibition on de facto export subsidies.<sup>74</sup> These countries also noted that this categorization of countries would have “far-reaching political and economic implications.”<sup>75</sup>

The protection of export subsidies for developing countries was also widely discussed during negotiations, with developing countries persistently defending export subsidies as promoting their developmental policy objectives and national interests.<sup>76</sup> For example, Bangladesh argued that developing countries should be allowed to maintain export subsidies, stating that “[s]ubsidies are an integral part of economic development programmes of the least-developed countries. Accordingly, the right of the least-developed countries to grant or maintain subsidies, including export subsidies, shall continue to be recognized.”<sup>77</sup> Developing countries also vigorously defended export subsidies on the ground that the subsidies were mere corrections for handicaps and disadvantages faced by companies operating in the developing world. They argued that export subsidies did not confer any advantages but simply leveled the playing field with developed countries by compensating developing countries for the disadvantages they face,<sup>78</sup> such as “inadequate exploitation of

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73. Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat: Meeting of 6 November 1990*, ¶ 3, MTN.GNG/NG10/24 (Nov. 29, 1990) (“It was proposed to delete the reference to de facto export subsidies . . . . It was also proposed to delete footnote 4.”).

74. *Id.*; see also *id.* (discussing concerns regarding the application of Article 27 of the SCM Agreement to developing countries).

75. *Id.*

76. See, e.g., Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat: Meeting of 27–28 March 1990*, ¶ 12, MTN.GNG/NG10/17 (Apr. 10, 1990) (“[Developing countries] recalled that subsidies were an integral part of economic development programmes, necessary to promote social and economic policy objectives.”); Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat: Meeting of 16–17 March 1987*, ¶ 9, MTN.GNG/NG10/1 (Mar. 27, 1987) (“The view was expressed that as developing countries had very limited financial resources, they used subsidies only for important development needs and could hardly afford any further commitments.”).

77. Negotiating Group on Subsidies and Countervailing Duties, *Communication from Bangladesh: Proposals on Behalf of the Least-Developed Countries*, MTN.GNG/NG10/W/28 (Nov. 13, 1989).

78. See, e.g., Negotiating Group on Subsidies and Negotiating Measures, *Note by the Secretariat: Meeting of 20–21 February 1990*, ¶ 16, MTN.GNG/NG10/16 (Mar. 20, 1990) (“Developing countries faced a number of external and internal distortions and the best way to

economics of scale, factor market imperfections, underdeveloped infrastructure, high costs of inputs, fragmented capital markets, inadequate foreign exchange market[s] and poor market infrastructure.”<sup>79</sup> The subsidies were especially needed because “in many cases developing countries had to use subsidies to maintain their competitive position vis-à-vis subsidized products from developed countries.”<sup>80</sup>

### *B. The Provisions of the SCM Agreement Regarding Export Subsidies*

The SCM Agreement classifies subsidies into three groups—nonactionable, actionable, and prohibited.<sup>81</sup> Nonactionable subsidies are permitted under the SCM Agreement and include “general non-specific subsidies such as spending on education or infrastructure.”<sup>82</sup> Actionable subsidies are also permitted, but should not cause adverse effects to other WTO members.<sup>83</sup> Actionable subsidies include specific forms of government assistance to firms or enterprises—such as giving assistance to one specific firm, firms in a specific industry, or firms in a geographic location.<sup>84</sup> Prohibited subsidies are categorically banned absent an exemption because they can be “clearly harmful” and can place some members at an unfair disadvantage.<sup>85</sup> The SCM Agreement identifies two types of prohibited subsidies: (1) export subsidies, which can be de jure or de facto, and (2) subsidies contingent upon the use of domestic rather than imported inputs.<sup>86</sup> This Note focuses on export subsidies.

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deal with them was to eliminate them at the source . . . . The objective of export incentives was not, therefore, to give an additional advantage . . . but to neutralize the handicap which developing countries had in their export markets and export activities.”); Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat: Meeting of 19–20 October 1989*, ¶ 14, MTN.GNG/NG10/14 (Nov. 15, 1989) [hereinafter SCM Negotiating Group 19–20 Oct.] (acknowledging the view of some members that “any export promotion measures which put the exporter *at par* with the international norms, irrespective of the method chosen for compensation, should remain permissible for developing countries” (emphasis added)).

79. SCM Negotiating Group 19–20 Oct., *supra* note 78, ¶ 14.

80. Negotiating Group on Subsidies and Countervailing Measures, *Note by the Secretariat: Meeting of 28–29 June 1988*, ¶ 12, MTN.GNG/NG10/8 (July 11, 1988) (emphasis added).

81. See SCM Agreement pts. II, III & IV.

82. TREBILCOCK ET AL., *supra* note 70, at 375.

83. SCM Agreement pt. III.

84. *Id.* arts. 2.2–2.3.

85. See GARY P. SAMPSON, *THE WTO AND SUSTAINABLE DEVELOPMENT* 89 (2005).

86. See SCM Agreement art. 3.1.

EPZ incentive packages are prohibited export subsidies within the meaning of Article 3.1(a). By operation of EPZ statutes, they are contingent on export performance and would thus be prohibited but for the exemption for developing countries.<sup>87</sup> Article 27 establishes this exemption by recognizing that “subsidies may play an important role in economic development programmes of developing country Members.”<sup>88</sup>

Different categories of developing countries receive different levels of preferential treatment under the SCM Agreement. First, LDCs, as designated by the United Nations,<sup>89</sup> are exempt from the prohibition on export subsidies pursuant to Annex VII(a) of the SCM Agreement so long as they hold that LDC designation.<sup>90</sup> Second, an enumerated list of countries in Annex VII(b) are excluded from the prohibition on export subsidies until their GNI per capita exceeds \$1,000 in 1990 dollars for three consecutive years.<sup>91</sup>

Until recently, even graduating countries—that is, those countries that no longer meet either exemption of Annex VII—could maintain EPZ export subsidies indefinitely pursuant to Article 27.4 of the SCM Agreement. This article provides ad hoc extension periods for export subsidies based on the “economic, financial and development needs of the developing country member in question.”<sup>92</sup> By applying for extensions, developing countries have heavily utilized this provision to preserve their EPZ programs, including the financial incentives linked to exports.<sup>93</sup> However, the honeymoon period of seemingly limitless extensions will soon come to an end: the WTO

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87. For example, as demonstrated above, Guatemala’s EPZ statute requires companies to export 80 percent of their products, a condition on export performance. *See supra* note 57 and accompanying text. This would violate Article 3.1(a) but for the developing-country exemption.

88. SCM Agreement art. 27.1.

89. For a list of LDCs, see *Least Developed Countries: About LDCs*, UNITED NATIONS OFFICE OF THE HIGH REPRESENTATIVE FOR LEAST DEVELOPED COUNTRIES, <http://www.unohrrls.org/en/ldc/25> (last visited Sept. 23, 2013).

90. *See* SCM Agreement Annex VII(a).

91. *See supra* note 17. The list of countries in Annex VII includes Bolivia, Cameroon, Congo, Côte d’Ivoire, the Dominican Republic, Egypt, Ghana, Guatemala, Guyana, Honduras, India, Indonesia, Kenya, Nicaragua, Nigeria, Pakistan, Philippines, Senegal, Sri Lanka, and Zimbabwe. For a list of those countries that have graduated from this list, see Committee on Subsidies and Countervailing Measures, *supra* note 24, ¶ 3 n.4.

92. SCM Agreement art. 27.4.

93. For a list of countries that have been granted their requested extensions for the maintenance of export subsidies, see OFFICE OF THE U.S. TRADE REPRESENTATIVE & U.S. DEP’T OF COMMERCE, *supra* note 21, at 25.



General Council recently mandated that the final group of extensions will expire on December 31, 2015.<sup>94</sup>

In accordance with this mandate, developing country members must design an “action plan” detailing how they will bring their EPZ programs into compliance with WTO law.<sup>95</sup> The action plan “shall indicate how the Member intends to eliminate export subsidies . . . including information as to legislative changes, administrative amendments and/or other procedures as may be necessary.”<sup>96</sup> To do this, developing countries will need to understand exactly how WTO tribunals have interpreted Article 3.1(a), especially the de facto export subsidization standard.

### C. *De Jure and De Facto Export Subsidies*

Several WTO dispute settlement panels and the WTO Appellate Body have interpreted the meaning of both de jure and de facto export subsidies and have announced standards regarding what evidence a complaining country must show to prove a prima facie violation of WTO law.<sup>97</sup> The Appellate Body in *Canada – Aircraft*<sup>98</sup> described the difference between de jure and de facto export subsidies as one of “what evidence may be employed to prove that a subsidy is export contingent.”<sup>99</sup> De jure export subsidies are proven “on the basis of the words of the relevant legislation, regulation or other legal instrument.”<sup>100</sup> In contrast, de facto export subsidies are

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94. WTO General Council, *Article 27.4 of the Agreement on Subsidies and Countervailing Measures—Decision of 27 July 2007*, ¶ 1(d), WT/L/691 (July 27, 2007).

95. *Id.* ¶ 1(f).

96. *Id.* ¶ 1(f) n.5.

97. A complaining country must first show a prima facie violation of the SCM Agreement before the responding country is required to present evidence. See *Legal Issues Arising in WTO Dispute Settlement Proceedings: 10.6 Burden of Proof*, WORLD TRADE ORG., [http://www.wto.org/english/tratop\\_e/dispu\\_e/disp\\_settlement\\_cbt\\_e/c10s6p1\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c10s6p1_e.htm) (last visited Sept. 23, 2013) (“As regards the required level of proof, the Appellate Body has clarified that the party bearing the burden of proof must put forward evidence sufficient to make a prima facie case (a presumption) that what is claimed is true. When that prima facie case is made, the onus shifts to the other party, who will fail unless it submits sufficient evidence to disprove the claim, thus rebutting the presumption.” (citing Appellate Body Report, *Korea—Definitive Safeguard Measure on Imports of Certain Dairy Products*, ¶ 145, WT/DS98/AB/R (Dec. 14, 1999))).

98. Appellate Body Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, WT/DS70/AB/R (Aug. 2, 1999) [hereinafter *Canada – Aircraft Appellate Body Report*].

99. *Id.* ¶ 167.

100. *Id.*

proven “from the total configuration of the facts constituting and surrounding the granting of the subsidy.”<sup>101</sup>

Interpretations of de facto subsidization have focused on Footnote 4 of the SCM Agreement, which elaborates on Article 3.1(a)’s prohibition of “subsidies contingent, in law or in fact, . . . upon export performance” in the following terms:

This 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. The mere fact that a subsidy is granted to enterprises which export shall not for that reason alone be considered to be an export subsidy within the meaning of this provision.<sup>102</sup>

WTO panels have set forth two tests for determining de facto export subsidies: the “but-for” test established by *Canada – Aircraft* and the “close-connection” test established by a second case, *Australia – Automotive Leather II*.<sup>103</sup> Insofar as WTO jurists will apply these standards to determine the legality of all EPZs, this Note discusses the cases in some detail.

1. *Canada – Aircraft and the But-For Test of De Facto Contingency*. In *Canada – Aircraft*, the Canadian government provided loans to the civil aircraft industry at below-market rates of return, loans that thus qualified as a subsidy.<sup>104</sup> In a decision upheld fully by the Appellate Body in both its interpretation and its application of de facto contingency,<sup>105</sup> the WTO panel held that the

101. *Id.*

102. SCM Agreement art. 3.1(a) & n.4.

103. Panel Report, *Australia – Subsidies Provided to Producers and Exporters of Automotive Leather*, WT/DS126/R (May 25, 1999) [hereinafter *Australia – Automotive Leather II* Panel Report]. The WTO officially refers to this decision as *Australia – Automotive Leather II*, even though no panel decision entitled *Australia – Automotive Leather I* exists, perhaps due to the fact that a “panel was established in January 1998 on the same matter and involving the same parties, but was never composed.” WORLD TRADE ORG., WTO DISPUTE SETTLEMENT: ONE-PAGE CASE SUMMARIES 50 n.3 (2012) [http://www.wto.org/english/res\\_e/booksp\\_e/dispu\\_summary95\\_11\\_e.pdf](http://www.wto.org/english/res_e/booksp_e/dispu_summary95_11_e.pdf).

104. See Panel Report, *Canada – Measures Affecting the Export of Civilian Aircraft*, ¶ 9.314, WT/DS70/R (Apr. 14, 1999) [hereinafter *Canada – Aircraft* Panel Report] (“[The Canadian Government] neither seeks nor earns a commercial rate of return on these contributions.”).

105. See *Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 220(b) (concluding that the Appellate Body “upholds the Panel’s interpretation and application of the expression ‘contingent . . . in fact . . . upon export performance’ and the Panel’s finding” (alteration in original) (emphasis added) (quoting SCM Agreement art. 3.1(a))).

low-cost loans were de facto export subsidies.<sup>106</sup> The panel interpreted the standard “contingent . . . in fact . . . upon export performance”<sup>107</sup> to be met when “the facts demonstrate that such [government] assistance would not have been granted . . . *but for* anticipated exportation or export earnings.”<sup>108</sup> The facts do not have to show that export performance is an actual condition of receiving fiscal incentives but only that “had there been no expectation of export sales . . . ‘ensuing’ from the subsidy, the subsidy would not have been granted.”<sup>109</sup> The but-for test is thus a less stringent standard than an actual showing that a country requires export performance as a condition of receiving fiscal incentives.

The panel then applied this standard to the Canadian government’s low-cost loans. The panel considered several circumstantial factors: (1) the governmental “Business Plan” referencing “high export potential” as a motivation for giving the loans, (2) a governmental annual report boasting that “[e]xports accounted for about 70 percent of sales,” (3) a governmental press release describing the loans as “generating economic growth and export dollars,” (4) governmental website material referring to increased exports as a motivating factor for the loans, (5) loan application materials requiring applicants to distinguish between domestic sales and exports when reporting forecast and actual sales, and (6) legislative charters identifying increased exports as a consideration of the program.<sup>110</sup> On these facts, the panel concluded that the low-cost loans would not have been granted but for the anticipated export earnings.<sup>111</sup> Although actual conditionality was not established, the panel nonetheless deemed Canada’s loans to be export subsidies.<sup>112</sup>

The Appellate Body, upon review, “[upheld] the Panel’s *interpretation and application* of the expression ‘contingent . . . in

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106. *Canada – Aircraft* Panel Report, *supra* note 104, ¶ 10.1.

107. SCM Agreement art. 3.1(a).

108. *Canada – Aircraft* Panel Report, *supra* note 104, ¶¶ 9.331–9.332.

109. *Id.* ¶ 9.339 (emphasis omitted). The panel emphasized the factual nature of this inquiry and emphasized that panels can consider any facts in making the determination. *Id.* ¶ 9.337 (“[A]ny fact could be relevant, provided it ‘demonstrates’ . . . whether or not a subsidy would have been granted but for anticipated exportation or export earnings.”).

110. *Id.* ¶ 9.340 (emphases omitted).

111. *See id.* ¶ 9.341 (“To us, therefore, these facts demonstrate that [the government’s] assistance to the Canadian regional aircraft industry would not have been granted but for some expectation of exportation or export earnings.”).

112. *Id.* ¶ 10.1.

fact . . . upon export performance,”<sup>113</sup> agreeing that the Panel’s decision to apply a but-for test was the appropriate approach to this inquiry under the WTO Dispute Settlement Understanding<sup>114</sup> when making the required “objective assessment of the facts of the case.”<sup>115</sup> The Appellate Body recognized that the panel did not establish that anticipated export earnings were actually conditioned on export performance, “but, rather, it found that those criteria helped to *demonstrate* the existence of *de facto* contingency” enough to satisfy the standard of Article. 3.1(a).<sup>116</sup> The Appellate Body thus endorsed the less stringent but-for standard.

2. Australia – Automotive Leather II *and the Close-Connection Test*. In *Australia – Automotive Leather II*, the panel considered two issues: (1) whether grant payments by the Australian government to Howe, an Australian leather producer, that were dependent on aggregate sales performance targets met the Footnote 4 standard of being contingent in fact upon export performance, and (2) whether a low-cost loan to Howe was contingent in fact upon export performance.<sup>117</sup> The panel emphasized that, in determining whether *de facto* export subsidization exists, it considers all facts and circumstances surrounding the subsidy in making its decision.<sup>118</sup> In considering such facts, the panel noted Footnote 4’s requirement that the subsidy be “tied to” actual or anticipated export earnings, which the panel interpreted to require a “close connection” between the grant or maintenance of a subsidy and export performance.<sup>119</sup>

In applying this close-connection test to the Australian government’s grant payments, the panel considered three factors. First, the Australian government was aware that Howe “exported a significant portion of its production.”<sup>120</sup> Second, the Australian market was too small to absorb Howe’s production.<sup>121</sup> Thus, to meet

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113. *Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 220(b) (alteration in original) (emphasis added) (quoting SCM Agreement art. 3.1(a)).

114. Understanding on Rules and Procedures Governing the Settlement of Disputes, Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 2, 1869 U.N.T.S. 401 [hereinafter DSU].

115. *Id.* art. 11.

116. *Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 178.

117. *Australia – Automotive Leather II* Panel Report, *supra* note 103, ¶¶ 2.3–2.4.

118. *Id.* ¶ 9.56.

119. *Id.* ¶ 9.55.

120. *Id.* ¶ 9.66.

121. *Id.* ¶ 9.67.

the sales targets, Howe would “have to continue and probably increase exports” to “reach the sales performance targets.”<sup>122</sup> Australia argued that the size of the domestic market “would penalize small economies where firms are often dependent on exports,” an argument which the panel found unavailing.<sup>123</sup> Third, given that Howe was “the only dedicated producer and exporter of automotive leather in Australia” and was the only company receiving the subsidies, these facts supported the conclusion that the subsidy was conditioned on anticipated exportation.<sup>124</sup>

In applying the de facto standard to the low-cost loan, the panel emphasized that “[t]here [was] nothing in the loan contract that explicitly link[ed] the loan to Howe’s production or sales, and therefore nothing . . . that would tie the loan directly to export performance.”<sup>125</sup> Moreover, that repayment of the loan could come from funds generated from export earnings was also inadequate to establish a sufficiently close tie between the loan and the anticipated exportation.<sup>126</sup>

The panel’s holding regarding loan agreement seems to conflict with the holding in *Canada – Aircraft*. In *Canada – Aircraft*, the Appellate Body determined a loan agreement to be tied to anticipated export earnings,<sup>127</sup> whereas in *Australia – Automotive Leather II*, the panel reviewing substantially similar facts *did not* find de facto contingency.<sup>128</sup> This suggests that the but-for test is more likely to find de facto export subsidies than the close-connection test. Given that the but-for test is the only test adopted thus far by the Appellate Body, developing countries should take extensive

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122. *Id.*

123. *Id.*

124. *Id.* ¶ 9.69.

125. *Id.* ¶ 9.74.

126. *See id.* ¶ 9.75.

127. *Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 220(b).

128. *Australia – Automotive Leather II* Panel Report, *supra* note 103, ¶ 10.1(a). In *Australia – Automotive Leather II*, just like in *Canada – Aircraft*, the WTO panel was presented with facts including a low-cost, below-market-rate loan to an industry highly geared toward exportation. Compare notes 117–26 and accompanying text (discussing the loan involved in *Australia – Automotive Leather II*), with notes 104–10 and accompanying text (introducing the loan at issue in *Canada – Aircraft*). In *Canada – Aircraft*, there was de facto contingency and thus a WTO violation. *See Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 220(b). In *Australia – Automotive Leather II*, there was not. *See Australia – Automotive Leather II* Panel Report, *supra* note 103, ¶¶ 220(b), 221.

precautions when reforming their EPZ regimes to guard against a WTO challenge of de facto export subsidization.

Even though the Appellate Body adopted the but-for test, the close-connection test retains importance for developing countries because Appellate Body decisions are not binding precedential authority, but rather can be only strongly persuasive authority.<sup>129</sup> Thus, countries should be aware of both tests, albeit with more attention paid to the but-for test, both because it is easier to violate WTO law under this test and because the Appellate Body has applied it.

#### *D. Key Implications of WTO Decisions for Reforming EPZs*

1. *Legislative Paths to Compliance.* To make EPZ statutes WTO-compliant, two of the most straightforward legislative reform possibilities are (1) the elimination of fiscal incentives, and (2) the elimination of export requirements. The first reform eliminates the EPZ subsidy completely. Because Article 1.1 of the SCM Agreement requires a “financial contribution” in order to find a subsidy, eliminating all fiscal incentives makes the EPZs WTO-compliant.<sup>130</sup> The second reform eliminates the contingency of the subsidy on exports and thus removes it from the scope of Article 3.1(a). Fiscal incentives without export requirements are actionable within the meaning of the SCM Agreement because of their geographic specificity,<sup>131</sup> but they are not “prohibited.”<sup>132</sup> Hence, the actionable subsidies will violate the SCM Agreement only if they cause injury to other WTO members.<sup>133</sup> In the absence of an export requirement, an EPZ’s fiscal incentives are unlikely to produce such injurious effects,

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129. See *Legal Effect of Panel and Appellate Body Reports and DSB Recommendations and Rulings: 7.2 Legal Status of Adopted/Unadopted Reports in Other Disputes*, WORLD TRADE ORG., [http://www.wto.org/english/tratop\\_e/dispu\\_e/disp\\_settlement\\_cbt\\_e/c7s2p1\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/disp_settlement_cbt_e/c7s2p1_e.htm) (last visited Sept. 23, 2013) (“[T]he reports of panels and the Appellate Body are not binding precedents for other disputes between the same parties on other matters or different parties on the same matter, even though the same questions of WTO law might arise. . . . If the reasoning developed in the previous report in support of the interpretation given to a WTO rule is persuasive from the perspective of the panel or the Appellate Body in the subsequent case, it is very likely that the panel or the Appellate Body will repeat and follow it.”).

130. See SCM Agreement art. 1.1.

131. See *supra* notes 81–85 and accompanying text.

132. See SCM Agreement art. 2.2 (establishing specificity for those subsidies limited to geographic areas).

133. See *id.* art. 5 (“No Member should cause, through the use of any [specific subsidy], adverse effects to the interests of other Members . . .”).

reducing the risk that the incentives could be successfully challenged before a WTO dispute-settlement panel.<sup>134</sup>

2. *Implications of the De Facto Standard of Export Subsidization.*

The panel and Appellate Body decisions regarding de facto export subsidization limit EPZ reform options in two principal ways. First, the decisions caution against using economic-performance requirements as alternatives to export requirements. Performance requirements for export-oriented industries, such as sales targets, job-creation requirements, or minimum-investment requirements, will likely support an inference that EPZ subsidies are tied to export earnings because a company may be forced to export its products to meet these economically oriented conditions.<sup>135</sup> If a panel applies the close-connection test, any economic output requirement will likely be analogized to the aggregate sales targets in *Australia – Automotive Leather II* and found incompatible with WTO law.<sup>136</sup>

Second, the decisions caution against heavy governmental control and monitoring of EPZ exports. The factors considered in *Canada – Aircraft* included high governmental interest in export earnings and requirements that companies distinguish between domestic and foreign sales when applying for subsidies.<sup>137</sup> Governments should thus not obligate export reports from companies in order to receive or renew EPZ permits.<sup>138</sup> Governments should also

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134. See GABRIEL GARI, INTER-AM. DEV. BANK, POLICY BRIEF NO. IDB-PB-138, THE USE OF FREE ZONES FOR THE PROMOTION OF THE OFFSHORE INDUSTRY IN MERCOSUR COUNTRIES: A REASONABLE CHOICE? 36 (2011), available at <http://idbdocs.iadb.org/wsdocs/getdocument.aspx?docnum=36837059> (“[F]ree zone incentives have not been the subject of any GATT/WTO claims.”).

135. See *Canada – Aircraft* Appellate Body Report, *supra* note 98, ¶ 171 (defining “tie” as limiting or restricting behavior).

136. See *Australia – Automotive Leather II* Panel Report, *supra* note 103, ¶ 9.67 (noting that having to increase production to meet economic targets counsels in favor of finding export subsidization).

137. *Canada – Aircraft* Panel Report, *supra* note 104, ¶ 9.341.

138. Countries should avoid conditionality, as used in Article 3.1(a), when awarding EPZ licenses. Several hypothetical scenarios help to illustrate the concept of conditionality. First, if the facts demonstrate that a developing country systematically awards EPZ permits to those companies that submit applications with high anticipated exports and deny permits to those companies with applications reporting low anticipated exports, this would tend to demonstrate that export performance is a de facto condition for the subsidies. Second, if a developing country routinely exerts pressure on companies to boost exports while threatening to revoke EPZ licenses, this too would be closer to demonstrating de facto contingency. Third, if EPZ companies that did not export have their EPZ permits revoked without explanation, this would also tend to show that export performance is a condition of receiving the subsidies. All three

avoid making export promotion the central legislative or policy focus of their EPZ regime but focus instead on nonexport benefits of EPZ systems.<sup>139</sup>

Countries can also take other, smaller actions to limit exposure to liability for de facto export subsidization by learning from the factors applied in *Canada – Aircraft* and *Australia – Automotive Leather II*. By encouraging companies to sell locally, changing the goals of EPZ systems to be worker advancement and job creation instead of export earnings, eliminating constant boasts about exports, and possibly even changing “Export” in EPZ to a more neutral term, countries will steer themselves toward WTO compliance. Overall, countries should carefully monitor how they associate their fiscal incentives with exports to ensure they are not implying that exports are a condition of their incentive regimes.

### 3. *Taking Advantage of the Limited Scope of the SCM Agreement.*

Countries should recognize that the SCM Agreement applies only to trade in *goods*.<sup>140</sup> Subsidies for services, such as financial services or the establishment of international call centers, are outside the SCM Agreement’s scope. Panama took advantage of this distinction by retaining fiscal incentives for service providers in its reformed EPZ law.<sup>141</sup> Although service sector companies have thus far played a relatively small role in EPZ systems,<sup>142</sup> services are among the fastest-growing sectors in some countries, with service-sector workers earning higher-than-average salaries.<sup>143</sup> Carlos Zúñiga, the Director of Operations for Nicaragua’s EPZ system, emphasized that one of

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scenarios would tend to show facts that demonstrate export performance as a de facto condition of subsidies.

139. For examples of EPZ statutes listing benefits other than exports, see *infra* note 229.

140. United Nations Conference on Trade and Development, *UNCTAD Series on Issues in International Investment Agreements: Incentives*, U.N. Doc. UNCTAD/ITE/IIT/2003/5, at 12 (2004) (“The SCM Agreement applies only to subsidies that affect trade in *goods*.” (emphasis added)).

141. See Law To Establish a Special, Integrated and Simplified Regime for the Establishment and Operation of Free Zones and Other Dispositions, Ley No. 32, 5 Apr. 2011, ch. V, art. 33, GACETA OFICIAL No. 26757-B (Panama) (granting income tax exemptions to service corporations even after the WTO compliance deadline of December 31, 2015).

142. See FAROLE, *supra* note 32, at 77 fig.3.5 (presenting graphical data demonstrating that the services industry is smaller than the textiles and manufacturing industries in most EPZ systems).

143. Theresa Bradley, *Latin American Offshoring Drives Gains amid Crisis*, VICTORIA ADVOC., (Apr. 12, 2009, 5:07 PM) (noting that the “starting salary of \$500 a month” in a Managua call center is “more than triple the country’s average wage”).



Nicaragua's most prosperous paths to development is the growth of the international business-services sector in its EPZs.<sup>144</sup> Moreover, research has demonstrated that developing better business services tends to encourage more successful manufacturing exports.<sup>145</sup> Whichever path countries choose to pursue in reforming their EPZ law, they will retain the option to continue to offer fiscal incentives to service providers.

### III. THE POLICY AND LEGAL INADEQUACIES OF PAST ATTEMPTS AT ACHIEVING WTO COMPLIANCE

Because EPZs directly impact essential aspects of economic development such as job creation and foreign direct investment, any change to an EPZ statute has the potential to influence the livelihoods of a nation's workers, either by ensuring the workers earn a sustainable income or by potentially driving them into poverty. With so much at stake, reforming EPZ statutes to meet *legal* obligations is just the beginning of EPZ reform. Governments must also consider the *policy* consequences of potential reforms.

This Part examines the critical policy consequences of EPZ reform, followed by a discussion of how the EPZ reforms of Costa Rica, El Salvador, and Panama may not be fully compliant with the obligations of Article 3.1(a) and also how these EPZ reforms fail to adequately address the impacts of reform on domestic policy. Section A argues that countries must consider policy implications such as investor flight and harm to domestic industries before drafting new EPZ statutes. Section B explains why the EPZ reforms of Costa Rica, El Salvador, and Panama may not be fully WTO-compliant and may not be wise policy choices.

#### A. *Governments Must Consider the Policy Consequences of EPZ Reform*

The looming deadline to reform EPZ statutes has led to rising tensions at the WTO over whether countries must completely eliminate subsidies from their EPZ statutes or simply modify them.

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144. Telephone Interview with Carlos Zúñiga, *supra* note 5.

145. See Esteban Ferro, Alberto Portugal-Perez & John S. Wilson, *Aid to the Services Sector: Does It Affect Manufacturing Exports?* 3 (World Bank, Policy Research Working Paper No. 5728, 2011), available at <http://elibrary.worldbank.org/content/workingpaper/10.1596/1813-9450-5728> (presenting empirical data showing "a positive effect of aid to services on downstream manufacturing exports of developing countries").

For example, when the Dominican Republic admitted that it had not yet reformed its EPZ statute and that it would “review and/or withdraw some of the incentives,” Colombia pressed the Dominican Republic on why the word “withdraw” was not enough.<sup>146</sup> Colombia added, perhaps somewhat aggressively, “As we all know . . . the final two-year phase-out period . . . shall end not later than 31 December 2015.”<sup>147</sup> Colombia had begun eliminating the fiscal incentives of its EPZ regime in 2007,<sup>148</sup> and wanted the Dominican Republic to do the same. The Dominican Republic, which previously failed to pass EPZ reform, promised to take action soon.<sup>149</sup>

As countries like the Dominican Republic consider legislative action under pressure from other countries, the two straightforward paths to compliance—eliminating either fiscal incentives or export requirements—highlight two key policy implications that countries should consider: (1) the potential flight of foreign investment due to the removal of fiscal incentives, and (2) the potential harm to domestic industries resulting from the removal of export requirements.

First, the elimination of EPZ fiscal incentives may result in lower investment by foreign companies. Fiscal incentives weigh heavily in corporate decisionmaking.<sup>150</sup> Because most corporate income tax rates in developing countries are between 25 percent and 30 percent,<sup>151</sup> the net present value of income tax exemptions can reach \$20 million for a twenty-year exemption period.<sup>152</sup> In addition, investors have ranked the level of corporate taxes as one of the “most important criteria” for their investment decisions.<sup>153</sup>

The complete elimination of fiscal incentives could contribute to an exodus of companies to neighboring countries, especially when considering that countries within the same geographic region will

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146. Committee on Subsidies and Countervailing Measures, *Replies to the Questions from Colombia Concerning the Updating Notification of the Dominican Republic*, G/SCM/Q3/DOM/18, at 2 (Oct. 4, 2012).

147. *Id.*

148. See L. 1004, diciembre 30, 2005, art. 240-1, DIARIO OFICIAL [D.O.] edición 46.138, at 96, 97 (Colom.) (increasing the corporate income tax rate for EPZ companies from 0 to 15 percent).

149. See Committee on Subsidies and Countervailing Measures, *supra* note 146, at 2 (“The plan is to resubmit the draft to Congress in the next few days.”).

150. FAROLE, *supra* note 32, at 146.

151. *Id.*

152. *Id.* at 147.

153. *Id.*

reach the Annex VII phaseouts at different times depending on when they reach the \$1,000 GNI threshold.<sup>154</sup> The “gaps” in differing phaseouts are significant: Costa Rica, for example, will reach its phaseout on December 31, 2015, while its northern neighbor, Nicaragua, does not expect to reach its phaseout until 2025 or later.<sup>155</sup> Because relocation is a plausible option for companies,<sup>156</sup> at least some government leaders would prefer to maintain the fiscal incentives.<sup>157</sup> Relocation is feasible for companies, in part, because developing countries maintain “investment promotion agencies” that specialize in assisting companies to establish themselves efficiently and quickly.<sup>158</sup>

Second, if, to avoid the flight of foreign businesses, countries choose instead to eliminate export requirements, they may cause harm to domestic businesses. Leonardo Martinez, the head of one of Nicaragua’s premier microfinance organizations, considers the statutory export requirements for EPZ companies to be vital to the health of small businesses in Nicaragua, which create about four hundred thousand jobs.<sup>159</sup> Due to the low cost structure, advanced technologies, and economies of scale of EPZ companies, the ability of EPZ companies to sell locally has the potential to raise unemployment among workers who depend upon small businesses for income.<sup>160</sup> Many small businesses produce apparel and footwear products similar to those manufactured by EPZ companies.<sup>161</sup> As a result, EPZ companies would be in direct competition with small

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154. *But see* Milner, *supra* note 37, at 231 (“[T]he net value of exports to an economy may be lower in the presence of ‘subsidies’ than in their absence. . . . [F]iscal incentives tend to be at the expense of resources for the development of greater marketing skills, export market information, and export marketing and promotion activities.”).

155. Telephone Interview with Carlos Zúñiga, *supra* note 5.

156. *See supra* note 28 and accompanying text.

157. *See, e.g.*, Telephone Interview with Carlos Zúñiga, *supra* note 5 (noting that the “preference” would be to keep fiscal incentives).

158. *See, e.g.*, *About PRONicaragua*, PRONICARAGUA, [http://www.pronicaragua.org/index.php?option=com\\_content&view=article&id=25&Itemid=141&lang=en](http://www.pronicaragua.org/index.php?option=com_content&view=article&id=25&Itemid=141&lang=en) (last visited Sept. 23, 2013) (explaining that ProNicaragua is ready to assist investors in “general start-up facilitation services,” “customized site visits,” “[c]omplete [i]nformation on business opportunities,” and “aftercare services,” among other services).

159. Telephone Interview with Leonardo Martinez, Exec. Dir. and Founder, Alternativa Microfinance (Nov. 7, 2012). Martinez has twenty years of experience working with over 1,500 small- and medium-sized businesses in Nicaragua. *Id.*

160. *Id.*

161. *Id.*

producers.<sup>162</sup> Martinez described Nicaragua's Annex VII phase-out period as "very worrisome,"<sup>163</sup> even though Nicaragua is still far from reaching the \$1,000 GNI per capita requirement that will trigger the phaseout.<sup>164</sup>

Other countries share Martinez's concerns. For example, the Philippines has enacted legislation that explicitly justifies the maintenance of export requirements as a way to protect domestic businesses.<sup>165</sup> Bangladesh strictly monitors the movement of goods out of an EPZ because of "concerns regarding security and leaks of EPZ products into the local market."<sup>166</sup> And Ghana, which allows EPZ companies to sell products locally only with prior governmental approval,<sup>167</sup> specifically safeguards the health of domestic enterprises by awarding them incentives to sell their goods to EPZ companies.<sup>168</sup>

*B. Past Attempts To Achieve WTO Compliance Have Been Inadequate from Both Legal and Policy Perspectives*

The confrontation between the Dominican Republic and Colombia discussed earlier in this Note<sup>169</sup> represents not only rising tensions regarding EPZs but also some governments' misdirected focus on eliminating fiscal incentives instead of conditioning them on factors other than export requirements. Although the complete elimination of incentives can benefit a country with increased revenues and resources for marketing EPZ systems,<sup>170</sup> governments

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162. *Id.*

163. *Id.*

164. See Committee on Subsidies and Countervailing Measures, *supra* note 24, ¶ 3 (listing Nicaragua's GNI in 2010 as \$616 in 1990 dollars).

165. An Act Providing for the Legal Framework and Mechanisms for the Creation, Operation, Administration, and Coordination of Special Economic Zones in the Philippines, Creating for this Purpose, the Philippine Economic Zone Authority (PEZA), and for Other Purposes, Rep. Act. No. 7916, § 26 (Feb. 21, 1995), available at <http://www.gov.ph/1995/02/24/republic-act-no-7916/> ("[I]n order to protect the domestic industry, there shall be a negative list of Industries that . . . shall not be allowed to sell their products locally.").

166. FAROLE, *supra* note 32, at 228.

167. See The Free Zone Act (Act No. 504/1995), § 23(1) (Aug. 31, 1995) (Ghana) ("The Minister may . . . authorize the sale of up to 30 percent of the annual production . . . to the national customs territory.").

168. See *id.* § 24(2) ("A domestic enterprise shall be eligible to benefit from the prevailing export incentives available to a national exporter . . . for sale of any goods and services to enterprises in the free zone or single factory zone.").

169. See *supra* notes 146–49 and accompanying text.

170. See Milner, *supra* note 37, at 231 ("[T]he fiscal incentives tend to be at the expense of resources for the development of greater marketing skills, export market information, and

should consider more nuanced potential reforms. Costa Rica, El Salvador, and Panama have each attempted to reform their EPZ regimes by taking a middle path without completely eliminating their fiscal incentives. This Note discusses both legal and policy reasons why these reforms may not be as effective as reforms based on CSR. These attempted reforms and their shortcomings will thus provide points of comparison for EPZ reforms based on conditions of CSR.

1. *Costa Rica*. In 2010, Costa Rica reformed its EPZ statute,<sup>171</sup> which, as a result of the amendment, stipulates that the income tax exemption for companies will expire on December 31, 2015.<sup>172</sup> The amended EPZ statute makes two types of companies eligible for fiscal incentives. First, EPZ companies in “strategic sectors” as defined by the Costa Rican government will be entitled to fiscal incentives,<sup>173</sup> although subject to lower minimum-investment requirements if the company establishes itself in disadvantaged regions of the country.<sup>174</sup> Second, companies making an initial investment of at least \$10 million and employing at least one hundred workers will be awarded fiscal incentives.<sup>175</sup> Fiscal incentives are greater if EPZ companies establish themselves in poor regions of the country.<sup>176</sup>

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export marketing and promotion activities.”). Some analysts suggest the additional tax revenue could be more important than any decreased competitiveness. *See id.* (“It is more important to use scarce resources to create an environment conducive to efficient production . . . than to subsidize exports . . .”); *see also* FAROLE, *supra* note 32, at 173 (“[T]he evidence shows that incentives do not compensate for a poor investment climate. Thus, the significant government investment of financial resources . . . should be devoted to delivering quality services to investors . . .”).

171. Modificación a la Ley de Régimen de Zonas Francas, No. 7210, de 23 de noviembre de 1990 [Amendment to the Law of the Free Trade Zones Regime, No. 7210, of Nov. 23, 1990], Ley No. 8794, 22 enero 2010, LA GACETA, no. 15 (Costa Rica), *available at* [http://www.gaceta.go.cr/pub/2010/01/22/COMP\\_22\\_01\\_2010.pdf](http://www.gaceta.go.cr/pub/2010/01/22/COMP_22_01_2010.pdf).

172. *See id.* transitorio IV (describing that after Costa Rica’s exemption period ends, companies will be subject to the normal income tax schedules).

173. *See id.* art. 2(f) (noting that companies in strategic sectors will continue to benefit from fiscal incentives); *see also* V. Andrés Gómez, *El Nuevo Régimen del Artículo 17 f) de la Ley del Régimen de Zonas Francas*, PWC INTERAMÉRICAS TAX NEWS MENSUAL, June 1, 2011, at 1–2, *available at* <http://www.pwc.com/ia/es/publicaciones/tax-news/assets/costa-rica-01-05-2011.pdf> (commenting on Costa Rica’s law).

174. Amendment to the Law of the Free Trade Zones Regime, No. 7210, of Nov. 23, 1990 art. 2(g).

175. *Id.*

176. *See id.* art. 1(a) (describing longer tax exemption periods for establishment in less developed regions of Costa Rica).

Costa Rica's solution may expose it to challenges of de facto export subsidization. Its massive minimum-investment requirement of \$10 million can be analogized to the sales performance requirements in *Australia – Automotive Leather II*, which were held as de facto export subsidies. Similar to Australia's subsidies, Costa Rica's high level of minimum investment combined with the tiny size of the Costa Rican market all but ensures that EPZ companies will export a substantial portion of their products. Costa Rica knows that its EPZs account for a large percentage of its exports—about 54 percent even after the decrease in exports due to the global economic slowdown<sup>177</sup>—and that EPZ companies will likely export many of their products. Both of these factors—substantial exports and a high likelihood of exports from companies receiving subsidies—are similar to factors considered by the Appellate Body in *Canada – Aircraft* in finding a violation of Article 3.1(a). Moreover, with respect to Costa Rica's fiscal incentives for strategic sectors, the overly malleable criteria such as “quality employment”<sup>178</sup> may prompt investigation into exactly how this standard is applied.

From a policy perspective, Costa Rica's law also suffers from shortcomings. The conditions for EPZ incentives do nothing to remedy potential harm to domestic industries that manifests as a result of eliminating export requirements.<sup>179</sup> Additionally, the limitation of EPZ fiscal incentives to strategic enterprises and those companies that meet the minimum-investment requirements may limit investment by other smaller companies.

2. *El Salvador.* El Salvador, after rejecting a proposal to condition fiscal incentives on CSR,<sup>180</sup> is taking a similar approach to Costa Rica in reforming its EPZ legislation. El Salvador recently

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177. *Exportaciones de Zona Franca Cayeron 7,7% a Noviembre*, FEDERACIONES DE CÁMARAS Y ASOCIACIONES DE EXPORTADORES DE CENTROAMÉRICA, PANAMÁ Y EL CARIBE 2, [http://fecaexca.net/index.php?view=article&catid=64%3Acrnews&id=783%3Aexportaciones-de-zona-franca-cayeron-77-a-noviembre&format=pdf&option=com\\_content&Itemid=87](http://fecaexca.net/index.php?view=article&catid=64%3Acrnews&id=783%3Aexportaciones-de-zona-franca-cayeron-77-a-noviembre&format=pdf&option=com_content&Itemid=87) (last visited Sept. 23, 2013).

178. Gómez, *supra* note 173, at 2 (author's translation).

179. See *supra* notes 159–63 and accompanying text.

180. See Claudia Contreras, *Reformas a Ley de Zonas Francas de El Salvador Privilegian Inversión Afuera de San Salvador*, REVISTA SUMMA (Oct. 11, 2011, 9:04 AM) <http://www.revistasumma.com/economia/17973-reformas-a-ley-de-zonas-francas-de-el-salvador-privilegia-inversion-afuera-de-san-salvador.html> (quoting Giovanni Berti, Director of the Investment Promotion Agency of El Salvador (PROESA), as rejecting incentives based on CSR as being prone to “inefficiency,” “corruption,” and “abuse” (author's translation)).

approved a law that will condition its fiscal incentives on a minimum investment of \$500,000 and a minimum job-creation requirement of fifty permanent jobs per business.<sup>181</sup> Additionally, companies that locate in poor regions of the country will receive more generous fiscal incentives.<sup>182</sup> As an incentive for increasing investment, El Salvador will extend the period of real estate tax exemptions for companies that double their initial investment after their initial year of operations.<sup>183</sup> With such simple economic-performance requirements, it is likely that operations will continue as usual for many companies in El Salvador that will still continue to receive incentives under the reformed EPZ regime.

El Salvador also exposes itself to liability for de facto export subsidization. Similar to Costa Rica, El Salvador's EPZ companies will likely have no choice but to maintain or increase exports to comply with the minimum-investment floor or job-creation requirement. El Salvador's economy is small<sup>184</sup> and most likely cannot absorb the current levels of subsidized production, which was a factor supporting de facto subsidization in *Canada – Aircraft*. Additionally, El Salvador boasts heavily about its exports,<sup>185</sup> which strengthens the case for satisfying the but-for test. Though El Salvador is likely not acting in bad faith,<sup>186</sup> its business-as-usual solution certainly raises the potential for a WTO complaint alleging de facto subsidization,

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181. Reformas a la Ley de Zonas Francas Industriales y de Comercialización [Reforms to the Law of Industrial and Commercialization Free Zones] art. 16, Dictamen No. 115, 11 Feb. 2013, available at <http://190.120.11.202/sesion-plenaria/seguimiento/legislatura-2012-2015/2013/no.-38-del-21-feb-2013/dictamenes/comision-de-hacienda-y-especial-del-presupuesto/comision-de-hacienda-y-especial-del-presupuesto-dictamen-115-favorable>. For purposes of comparison, Costa Rica's minimum-investment requirement of \$10 million discussed above is twenty times higher than that of El Salvador's \$500,000 requirement.

182. See *id.* art. 15(d) (noting that companies outside of metropolitan areas receive twenty years of full tax exemption instead of only fifteen years).

183. See *id.* art. 15(f) (giving an additional five years of exemption to companies that double their investments over their initial exemption period).

184. In 2011, El Salvador's GNI measured only \$21.8 billion. *1.1 World Development Indicators: Size of the Economy*, WORLD BANK (2013), <http://wdi.worldbank.org/table/1.1#>.

185. El Salvador's government maintains a website dedicated solely to promoting their export statistics, export procedures, and other export-related items. AGENCIA DE PROMOCIÓN DE EXPORTACIONES E INVERSIONES DE EL SALVADOR, <http://exportaciones.proesa.gob.sv> (last visited Sept. 23, 2013).

186. See Contreras, *supra* note 180 (noting that El Salvador had "30 meetings" with business leaders in attempts to agree on EPZ reform (author's translation)).

especially in light of tense confrontations between developing countries regarding EPZ reforms.<sup>187</sup>

El Salvador's solution also suffers from similar policy shortcomings as Costa Rica's. Instead of conditioning fiscal incentives on CSR, El Salvador's proposal does nothing to mitigate the potential negative impacts that EPZ reform will have on domestic industries.<sup>188</sup> It may also fail to provide investors with the legal certainty they crave by adopting an unimaginative solution vulnerable to a WTO challenge.

3. *Panama.* Panama reformed its EPZ law to eliminate some fiscal incentives but not others. It has eliminated the income tax exemption for the manufacturing sector, but it will continue to award EPZ companies financial contributions through tax-free importation of production equipment.<sup>189</sup> Panama may have relied on Footnote 1 of the SCM Agreement in believing this exemption is outside the scope of the SCM Agreement.<sup>190</sup> Footnote 1, however, most likely applies to products, not production equipment.<sup>191</sup> Although the provision has never been interpreted by the WTO, commentators note that the views of the SCM Committee support the contention that it applies to products, not production equipment.<sup>192</sup> Panama could also argue that tax-free exemptions for production equipment are not included in the illustrative list of export subsidies set forth in Annex I of the SCM Agreement.<sup>193</sup> But the list in Annex I is illustrative, not exhaustive.<sup>194</sup>

187. For a description of the confrontation between the Dominican Republic and Colombia over the future of EPZ systems, see *supra* notes 146–49 and accompanying text.

188. For details on how CSR may address impacts on domestic industries, see *infra* notes 212–15.

189. See Law To Establish A Special, Integrated and Simplified Regime for the Establishment and Operation of Free Zones and Other Dispositions, Ley No. 32, 5 Apr. 2011, ch. V, art. 31, GACETA OFICIAL No. 26757-B.

190. See SCM Agreement art. 1.1(a)(1)(ii) n.1 (“[T]he exemption of an exported product from duties or taxes . . . shall not be deemed to be a subsidy.”). This exemption extends to imported inputs for finished products. See Raúl A. Torres, *Free Zones and the World Trade Organization Agreement on Subsidies and Countervailing Measures*, 2 GLOBAL TRADE & CUSTOMS J. 217, 221 (2007) (“[D]uty exemptions on inputs are permitted under Footnote 1 . . .”).

191. See Torres, *supra* note 190, at 221 (“[Footnote 1] do[es] not provide coverage for exemptions and remissions of duties and indirect taxes on capital goods used in the production process of the exported product.”).

192. Creskoff & Walkenhorst, *supra* note 2, at 34.

193. See SCM Agreement Annex I. Illustrative examples listed in Annex I include, direct subsidies, provision of freight charges, tax exemptions and deferrals, and special deductions, among others. *Id.*



Hence, although Panama may have diminished its competitiveness by eliminating the income tax exemption for EPZ companies, it still subsidizes its EPZ companies within the meaning of the SCM Agreement.<sup>195</sup>

Panama's statute includes several provisions that may support claims of de facto export subsidization. The Panamanian National Commission for EPZs reviews all applications by EPZ applicants and either approves or denies them.<sup>196</sup> To initially obtain and then maintain approval, a company must submit a detailed report to the SCM Commission with information on how it will operate<sup>197</sup> and on its "principal markets of destination."<sup>198</sup> A WTO panel may view these provisions as evidence that the Panamanian government concerns itself with the location in which a company sells products. Under the but-for test of *Canada – Aircraft*, this monitoring structure may convince a panel that the subsidies would not have been granted but for anticipated exports,<sup>199</sup> especially given that the Panamanian government identifies one of its primary goals on its website as "promotion of the export[] of national products."<sup>200</sup> This export-oriented goal may tip the balance further in favor of de facto export subsidization as interpreted by the WTO.

As a policy matter, Panama has potentially left itself exposed to a WTO dispute while diminishing its competitiveness by eliminating major fiscal incentives. Panama's lower fiscal incentives may deflect investment, its elimination of de jure export requirements may harm

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194. Annex I is entitled "Illustrative List of Export Subsidies." *Id.*

195. The subsidies for tax-free importation production equipment would qualify as subsidies under Article 1.1 of the SCM Agreement, thus exposing Panama to liability for a de facto inquiry based on the legal standards established by *Canada – Aircraft* and *Australia – Automotive Leather II*.

196. See Law To Establish A Special, Integrated and Simplified Regime for the Establishment and Operation of Free Zones and Other Dispositions, Ley No. 32, 5 Apr. 2011, ch. II, art. 6, GACETA OFICIAL No. 26757-B ("The National Commission of Free Zones will have the following functions: . . . approving or canceling the operation licenses and development licenses of the free zones and the licenses of the established businesses therein." (author's translation)).

197. See *id.* ch. III, art. 19(7) (requiring a report with a "description of the objectives, activities, structures, organization, and services of the business" (author's translation)).

198. *Id.* ch IV, art. 28(7) (author's translation).

199. See *Canada – Aircraft* Panel Report, *supra* note 104, ¶ 9.340 (discussing the but-for test).

200. *About Proinvex*, PAN. TRADE & INVESTMENT AGENCY, [http://proinvex.mici.gob.pa/index.php?option=com\\_content&view=article&id=93&Itemid=55&lang=en](http://proinvex.mici.gob.pa/index.php?option=com_content&view=article&id=93&Itemid=55&lang=en) (last visited Sept. 23, 2013).

its domestic industries, and its monitoring of export destinations may expose it to de facto export subsidization challenges. By not providing investors legal certainty and offering them reduced fiscal incentives, Panama may find itself relying on its strategic location rather than its EPZ statute to attract investment.

#### IV. REFORMING WTO STATUTES BY CONDITIONING EPZ INCENTIVES ON CORPORATE SOCIAL RESPONSIBILITY

For decades, many commentators have criticized the global trading system for questionable business practices such as the provision of inadequate working conditions or the exploitation of environmental resources. As the global community strives to tackle these concerns, the upcoming WTO deadline for EPZ reform conveniently presents an opportunity to advance labor and environmental rights. As explained below, by reforming EPZ statutes and conditioning fiscal incentives on standards of CSR, government leaders have the potential to harness competitive market forces for the advancement of corporate citizenship. Using this approach, not only will government leaders be able to fulfill their legal *and* policy goals, but they will also have the potential to bring progressive change to the global trading system.

This Part sets forth a path to making EPZ statutes WTO-compliant by conditioning EPZ incentives on standards of CSR. Section A introduces and elaborates upon the granularity of CSR. Section B details how countries are able to use CSR standards in their EPZ statutes in a way that satisfies WTO requirements and makes for sound public policy. Finally, Section C anticipates and responds to potential counterarguments to the proposal of conditioning EPZ incentives on CSR.

##### A. *An Introduction to CSR*

CSR generally refers to “the social obligations of companies, as citizens, . . . to the societies in which they are embedded.”<sup>201</sup> Those obligations can be to employees, consumers, communities, or the environment.<sup>202</sup> There is no single definition of CSR,<sup>203</sup> and CSR

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201. Cynthia A. Williams, *Corporate Social Responsibility in an Era of Economic Globalization*, 35 U.C. DAVIS L. REV. 705, 721 (2002).

202. *Id.*

203. See Henry N. Butler & Fred S. McChesney, *Why They Give at the Office: Shareholder Welfare and Corporate Philanthropy in the Contractual Theory of the Corporation*, 84 CORNELL

obligations “vary by industry.”<sup>204</sup> Even though the meaning of CSR differs across countries and cultures,<sup>205</sup> the International Organization for Standardization (ISO)<sup>206</sup> has developed international CSR guidelines in its ISO 26000 Report for use by international companies.<sup>207</sup> The ISO guidelines recommend CSR policies in seven core subject areas: (1) organizational governance, (2) human rights, (3) labor practices, (4) the environment, (5) fair operating policies, (6) consumer issues, and (7) community involvement and development.<sup>208</sup> The ISO encourages countries to use these guidelines as a foundation for developing national CSR standards.<sup>209</sup> For industries that are particularly prevalent in EPZs, such as textiles, footwear products, and light manufacturing, the critical CSR issues include labor conditions and the permissibility of worker unionization, among others.<sup>210</sup> This Note will provide examples of two areas particularly important for EPZ reform: (1) labor practices, and (2) community involvement and development.

First, the implementation of adequate labor practices is significant for the continued improvement of EPZs because the International Labor Organization has documented problems such as forced overtime work, the absence of remedy mechanisms for worker complaints, and unhealthy working conditions.<sup>211</sup> Countries could address these issues by adopting regulations such as requiring companies to permit worker unionization, requiring companies to educate workers about their labor rights, mandating healthy and safe

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L. REV. 1195, 1195 (1999) (“For centuries legal, political, social, and economic commentators have debated corporate social responsibility . . .”).

204. Williams, *supra* note 201, at 722.

205. INT’L INST. FOR SUSTAINABLE DEV., ISO SOCIAL RESPONSIBILITY STANDARDIZATION: AN OUTLINE OF THE ISSUES 2 (2004).

206. The International Organization for Standardization was founded in 1947 and has published over 19,000 guidelines for international standardization. *About ISO*, INT’L ORG. FOR STANDARDIZATION, <http://www.iso.org/iso/home/about.htm> (last visited Sept. 23, 2013). The ISO has 163 country members. *Id.*

207. See Int’l Org. for Standardization, *Guidance on Social Responsibility*, ISO/FDIS 26000:2010(E) (2010).

208. *Id.* ¶ 6.1 fig.3.

209. See *id.* ¶ 1 (“This International Standard is intended to provide organizations with guidance concerning social responsibility and can be used as part of public policy activities. . . . This International Standard is not intended to prevent the development of national standards that are more specific, more demanding, or of a different type.”).

210. Williams, *supra* note 201, at 722.

211. See generally McCallum, *supra* note 4 (explaining inadequate labor conditions worldwide).

working conditions, and establishing administrative and enforcement mechanisms to receive, investigate, and address worker complaints. Conditioning fiscal incentives on these types of CSR issues would allow a country to maintain economic competitiveness while benefiting from the applicability of these CSR standards to companies.

Second, community involvement and development, defined by the ISO as “an organization’s proactive outreach to the community,”<sup>212</sup> is also critical to alleviate potential negative impacts that EPZs may have on some economic sectors in their host communities.<sup>213</sup> Countries could encourage community involvement as a condition of fiscal incentives through community input forums and organizational participation in local government.<sup>214</sup> Community-development regulations could include the maintenance of social-investment programs such as scholarships to promote education, business development programs for small businesses, or antipoverty programs.<sup>215</sup>

#### *B. A Path To Maintain Fiscal Incentives Conditioned upon CSR*

Conditioning fiscal incentives on objectively verifiable standards of CSR is an effective solution to EPZ reform for four reasons. First, unlike minimum-investment and job-creation requirements, CSR conditionality is fully compliant with Article 3.1(a) of the SCM Agreement; making fiscal incentives contingent on noneconomic criteria such as labor conditions, worker unionization, or social-investment<sup>216</sup> guarantees that an EPZ company can operate at any level of production without pressure, including producing only for domestic consumption if it chooses. As a result, any exports will be

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212. Int’l Org. for Standardization, *supra* note 207, at 63.

213. For a discussion of the possible negative impacts of EPZs on host communities, see *supra* notes 159–63.

214. See Int’l Org. for Standardization, *supra* note 207, at 64 (listing “participat[ion] in local associations” as a potential action of community involvement).

215. See *id.* at 68 (describing various potential forms of “social investment” by companies).

216. These social criteria have goals that can be easily distinguished from economic-performance requirements. Whereas economic-performance requirements have goals such as job creation and GNI growth that may depend upon export performance, the goals of increasing corporate citizenship, such as respect for workers’ human rights and humane working conditions, serve purposes completely disconnected from a company’s export performance. For a discussion of CSR as the fulfillment of obligations to various stakeholders in a community, see *supra* notes 201–02. The near nonexistent relationship between the goals of CSR and export performance will help developing countries avoid a WTO challenge to their EPZ statutes.

the result of a company's own profit-maximization strategy, not a result of government-mandated job creation or economic-performance rules.<sup>217</sup> A company's complete freedom to export its products or sell those products locally makes it much less likely that a WTO panel will find that fiscal incentives are tied in any way to exports, allowing governments to steer clear of de facto export subsidization under the but-for test or close-connection test.<sup>218</sup>

CSR conditionality also enables both domestic and foreign companies to utilize EPZ systems, avoiding suspicions that smaller, nonexporting firms are excluded from EPZ systems. With a large minimum-investment requirement such as \$10 million, Costa Rica will be essentially limiting its EPZ systems to large, export-oriented firms. In contrast, using CSR opens EPZ systems to companies of all sizes by not being tied to economic-performance requirements. This noneconomic nature of CSR conditionality will also reduce a country's exposure to WTO liability for de facto export subsidization by conditioning financial incentives on factors that—unlike job-creation requirements—a WTO dispute settlement panel is less likely to analogize to the sales targets found problematic in *Australia – Automotive Leather II*.<sup>219</sup>

Second, CSR conditionality will give investors legal certainty. A country offering business-as-usual incentive packages may seem facially more attractive than a country offering incentives based on CSR conditionality,<sup>220</sup> but investors also place a high premium on legal certainty.<sup>221</sup> Because CSR conditionality is likely to be compatible with the SCM Agreement, it offers investors this security. EPZ investors make initial investment decisions with long-term

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217. As long as companies choose to export their products without restrictions on their behavior, this will likely not be deemed a violation of the SCM Agreement. See SCM Agreement art. 3.1(a) n.4 (noting that awarding subsidies to companies that export shall not be sufficient to be deemed an export subsidy).

218. For a discussion of the differences between the but-for and close-connection tests, see *supra* Parts II.C.1–2.

219. See *Australia – Automotive Leather II* Panel Report, *supra* note 103, ¶ 9.67 (discussing sales performance targets and how they will likely lead companies to have to export in order to meet them).

220. For a critique of the argument that CSR conditionality will reduce the competitiveness of developing countries, see *infra* Part IV.C.

221. See, e.g., Rodriguez Yong, *supra* note 29, at 409 (“In 2008 the largest mining companies operating in Colombia warned the Colombian government that if it could not assure ‘legal stability with clear rules,’ they would abstain from making planned, future investments in the country worth \$200 million.”).

future visions.<sup>222</sup> Hence, legal certainty counsels in favor of CSR conditionality rather than economic-performance requirements. As an added bonus, companies can also build goodwill with consumers by demonstrating that they are investing in countries where companies are held to certain labor codes and human rights standards.<sup>223</sup>

Third, even though El Salvador discarded its initial idea of conditioning EPZ fiscal incentives on CSR for being “complex,”<sup>224</sup> enforceable options based on objective factors exist. As previously mentioned, objective criteria for CSR conditionality could include adopting strong workers’ rights codes, guaranteeing the right to worker unionization, or requiring a certain investment in microfinance activities to offset a potential rise in the unemployment rate among small business owners.<sup>225</sup> In addition, national EPZ commissions are well-equipped with statutory monitoring and investigative powers to make sure companies satisfy these criteria.<sup>226</sup>

Fourth, regardless of which objective factors governments choose, CRS conditionality will give the international community—including EPZ companies in other countries, other governments, and the WTO—an interest in enforcing those CSR standards. In essence, CSR conditionality will harness competitive market forces to support the enforcement of CSR standards. No EPZ company in Colombia, for example, will want EPZ competitors in the Dominican Republic to gain an economic advantage by receiving fiscal incentives without holding up their end of the EPZ bargain. In this way, CSR

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222. Though EPZ investors make their *initial* investment decisions based on long-term horizons, they are still able and willing to relocate if the assumptions on which their long-term investment decisions were based change. For instance, industries have fled from Honduras to Nicaragua based on changing business conditions. *See supra* note 28.

223. *See European Competitiveness Report 2008*, at 106–18, COM (2008) 774 (2009) (providing an overview of the links between CSR and competitiveness); *The Rankings*, BETTER WORLD SHOPPER, <http://www.betterworldshopper.com/rankings.html> (last visited Sept. 23, 2013) (ranking top companies for records of CSR, including apparel and footwear manufacturers that are especially prevalent in EPZ regimes).

224. Contreras, *supra* note 180 (author’s translation).

225. *See supra* Part IV.A.

226. *See, e.g.*, Law To Establish a Special, Integrated and Simplified Regime for the Establishment and Operation of Free Zones and Other Dispositions, Ley No. 32, 5 Apr. 2011, ch. IV, art. 28(7), GACETA OFICIAL No. 26757-B (Panama) (giving EPZ commissions extensive information-gathering powers within EPZs).

conditionality may spark discussions about increased transparency and monitoring in the global trading system.<sup>227</sup>

In conclusion, although current reforms eliminate de jure export subsidization, they nonetheless expose countries to significant potential liability for de facto export subsidization based on the tests applied in *Canada – Aircraft* and *Australia – Automotive Leather II*. CSR conditionality, in contrast, reduces this liability, promotes legal certainty, and has the potential to harness competitive market forces to enforce workers' rights around the world.

### *C. Potential Counterarguments to CSR Conditionality Do Not Withstand Scrutiny*

Those skeptical of CSR conditionality will likely raise three potential counterarguments: conditionality (1) may not meet the but-for test of *Canada – Aircraft*, (2) will make graduating countries less economically competitive than their counterparts who do not adopt CSR conditionality, and (3) is too complex to be managed by understaffed, under-resourced governments of graduating countries. None of these arguments withstand any level of scrutiny.

First, opponents may argue that CSR conditionality fails the but-for test. Because many developing countries tend to have small domestic economies, the majority of EPZ products will likely be exported even in the absence of export requirements, leading to large export earnings for countries implementing CSR conditionality. Opponents will argue that these increased export earnings only have to be a condition, not the sole condition, for a finding of de facto export subsidization. They will argue that EPZ systems would be unlikely to exist if all companies sold 100 percent of their products domestically, making export earnings a but-for condition of the EPZ system's existence.<sup>228</sup> Thus, even if countries have more than one goal—such as improved corporate citizenship, job creation, and

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227. The argument that EPZ companies in one country will enforce the CSR standards of their competitors in another country assumes transparency and an ability to monitor other companies in the global trading system. Although governmental commissions do have the tools necessary to monitor compliance, other private companies often will not. Further research could investigate collaborative ways to enforce such CSR conditionality on a private level. Nevertheless, the interests of private companies will still be strongly aligned with the enforcement of CSR conditionality.

228. See *Canada – Aircraft* Panel Report, *supra* note 104, ¶ 9.339 (noting that the de facto standard only requires the facts show that “had there been no expectation of export sales . . . ‘ensuing’ from the subsidy, the subsidy would not have been granted” (emphasis omitted)).

increased export earnings—export earnings would still be a but-for cause of the EPZ system.

This argument fails because it unjustifiably assumes governments would eliminate EPZs absent export earnings. When graduating countries realize that EPZ companies may not export products without export requirements, factors such as economic growth and increasing the taxpayer base would likely continue to motivate governments to establish EPZs.<sup>229</sup> No reason exists to assume that factors other than exports—employment creation or increased levels of CSR, for example—are not sufficient to justify maintenance of an EPZ system. Additionally, the burden of proof lies with the complaining country to show that the EPZ system would not exist but for export earnings.<sup>230</sup> In a case of equipoise, the principle of good faith in WTO law counsels in favor of the responding country.<sup>231</sup>

The opponents' argument also fails because even if exports do result from EPZs, they are the product of profit-maximization strategies of individual companies, not governmental economic-performance conditions such as those in *Canada – Aircraft*. Footnote 4 of the SCM Agreement explicitly prohibits a finding of export subsidization simply because companies receiving subsidies happen to

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229. Countries establish EPZs with an eye toward multiple factors, such as economic relationships with other countries, domestic economic growth, and general development. *See, e.g.,* Ley No. 8-90 Sobre el Fomento de las Zonas Francas [Law No. 8-90 On the Promotion of Free Zones], GACETA OFICIAL NO. 9775, Jan. 15, 1990 (Dom. Rep.) (listing the creation of employment and income for the local population as the first goal of EPZs); Free Zone Act, LAWS OF ST. LUCIA, ch. 15.17, pmb. (rev. ed. 2005) (listing “commerce, trade and investment with other countries,” “economic growth,” and “development” as purposes of the Act).

230. *See supra* note 97 and accompanying text.

231. The principle of good faith underlies all WTO law. *See* Andrew D. Mitchell, *Good Faith in WTO Dispute Settlement*, 7 MELB. J. INT'L L., 339, 352 (2006) (noting that good faith “influences the interpretation of every WTO provision”). The Appellate Body has stated that panels should not presume that Members have acted in bad faith. *See* Appellate Body Report, *Chile—Taxes on Alcoholic Beverages*, ¶ 74, WT/DS87/AB/R, WT/DS110/AB/R (Dec. 13, 1999) (avoiding a “presumption of bad faith”). Additionally, Panels should presume that Members have acted in good faith in executing their WTO obligations “as required by the principle of *pacta sunt servanda* articulated in Article 26 of the *Vienna Convention*.” Appellate Body Report, *European Communities—Trade Description of Sardines*, ¶ 278, WT/DS231/AB/R (Sept. 26, 2002). Hence, based on this principle of good faith engrained in WTO jurisprudence, dispute settlement tribunals should not infer that subsidies are conditioned from exports simply because subsidies are correlated with exports unless the presumption of WTO compliance is sufficiently rebutted by an “objective assessment of the facts of the case.” *See* DSU art. 11. When tribunals are unsure whether de facto export contingency exists, they should find in favor of the responding party. The burden is on the complaining party to present a prima facie case to rebut the presumption of good faith.



export.<sup>232</sup> The lack of economic-performance conditions, coupled with substantial EPZ benefits apart from exports, makes any WTO challenge of de facto export subsidization to CSR conditionality extremely weak.

Second, opponents may argue that CSR conditionality will reduce a graduating country's economic competitiveness. Allowing worker unionization could lead to higher wages and/or more favorable schedules for workers. Creating standards of community integration, social investment, or superior labor conditions applicable to EPZ companies may add to a company's operating costs. Opponents may thus argue that when a neighboring country offers EPZ incentives in exchange for simple minimum-investment requirements instead of CSR, the logical economic impulse for large companies will be to race to the bottom and accept minimum-investment requirements.<sup>233</sup>

This race-to-the-bottom argument ignores many nuances that guide EPZ investments. Investors value legal certainty in EPZ systems,<sup>234</sup> and assurances of WTO compliance will help overcome any additional operating costs of implementing CSR standards. EPZ companies also benefit from low worker turnover, and CSR will likely help reduce turnover by implementing more worker-favorable policies.<sup>235</sup> Experience also suggests that CSR will not prompt investor

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232. SCM Agreement art. 3.1(a) n.4.

233. Compare Ray Kiely, *The Race to the Bottom and International Labor Solidarity*, 26 REVIEW 67, 68 (2003) (“[C]apital is now so mobile that it bypasses nation-states, and invests where it can most benefit from low costs. Such benefits to capital may be low wages, low rates of taxation, and weak environmental regulation.”), *with id.* at 75 (labeling the race-to-the-bottom argument as “unconvincing” because the cost of labor is simply one factor of many that influence capital investment).

234. For an example of EPZ investors expressing the need for legal certainty, see *supra* note 29. The importance of legal certainty is not unique to EPZ investors; rather, it can play a significant role in investment decisions more generally. See *US Firms Decry Lack of Legal Certainty*, JAKARTA POST (June 28, 2013, 2:14 PM), <http://www.thejakartapost.com/news/2013/06/28/us-firms-decry-lack-legal-certainty.html> (“Expressing shared concerns over the investment climate in the country, a number of US multinational companies are expecting the Indonesian government to revamp the bureaucracy, ensure legal certainty and improve infrastructure.”).

235. See Zheng WeiBo, Sharan Kaur & Tao Zhi, *A Critical Review of Employee Turnover Model (1938-2009) and Development in Perspective of Performance*, 4 AFR. J. BUS. MGMT. 4146, 4150 (2010) (listing as factors for worker retention “[t]he degree to which individuals like their jobs,” “[t]he nature of the work schedule,” and “[t]he degree to which the organization is perceived to be reputable and well-regarded”). Low worker turnover allows for the accumulation of human capital over time in EPZs. Higher retention rates among employees will result in lower costs for replacement hires and training.

flight; for example, some countries have already taken steps toward guaranteeing worker unionization without witnessing an exodus of investors.<sup>236</sup> Lastly, to the extent that CSR conditions may slightly increase operating costs,<sup>237</sup> countries can work to gain advantages in other areas important to EPZ investors.<sup>238</sup>

Third, opponents may argue that CSR conditionality is too complex for under-resourced governments to manage. Similar to El Salvador's perspective,<sup>239</sup> opponents may view CSR conditionality as prone to corruption and requiring a system of monitoring and surveillance beyond the capability of developing countries. CSR conditionality, the argument goes, will thus be ineffective in promoting corporate citizenship.

This argument fails to recognize the advanced capacities of developing-country governments for three reasons. First, many governments already monitor EPZ companies to collect a multitude of advanced statistical factors for economic analysis by central banks.<sup>240</sup> Nothing prevents these governments from using the same

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236. For example, Nicaragua forged an agreement in 2010 between the government, business leaders, and eight union leaders to increase wages, improve working conditions, and promote the well-being of EPZ workers and their families. *See generally* GARY GEREFFI & JENNIFER BAIR, CTR. ON GLOBALIZATION, GOVERNANCE & COMPETITIVENESS, STRENGTHENING NICARAGUA'S POSITION IN THE TEXTILE-APPAREL VALUE CHAIN: UPGRADING IN THE CONTEXT OF THE CAFTA-DR REGION (2010), *available at* [http://www.cgcc.duke.edu/pdfs/2010-12-20\\_Gereffi\\_Bair\\_Nicaragua-apparel-report.pdf](http://www.cgcc.duke.edu/pdfs/2010-12-20_Gereffi_Bair_Nicaragua-apparel-report.pdf) (setting forth a framework for social improvement within Nicaraguan EPZs). Nicaragua's EPZs have continued to grow with this agreement, and might still be growing due to the predictability that the agreement has brought to Nicaragua by resolving labor disputes. *See* Gisella Canales Ewest, *Empleo Récord en Zona Franca*, LA PRENSA, <http://www.laprensa.com.ni/2012/04/14/activos/97886-record-zona-franca> (last visited Sept. 23, 2013) (noting that employment in EPZs continues to increase and that the Tripartite Labor Commission's efforts on behalf of workers has brought stability to labor relations issues).

237. Costs of compliance with CSR conditions may only be slight because the costs could be partly or fully offset by other gains, such as an improvement of relations with labor unions, fewer worker strikes, and thus more production. *See* Ewest, *supra* note 236 (implying that salary increases for workers has actually worked to boost investment because investors are enjoying healthy relations with workers, resulting in a predictable investment environment).

238. *See* FAROLE, *supra* note 32, at 117 (positing that a variety of factors influence EPZ investment, including, among other things, "infrastructure and administrative environment for firms," the "governance environment" at a national level, and "the position of [EPZs] relative to national, regional, and global markets").

239. El Salvador rejected CSR conditionality for being too "complex." *See supra* note 224 and accompanying text.

240. *See, e.g.*, FAROLE, *supra* note 32, at 235 box 7.9 ("The Dominican Republic, like most countries with established [EPZ] programs, requires companies to provide information on their activities on a regular basis. . . . The Dominican Republic enforces the data requirements, so compliance rates are high.").

monitoring capacities to enforce CSR conditionality. Second, governments already have experience drafting sophisticated legislation and regulations that govern their EPZ systems. These skills, combined with assistance from international organizations, will allow governments to implement well-drafted, enforceable regulations of CSR conditionality. Third, government investment agencies often have offices inside EPZs within walking distance of companies,<sup>241</sup> making on-the-ground monitoring and complaint investigation very feasible.

### CONCLUSION

As the phaseouts for export subsidy exemptions approach, developing countries must consider how to reform their EPZ statutes to meet both de jure and de facto standards of export subsidization. The touchstone limitations that the little-considered de facto standard imposes on developing countries include steering away from both economic-performance requirements and monitoring the export levels of EPZ companies. The two straightforward paths toward compliance explained in this Note that meet the de facto standard—either eliminating fiscal incentives or export requirements—highlight the competing policy choices of maintaining levels of investment and safeguarding domestic industries.

Because past attempts at EPZ reform may not meet the de facto standard, this Note has proposed conditioning EPZ fiscal incentives on standards of CSR to provide full WTO compliance. Conditioning fiscal incentives on objective standards of CSR presents a unique opportunity to harness competitive market forces for the enforcement of labor standards, workers' unions, and ethical business practices. Other EPZ companies, other developing countries, the WTO, and the greater international community will be vigilant in ensuring that host countries enforce CSR conditions. It is likely that competitively minded EPZ companies will not hesitate to be whistleblowers that expose their competitors' failures to uphold standards. When this private-market enforcement is coupled with the substantial statutory authority that national EPZ commissions possess to monitor and investigate EPZ companies, enforcement of a host country's choice of

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241. For example, the National Commission of Free Zones of Nicaragua has its home office located inside the largest EPZ in the country. See *Contact Us*, COMISIÓN NACIONAL DE ZONAS FRANCAS, <http://www.cnzf.gob.ni/?q=en/contact-form> (last visited Sept. 23, 2013) (listing the address of the Commission).

CSR standards becomes a very feasible possibility. Overall, EPZ reform is not a burden, but rather an opportunity to achieve WTO compliance while advancing corporate citizenship worldwide. Developing countries should act now to provide investors with legal certainty for their EPZ systems.