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Reforming the WTO's subsidy rules - A new opportunity to tackle the global distortions of China's state capitalism

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The African Group proposes to reform the WTO's subsidy rules for industrial goods. Even if this demand for more policy space entails some problems, the EU should view this as an opportunity. By combining the African Group's proposal with new rules against trade-distorting industrial subsidies by major global players, the EU can start a new initiative to tackle global economic distortions emanating particularly from non-market economies. While this initiative is no panacea, it offers various attractive advantages.

Introduction and background

In order to keep the World Trade Organization (WTO) fit for purpose, renewed interest from the main trading partners is required. An important reason for the WTO's demise is its inability to guarantee a level playing field for trade in industrial goods. The Agreement on Subsidies and Countervailing Measures (ASCM) is inadequate to rein in the serious competitive distortions emanating from non-market economies such as China.

China's state capitalism relies on industrial policy support, extensive and broad-based subsidies and state-owned enterprises (SOEs). This system has proven successful for China. However, as the Chinese economy has grown, the spillovers of its economic system to the world market have led to increasing competitive distortions on a global scale. Growing evidence shows that while also other countries use industrial subsidies to some extent, China does so disproportionately. As a result, Chinese firms outcompete otherwise efficient European firms in more and more markets and large Chinese overcapacities depress world prices in several important sectors.

Several efforts to reform the ASCM, continually initiated mainly by the US and the European Union (EU) in the past, did not succeed. In addition, a Trilateral Initiative including Japan, focused on industrial subsidies and SOEs. Several communiques were published, and in November 2018 a formal proposal to improve the notification practice for industrial subsidies was submitted to the WTO on the basis of an even broader coalition of co-sponsors. However, all of these initiatives met with China's resistance. As the WTO's decision making is based on consensus, these reform initiatives were therefore doomed to failure.

In recent years, this development has contributed to a global subsidy race and the increasing use of trade barriers. If this continues, the multilateral trading order will come under increasing pressure and the WTO's future looks dim.

New Initiative to reform ASCM

Independent of this background, the African Group has recently proposed a reform of the ASCM in order to broaden the leeway for industrial policy measures in developing countries.

- Against the backdrop of the compounding global challenges, the African Group argues that flexibilities concerning the provision of subsidies by developing countries should be extended and expanded.
- One proposal is to update and extend the definition of the conditions that determine what kinds of flexibilities apply to countries depending on the income levels. For example, it is proposed to update the current GNP per capita threshold of $ 1,000.
- Furthermore, prohibitions to local content requirements should not apply to developing countries. Local content requirements postulate, e.g., that foreign firms have to use a certain share of domestic inputs which aims at fostering the development of domestic industries.
- Developing countries should be able to grant subsidies for research and development, regional development, and environmental protection. To this aim, the expired provisions of Article 8 of the ASCM should be reinstated and amended to acknowledge the greater scale of the climate change crisis.
- Moreover, the threshold for the termination of countervailing duty investigations should be increased and the standard for negligibility revised.

Proposal: Package deal for ASCM reform

The authors proposed that the EU should take up and support the African Group's proposal, provided certain conditions are met:

- First and foremost, the proposal to widen the policy space for developing countries must not be applicable to China. Therefore, the status as a developing country, which China formally still has in the WTO, cannot be the decisive criterion. Rather, eligibility to weaker ASCM disciplines must be restricted to countries in need.
- The proposal of the African Group should be used as an impetus for a broader reform of the ASCM: more policy space for poor countries on the one hand and stricter ASCM rules on the other, but only for major trading partners, with regard to trade-distorting industrial subsidies and trade-distorting practices of SOEs.
- The term 'major trading partner' is to be understood either as a country with an income level above a certain threshold or as a country with a global trade share above a certain threshold, irrespective of the country's formal status as a developing country in the WTO.

The content of the additional ASCM rules that apply to major trading partners need to be defined with great care. The following three pillars can serve as a basis:

- The Trilateral initiatives' communique of 14 January 2020 considers it necessary to expand the current list of prohibited subsidies in the ASCM. Among other subsidies, unlimited guarantees, certain forms of debt forgiveness, subsidies to an insolvent or ailing enterprise in the absence of a credible restructuring plan should be included. For other types of harmful subsidies, a reversal of the burden of proof is requested so that the subsidising member would have to demonstrate that there are no serious negative trade or capacity effects. If that is not the case, the subsidy would have to be withdrawn. The three partners discussed several forms of problematic subsidies, including excessively high subsidies, subsidies creating massive manufacturing capacity as well as subsidies that prop up uncompetitive firms and prevent their exit from the market.
- Moreover, relevant overviews and surveys of China's trade distorting subsidy system and recent OECD studies on global subsidies should be taken into account. Based on case studies for relevant sectors and forms of subsidies, the OECD provides very instructive insights to build upon. It shows, in particular, that in several sectors and fields the amount of industrial policy support in China stands out by a large margin, indicating substantial competitive distortions.
- In addition, the chapters on disciplines for industrial subsidies and SOEs in some recent free trade agreements can serve as a basis. This could, for example, be the case for the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). However, the degree of ambition would have to be further increased.

The EU should strive to find co-sponsors for its approach among like-minded countries such as the US, Japan, Canada and others.

Opportunities and benefits

The proposal by the African Group offers the EU the opportunity to bring the issue of ASCM reform back to the WTO's table. Seizing this opportunity has several advantages:

- The loopholes of the ASCM become ever more problematic and the need to close them all the more pressing, the larger the Chinese economy becomes and the more Chinese companies enter world markets.
- Reforming the ASCM can contribute to limiting the growing global subsidy race.
- As an ASCM reform is a vital issue for many industrialised countries, the initiative has the potential to rekindle the interest of this influential group in the WTO. In the run-up to the 13th Ministerial Conference (MC13) in Abu Dhabi in February 2024, it is particularly relevant to bring the WTO back on the stage of relevant trade policy decision-making.
- The EU and its potential co-sponsors can join forces with the African Group in the global competition between China and the West to draw developing countries on their side. Thus, an ASCM reform proposal can flank the EU's Global Gateway Initiative in response to China's Belt and Road Initiative (BRI) and to China's attempt to instrumentalise the BRICS+ in its geopolitical interests.
- Poorer developing countries that progress on the income ladder should have an interest in limiting the subsidies which advanced countries and larger trading partners can hand out, because the fiscal space of developing countries is much more limited. Thus, stricter ASCM rules for the major trading partners to ensure a level playing field, are a necessary complement to the proposal of the African Group. Otherwise, the reform of the ASCM would be one-sided.
- China would be covered by the stricter ASCM rules despite the fact that it is still considered a developing country in the WTO. Thus, the initiative would put pressure on China to eventually recognise and accommodate the interests of the EU and its potential co-sponsors in a sufficiently levelled playing field on world markets regarding industrial subsidies.
- In addition, the EU could counter China's attempt to present itself as the supporter of developing countries' interests in Geneva. If China blocked the ASCM reform, it would also block the vital interests of the African Group and other developing countries in gaining more policy space for development.

Conclusion and open questions

Reforming the ASCM will remain difficult. China's opposition is likely to remain strong. However, some progress might be possible. Moreover, raising the pressure on China to move in the WTO is in itself a benefit. The same is true for showing the African Group that the EU is on their side.

Moreover, working out the details of the ASCM reform proposal will be a major challenge. In particular, a decision is required on good and bad subsidies. This is especially relevant for green subsidies, as the EU and the US have begun to massively subsidise green technologies – partly as a reaction to China's massive subsidies in this field. Furthermore, thresholds need to be defined for de minimis levels of government support also in other industrial sectors. Looking at the treatment of agricultural subsidies in the WTO might be helpful in this respect. For example, the box-approach can be instructive, defining red, amber and green boxes, with the latter applying to allowed subsidies.

Moreover, the EU might struggle to find co-sponsors. Especially, the US would have to come on board rather sooner than later. However, the Biden administration might not be prepared to tie its hands with an ASCM reform in view of the ongoing subsidy race with China in many fields. Nevertheless, it might also see the opportunity to raise the pressure on China in Geneva and to expose China's paradoxical status as a developing country.