Ch. 5 Economic Philosophy and Competitiveness
Section A: Trade-related Tied and Untied Aid

Introduction

The U.S. government has been pursuing OECD disciplines on aid since the 1970s. The U. S. government goal is to limit the trade distorting impacts of aid by establishing specific rules to which trade-related aid must conform. Accordingly, an OECD agreement to discipline aid that has the greatest potential to be trade distorting (also known as "tied aid" or aid tied to procurement from the donor's country) was agreed in 1992.

The OECD tied aid rules have helped reduce tied aid to an average of about $3-4 billion annually (despite a surge in Japanese tied aid from 1998 to 2001). In 2002, Helsinki tied aid had reached its lowest level on record of approximately $2.1 billion. In 2003, although Helsinki tied aid offers rose to about $2.6 billion (**see Figure 20**), this figure continues to represent an over 70% reduction from the level before the implementation of the tied aid rules and is the second lowest total on record

Nevertheless, many foreign tied aid programs are likely to continue, and many projects supported by these programs contain a significant portion of capital goods that may have commercial implications. As a result, some US exporters perceive themselves as uncompetitive because Ex-Im Bank is generally unable to match tied aid offers for capital goods exports to developmentally-focused projects for which foreign tied aid is permissible.

In light of the success of the tied aid disciplines, U.S. government concern over the past few years has shifted focus to untied aid flows, which witnessed a dramatic rise in 2003 (although still significantly below the levels experienced in the mid-1990's). The concern began in the middle of the past decade when Japanese untied aid peaked at over $10 billion per year. The U.S. has gathered anecdotal evidence and has also challenged a Japanese untied aid offer that served as a case study of the potential for untied aid abuse, when the U.S. demonstrated and convinced other OECD Members that the offer was de facto tied to Japanese procurement.

The U.S. has been seeking since 2000 to extend the principles of the tied aid disciplines to untied aid. However, these discussions have met vehement opposition from Japan and the principal untied aid donors of the EU, who claim that untied aid poses no serious threat to free trade. Opponents to the U.S. proposal to extend tied aid disciplines to untied aid argue that untied aid is developmental, and *not* trade distorting or even trade related. Moreover, as instances of de facto tying have not surfaced as a complaint since the mid-1990s, Japan and the EU argue that disciplines for untied aid would only serve to reduce much needed aid to developing countries instead of addressing a trade distortion. The U.S. has countered by noting that disciplines limiting trade distortions would only limit untied aid that had a trade motivation.

Responding to foreign opposition to discipline untied aid and in an effort to advance the technical negotiations beyond an OECD stalemate, during 2003 the United States proposed an interim agreement to enhance transparency of untied aid offers. That is, the U.S. proposed that untied aid donors agree to make their <u>offers</u> public to allow for competitive international bidding, and to report the nationalities of bid winners. The purpose of the transparency proposal is to: (1) gather information that would help U.S. exporters compete for sales financed with foreign untied aid; and (2) compile evidence of possible de facto tying of "untied" aid to procurement from the donor country. If the transparency exercise is adopted, U.S. exporters will be in a better position to bid on projects financed with foreign untied aid and donors may be under pressure to avoid unfair bid awards.

U.S. Government and Ex-Im Bank Policy

The U.S. favors aid that represents *bona fide* development assistance. The U. S. thereby seeks to reduce (ideally eliminate) aid that is trade distorting because it:

- Disadvantages U.S. exporters, i.e., redirects business away from U.S. and other suppliers whose products are superior in quality and price.

- Closes markets and misallocates both international and developing country resources. Furthermore, it results in higher contract prices, a capital-intensive development bias, skewed technology choices and an increased debt burden.

Consistent with long-standing U.S. export financing policy, Ex-Im Bank does not initiate tied aid. Instead, Ex-Im Bank and the U.S. Treasury Department work together to determine whether to match a foreign tied aid offer. The decision to match is made on the basis of largely objective criteria, used to determine whether a tied aid match provides negotiating leverage for introducing new disciplines or is useful for enforcement of existing disciplines. The U.S considers that tied aid used within the rules to gain a longer-term advantage for sales on market terms violates the spirit of the tied aid rules and should be matched. The USG would generally not require multiplier criteria to match foreign de minimis tied aid offers for commercially viable projects. This is because such tied aid can sometimes represent a competitive issue for U.S. exporters even though it was excluded from the OECD tied aid rules to reduce the administrative burden on ECAs.

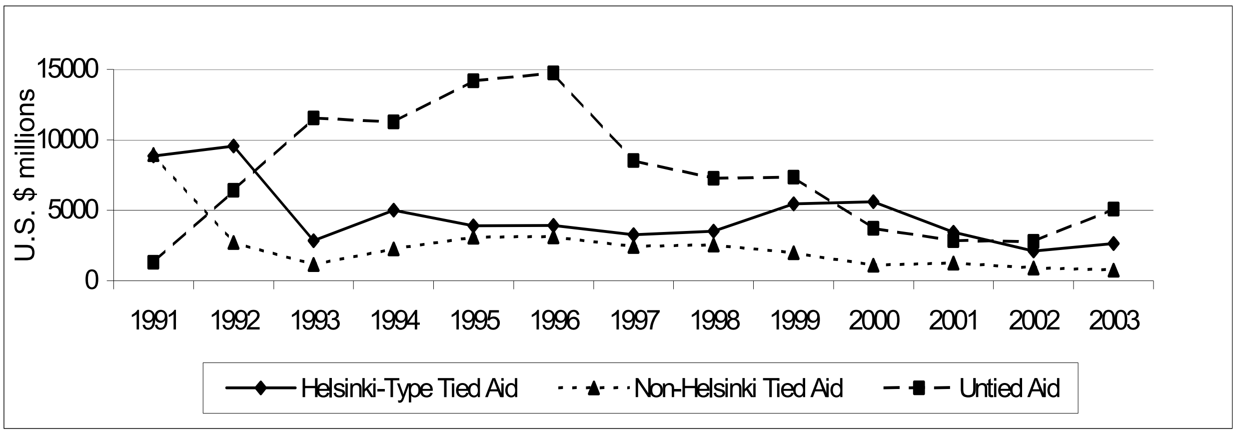
Responding to U.S. exporters' demands for a U.S. Government response to foreign governments' use of concessional financing for development-related capital projects, in 2002 the TPCC introduced a USG mixed credit concept. The idea was, and still is, to combine USAID grants with Ex-Im Bank standard export credit financing for development-related projects that are identified as priorities by USAID and consistent with the OECD tied aid rules. (When combined, the two funding sources create a tied aid credit.) In 2004, USAID and Ex-Im Bank identified an inaugural project to test the mixed credit concept and are currently working out how to implement the project.

Summary Data

The 2003 aid data shows that tied aid levels have remained fairly stable since 2000. While tied aid program sizes remain stable, Spain, Finland and Portugal reported increased (and somewhat targeted) tied aid activity. However, only Spain is globally significant, with tied aid notifications in 2003 of approximately $750 million. On the other hand France, the Netherlands and Japan (who typically report high levels of tied aid) all seem to be containing their tied aid programs.

Small or "de minimis" tied aid offers (tied aid offers under approximately $2.5 million) increased to their highest level since 2000. In 2003, donors reported 90 de minimis tied aid offers compared to 74 offers reported in 2002 and 60 in 2001. In terms of volume of de minimis offers, in 2003 the volume rose to $147 million, up from approximately $94 million in 2001. However, both figures are far below the peak of $455 million that de minimis tied aid reached in 1995. As the de minimis tied aid offers are only subject to notification requirements, such tied aid can be offered (and was) for projects in commercially viable sectors such as power, industry and transport. The main donors of de minimis tied aid were Spain (34 cases); Austria (17 cases) and Denmark (12 cases).

Figure 20: Aid Credit Volume by Type



Note: "Helsinki-type" tied aid is subject to three principal disciplines: (1) no tied aid for commercially viable projects; (2) minimum 35% concessionality; and (3) country limitation (no country recipients with a per capita income above $2,935, but the figure may change annually as it is based on annual World Bank lending criteria; see **Appendix G, Annex 1**). OECD Participants determine commercial viability based on the nature of the project, a feasibility study presented by the donor, and, if needed, a "consultations" meeting held to discuss the commercial viability of the project.

"Non-Helsinki-type" tied aid includes: stand-alone *de minimis* projects (valued at less than approximately $2.6 million), grants or near-grants (at least 80% concessionality) and partial grants (at least 50% concessionality) offered to the poorest countries (the UN declared Least Developed Countries, or LDCs). Except for de minimis tied aid offers, these types of aid offers are normally not considered to have serious trade-distorting effects and, therefore, are exempt from the Helsinki rules regarding commercial viability and the consultations process (although all tied aid is subject to notification requirements, and *de minimis* tied aid must meet minimum concessionality and per capita income requirements).

During 2003, Ex-Im Bank made no new tied aid authorizations. However, the Bank approved a $19.2 million Tied Aid Letter of Interest for a transaction in Jamaica. The Tied Aid Letter of Interest was approved to match a foreign tied aid offer that was in violation the OECD rules. The U.S. brought this violation to the attention of the OECD and obtained support to reopen the bidding process. The U.S. exporter ultimately did not win the bid but this was due to technical – not financing -- concerns. In addition, Ex-Im Bank reinstated a previously approved tied aid transaction where the final disbursement date had expired. The borrower and exporter requested an extension in order to complete shipments and disbursements. Nonetheless, in 2003 Ex-Im Bank did not expend any of the $260.5 million in the Tied Aid Capital Projects Fund.

Figure 21: Notifications of Helsinki Tied Aid and Consultations Group Examinations

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	Total
Number of notifications	128	138	262	226	212	195	191	213	181	123	136	129	2,134
Number of projects examined by Consultations Group	39	25	31	14	4	2	5	2	4	2	1	2**	131
Number of non-compliant projects	16	12	21	4	3	2	5	1	4	1	0	1	70*

*Of the "non-compliant" cases (i.e., cases deemed commercially viable by the OECD Consultations Group), 19 were abandoned and 33 proceeded within Arrangement procedures or on commercial terms. The disposition of several cases is presently unknown.

Both projects were found to be financially viable but one project was found to be commercially non-viable due to lack of ECA cover in that particular market, which meant that the project was eligible for tied aid. Ex-Im Bank's matching authority is generally used to deter foreign tied aid offers that do not comply with the letter and/or spirit of the Helsinki rules, which have been reduced to practically zero at present, or to create negotiating leverage to establish new disciplines (see **Appendix G, Figures G4 and G5).

Exporter and Lender Survey Results

Only half of the survey respondents commented on tied aid, with one reporting that they had not seen such competition in several years and none reporting sales lost due to tied aid. Nevertheless, of those responding, over half expressed frustration with respect to foreign trade related aid programs, rating the Bank's tied aid program as having a "negative" impact on their competitiveness. In particular, on tied aid, exporters continue to complain that Ex-Im Bank should use its matching authority more frequently. As for untied aid, focus group participants noted an emerging trend in which untied aid offers are won (potentially displacing U.S. sales) by third-country subsidiaries of companies based in the donor country.

Conclusion

The total amount of tied aid levels rose slightly in 2003, and de minimis tied aid rose at a greater rate, but both remain dramatically below past levels. In sum, several of the G-7 OECD Members (and some other OECD Members) have aid programs that initiate tied aid and operate within the international disciplines that were set forth in the OECD tied aid rules. The TACF today (jointly overseen by Treasury and Ex-Im Bank) is clearly focusing its use on matching only those cases that leverage ongoing negotiations, enforce current disciplines or threaten to distort commercially based competition in the future. Moreover, the competitive environment today is one in which volumes of tied aid have dropped over the past decade, while untied aid levels are rising. Most foreign aid offers comply with negotiated disciplines or have a developmental cast, and no new tied aid negotiations are ongoing or imminent. As a result, there are very few (and in some years, no) final authorizations of the TACF (although two to three cases per year do meet the current criteria and are offered support from the TACF). The success of the tied aid rules and diminished need for use of TACF to match foreign offers is consistent with overarching U.S. trade policy (although unsatisfactory from the view of some exporters).