International Cooperation on Subsidies and Industrial Policy[1]

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A central source of trade tensions between the EU and the US on the one hand and China on the other concerns the use of subsidies and industrial policies. But the use of subsidies by national and sub-national governments is not simply a 'China issue'. Subsidies of one type or another constitute the great majority of trade interventions imposed since the Global Financial Crisis of 2009. The Global Trade Alert, an independent initiative that compiles data on trade policies, has documented that subsidies account for more than half of the 20,000+ measures implemented by G20 member countries affecting trade in the last decade (Evenett, 2021).[2]

The main WTO instrument for non-agricultural subsidy-related policies, the Agreement on Subsidies and Countervailing Measures (Li and Rubini, 2021), prohibits export subsidies and regulates the use of countervailing duties to offset injurious effects of foreign subsidies on domestic producers. The agreement applies only to trade in goods. The focus is on potential adverse effects of national subsidies on foreign products. A broad notion of actionable subsidies applies: measures that impose a direct burden on the government budget (including fiscal transfers through tax expenditures). To be actionable a subsidy must be specific (as opposed to benefitting economic activity more generally), and convey a benefit to the recipients. Financial support for exports and local content requirements are prohibited.

WTO rules have important gaps and many nations agree with the EU position that there is a need to revisit and update the rules of the game for subsidy policies. The current set of rules were crafted in the 1980s, before the rise of global value chains, the emergence of China as a major trading nation, and the growth in trade in services and the digital economy. They do not cover investment incentives or services activities. They leave unclear how to treat the activities of state-owned enterprises and whether such entities are a 'public body', or whether input subsidies or differential taxes that lower domestic prices of inputs are covered (Li and Rubini, 2021).

As discussed at greater length in Hoekman and Nelson (2020), subsidies are appropriate instruments for many policy goals, but will generally have spillovers via effects on trade. Any subsidy policy can have spillover effects on other sectors and on other countries. Some of these spillovers may be positive, others will be negative. To be successful, any revision of the international subsidy regime must rest on a clear understanding that the economics and politics of subsidies differ across polities; consider the goals that motivate their use; and the nature of cross-border spillovers they create. If the goal is to discipline policies

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[2] See https://www.globaltradealert.org/.

that give rise to spillovers, the focus of attention must be on effects as opposed to narrowly defined policy instruments.

The optimal response to foreign subsidies that affect competitive conditions will vary depending on the objective functions of both (all) national policymakers. WTO rules pay no attention to the objectives of governments using subsidies. There is no notion in the WTO of what constitutes a “good” subsidy. This contrasts with EU law, which recognizes the legitimate role of certain types of subsidies and establishes a presumption these are not objectionable. Hoekman and Nelson (2020) describe an economic approach that can be used to assess whether a subsidy effectively addresses a market failure or objectives of common interest, balanced against associated negative effects on competition in the relevant market. An important feature is a shift away from rigid ‘hard law’ rules to focusing on the effectiveness of subsidies in attaining economic and non-economic objectives and their effects on markets.

The international subsidy regime can move in this direction through application of relatively simple, robust rules of thumb derived from the theory of economic policy. These recognize the right of nation states to engage in a wide range of domestically warranted subsidy policies, but also that conflicts will emerge over modalities and levels of acceptable competitiveness spillovers. Making such conflicts the subject of technical discourses focused on establishing the goal of a subsidy, whether it addresses a market failure, or pursues a legitimate domestic goal in a plausible way, and whether trade spillover effects are necessary to achieve the goal, may deflect much of the political heat associated with conflicts over inherently domestic issues.

A revamped subsidy regime requires participation of the United States, the European Union, and the People’s Republic of China – the three global trade powers (Hoekman and Wolfe, 2021). The rules must be seen as supporting the generalized gains from open trade and global production, not an attempt to isolate or ‘reform’ China. At the same time, China should accept that it has a leading role to play in the regime. The three majors should recognize their political economies are consistent with a broadly liberal international regime even though they are, and will remain, profoundly different from one another. This is not new ground for the WTO. An initial effort to include a category of non-actionable subsidies in the WTO expired in 1999. It was too narrow, and did not distinguish subsidies that address (global) market failures from those that do not. WTO members should revisit what was started over 20 years ago. Preparing the ground requires a collective effort to measure and analyze the prevalence and effects of subsidies, using robust, transparent methodologies. A cooperative rather than adversarial approach is called for, centered on deliberation informed by a concerted data collection program and analysis.

Governments can see distortions that look like they were caused by subsidies offered by other countries, but they lack the data to illuminate that state support. A first step can be taken by launching a work program to compile information and analyze existing subsidy programs in systemically important economies, bringing together the epistemic community with expertise and interest in subsidies. This should include a focus on sub-national subsidies (Evenett and Kong, 2021). No international platform exists that brings together national Finance and Economy ministries, competition authorities and international organizations concerned with the governance of subsidies. Building bridges across these groups can help provide a basis for mutually beneficial cooperation in this area.

Development of a body of professionally competent, peer reviewable, internationally balanced work will generate common ways of talking about and thinking about the issue of subsidies. For all the differences in national regimes, this may support agreement over time on good practice norms and standards. As those become more widely accepted, national governments can legitimate subsidy policy internationally by adopting those standards. The more this is treated as a technical, not a political, endeavor, the greater the likelihood of an epistemic community on subsidy issues taking root. Disciplines on subsidies must begin with information, and this public good is under-supplied. Formal notifications may not be the best way to enhance understanding of policies that might be affecting the health of the trading system. Countries need to understand the incidence of subsidies – including those that are granted by or applied to state-owned enterprises – before they can analyze the potential trade distortions, a necessary input into any negotiation on new international disciplines.

Delegation of both measurement and analysis to a trusted, neutral and technically capable body is critical to support the needed deliberation by states. The OECD has played this role for decades in producing comparable analyses of subsidy regimes in agriculture. This work illustrates the importance of going beyond documenting policies to measure the magnitude of interventions using well-defined indicators. Many international organizations collect information on and monitor the use of subsidy instruments. A joint initiative that spans the OECD and specialized international financial and development organizations in which the major emerging economies are members can provide the needed technical and analytical support. The G20 Trade and Investment Working Group is an existing mechanism that includes the major international agencies. The need for such an effort has become even more urgent and salient given the COVID-19 pandemic-related increase in the use of subsidy programs.

The WTO should provide a platform to members willing to invest resources into a work program to compile information and analyze existing subsidy programs in systemically important economies, bringing together the epistemic community with expertise and interest in subsidies. A call to launch an international work program on subsidies may be criticized as kicking the can down the road. It is not. WTO members simply do not have sufficient information to develop a common understanding of where new rules are needed and the form they should take. Calling a time out on the current focus on unilateral action and bilateral/trilateral talks to establish new rules in order to develop such understanding is a necessary condition for keeping the WTO relevant in the 21st century. The need for such a mechanism has only become more urgent to assist countries manage the aftermath of the COVID-19 pandemic.

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