



Institute for International Trade

INDUSTRIAL SUBSIDIES, STATE-OWNED ENTERPRISES AND WTO REFORM: PROSPECTS FOR COOPERATION?

Executive Summary

The role of the state and market-distorting state intervention in the global economy have come increasingly to the fore in recent times, in large part as reaction to China's rise to becoming the second largest world economy, and a direct competitor with developed economies across many sectors. State-owned enterprises (SOEs) and industrial subsidies have played an important part in China's development, a fact that has become increasingly contentious in developed country capitals. The Trilateral Trade Ministerial Cooperation (Trilateral Cooperation) comprised of the US, EU and Japan has laid out an agenda for World Trade Organization (WTO) reform targeting SOEs and industrial subsidies. China has separately laid out its own reform agenda that includes removing agriculture subsidies entitlements in developed economies. In many ways both reform agendas are pulling in opposite directions, indicative of growing geo-economic tensions between these leading economic powers. This policy brief outlines the two opposing reform agendas and proposes a process for getting to a realistic landing zone for reforms.

The Problem: Conflicting Agendas on Industrial Subsidies, SOEs and WTO Reform

The distorting effects of SOEs and industrial subsidies on global market competition has become a topic of increasing importance for many WTO members in recent years. There is growing pressure for WTO reform that involves new rules for governing use of industrial subsidies, notification of subsidies by governments, and also the role of SOEs. On these issues the US, EU and Japan are cooperating

under the Trilateral Cooperation to clarify their specific concerns and propose solutions. China can reasonably be viewed as the major target of Trilateral Cooperation reform proposals owing to the central role of SOEs in its economy, and the tensions arising from increased economic competition globally between China and leading developed economies in many sectors. Any reform viewed as China-specific will be dealt short shrift in Beijing. Likewise, any counter proposal that ignores developed country concerns about unfair competition deriving from industrial subsidies and their deployment by SOEs will meet strong resistance from the Trilateral Cooperation. The risk is that opposing reform agendas become an intractable standoff between direct competitors. Understanding the nature of both proposals is crucial to identifying a political process for getting to a possible agreement.

The Trilateral Cooperation Industrial Subsidies Reform Agenda

The Trilateral Cooperation trade ministers have held three meetings since January 2019, each with publicly released 'Joint Statements' outlining an emerging shared agenda for addressing key issues in international trade¹. The agenda was broadly framed as follows in the brief January 9, 2019 joint statement:

The Ministers advanced discussions on their shared objective to address non market-oriented policies and practices of third countries that lead to severe overcapacity, create unfair competitive conditions for their workers and businesses, hinder the development and use of innovative technologies, and undermine the proper functioning of international trade, including where existing rules are not effective.

¹ The joint statements from each of the three meetings can be found here: January 9, 2019: <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/january/joint-statement-trilateral-meeting> May 23, 2019: <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/may/joint-statement-trilateral-meeting> January 14, 2020: https://trade.ec.europa.eu/doclib/docs/2020/january/tradoc_158567.pdf

In outlining a broad programme for reform the January statement identifies amongst others the need to deal with ‘industrial subsidies and state-owned enterprises, forced technology transfer policies and practices’, as well as emphasizing the problems arising for fair competition from non-market orientated policies and practices of ‘third’ countries. Reasonable observers may assume the unnamed ‘third’ country is China.

The May 2019 Trilateral communique adds further details with regard to claims of ‘third’ country deviance, outlining concerns about third parties’ developing State Enterprises into national champions, distorting global market prices, and using State Enterprises for strategic political purposes relating to the goal of controlling key global markets. The May 2019 Trilateral statement affirms a shared commitment to deal with problems posed by SOEs to competitive, open markets. One path advocated by the Trilateral Cooperation is to strengthen disciplines on industrial subsidies².

A third Trilateral Joint Statement was released on 14 January 2020, and provides some further concrete proposals for reforms on the key themes of industrial subsidies, and also outlines their position on the causal origins of the WTO Appellate Body (AB) crisis. Regarding subsidies, the Agreement on Subsidies and Countervailing Measures (ASCM) is identified as ripe for reform (Box 1). Key Trilateral ASCM reform proposals are:

- (1) The current list of prohibited subsidies in Article 3.1 is too narrow to deal with some ‘third’ country practices, and needs to be expanded.
- (2) The expanded list ought to include: unlimited financial guarantees; subsidies to insolvent enterprises that lack a credible restructuring plan; subsidies to firms unable to obtain commercial financing or operating in sectors with overcapacity; and some forms of direct debt forgiveness.
- (3) ASCM reform should include reversing the burden of proof for very large subsidies.
- (4) A clause of serious prejudice to the interests of WTO members should be added to Article 6.3 in relation to subsidies that distort capacity³.
- (5) Stronger incentives to notify subsidies should be added to Article 25.

A point of further note is that the January 2020 communique intervenes in the AB crisis, relating specifically to SOEs (see next paragraph). This has its roots in long-standing US complaints that the AB has engaged in unacceptable (to the US) judicial activism through strong interpretations of existing ambiguities in WTO agreements, and by making rulings that set new precedents and new law by filling in gaps in the existing statutes⁴. In doing so, the US argues that AB rulings have impinged upon its national sovereignty by adding to its rights and obligations in WTO agreements contrary to Article 3.2 of the Dispute Settlement Understanding, which states that ‘recommendations and rulings of the Dispute Settlement Body cannot add to or diminish the rights and obligations provided in the covered agreements’. This is the reasoning behind its decision to block new appointments and thereby defenestrate the AB indefinitely.

Neither the EU nor Japan supported the US’s nuclear option of blocking new appointments to the AB over its concerns with AB activism⁵. However, and in relation to the issue of subsidies reforms

discussed here, the EU and Japan have lent their support to the US critique of the AB’s ruling on a case with high importance for dealing with industrial subsidies through the DSU provisions. The US contends that the 2011 AB report on the case⁶ incorrectly re-defined the broad definition of a ‘public body’ in the original ASCM as any entity controlled by government to a much narrow definition as ‘an entity that possesses, exercises, or is vested with governmental authority’ (paragraph 317). The definition is central to current debates on ASCM reform, and is particularly relevant to economies with a large SOE presence. The AB report further stated that the burden of proof to show that ‘the government exercises meaningful control on the conduct of the entity concerned and that it has bestowed it with governmental authority’ (paragraph 318) should fall upon the investigating authority (paragraph 352).

By way of this ruling the AB narrowed the original ASCM definition of a public body and added new burden of proof requirements for successful litigation by complainants. The January 2020 Trilateral Cooperation statement states that ‘The Ministers agreed that the interpretation of ‘public body’ by the WTO Appellate Body in several reports undermines the effectiveness of WTO subsidy rules’, and goes on to fully repudiate the AB ruling by stating: ‘To determine that an entity is a public body, it is not necessary to find that the entity possesses, exercises or is vested with governmental authority’.

This statement is a definitive condemnation of the AB’s alleged activism on the definition of ‘public body’. The Trilateral Cooperation offer no solution to the AB crisis, but make a commitment to continue working on the problem. While it is clear the Trilateral Cooperation has a broad reform agenda in mind, it should also be clear that their agenda specifically targets practices and policies typical to non-market economies that have a significant SOE component, i.e. China. Therefore, we next turn to the subsidies reform agenda from China’s perspective.

Box 1: Agreement on Subsidies and Countervailing Issues

ASCM

The ASCM specifically addresses multilateral disciplines used to regulate the provision of subsidies and the application of countervailing measures for offsetting domestic economic injury arising from subsidized imports. To identify a subsidy as defined within the ASCM three basic elements must all be present: (1) a financial contribution (2) by a government or any public body within the territory of a Member (3) that confers a benefit. The applicability of subsidy discipline is further determined by whether a subsidy is “specific”. “Specificity”, as outlined in Article 2, requires that access to a subsidy is limited to a certain enterprise or limited number of enterprises, or enterprises within a defined geographical region within the jurisdiction of the bestowing authority. On the other hand, there is no specificity where objective criteria exist for eligibility for receiving a subsidy, and where those criteria automatically apply to all enterprises and are publically accessible.

² For a policy-orientated assessment of this proposal see: Hu, Weinian, ‘Industrial Subsidies, State-Owned Enterprises and Market Distortions: Problems, Proposals and a Path Forward’, *Institute for International Trade*, PB 05, December 2019. Available at: <https://iit.adelaide.edu.au/news/list/2019/12/20/industrial-subsidies-2>

³ Subsidies that distort capacity are described within the third Trilateral Cooperation Joint Statement as: “subsidies creating massive manufacturing capacity, without private commercial participation”.

⁴ See United States Trade Representative ‘Report on the Appellate Body of the World Trade Organization’, February 2020; see also Cartland, Depayre and Woznowski (2012) ‘Is Something Going Wrong in the WTO Dispute Settlement?’, *Journal of World Trade* 46(5): 979-1016, for analysis that supports the US view on AB activism.

⁵ The EU, for example, moved immediately to set up an ad-hoc appeal body to which a further 16 WTO members had signed up by late January 2020. <https://www.euractiv.com/section/economy-jobs/news/china-wto-members-join-eus-ad-hoc-appellate-body-in-davos/>

⁶ Appellate Body Report, *United States – Definitive Anti-Dumping and Countervailing Duties on certain products from China*, WT/DS 379/AB/R adopted 25 March 2011.



The Chinese Subsidies Reform Agenda

The Chinese government outlined its own agenda for WTO reform in a document submitted for circulation at the WTO General Council on 13 May 2019⁷. While this document is intended for multilateral-track reform, it also indicates China's position for any plurilateral negotiations outside of the WTO framework, which is where subsidies reform progress will likely need to initially occur. China's views on reform rest on three broad pillars:

- (1) Reform must conserve the multilateral principles of non-discrimination and openness.
- (2) Reform should protect the interests of developing Members.
- (3) Reform should follow the principle of consensus decision-making.

In briefly assessing each of these points, starting with pillar three, it is clear that in the currently log-jammed WTO reaching a consensus on key issues, including subsidies, will be difficult. The principles encompassed in pillar one have been in retreat since 2009 as discriminatory measures have proliferated⁸; while pillar two is under threat as debates on Special and Differential Treatment (S&DT) and graduation criteria emerge⁹. Nevertheless, China provide specific policy recommendations that require careful consideration. These are as follows:

- (1) Full elimination of the Aggregate Measure of Support entitlements for developed countries — which allows them to provide higher levels of agriculture subsidies than their de minimis level.
- (2) End the AB appointment blockage, and begin an informal process to resolve the issues underlying the AB crisis¹⁰.
- (3) End the abuse of the security exception used by a 'certain Member' for unilateral actions.

- (4) Improve trade remedies rules, including curbing what China views as unilateral misuse of trade remedies by certain Members.

Annex 1 provides a comparative overview of the main reform positions staked out by the Trilateral Cooperation and China during 2019–2020. Clearly the two reform agendas are pulling in different directions, based on the interests of the proponents. A realistic view is that these will not be resolved all at once, nor in the short-term. The upshot, however, is that there are potential trade-offs to be made which can provide the grist for a negotiation mill to get up and running. Our recommendations below will speak directly to the processes for establishing such a negotiation.

Goeconomic tensions

'Goeconomics' refers to analysis of international relations through economic variables. There can be little doubt that China's economic rise is central to international tensions over its economic system, and concerns that unfair advantages accrue to its SOEs and wider industrial system as a consequence of the nature of relations between the Chinese state and its state-owned entities. The US political system has increasingly come to view China as a strategic rival during the 2010s¹¹, a period when China became the world's second largest economy measured in market prices, and largest when measured in purchasing power parity. During this decade China also failed to converge towards a more open, democratic political system that many assumed would occur in tandem with economic liberalization. Instead, the one-party political system is firmly entrenched, and SOE domination over large swathes of the economy at the expense of private firms has grown under Xi Jinping's leadership.¹² Overall, the view that market access reciprocity has been lacking in China, coupled with the view that China's SOEs have received unfair state aid that has helped the country become an export powerhouse, are significant factors driving the Trilateral reform agenda.

⁷ *China's Proposal on WTO Reform*, WT/GC/W/773, 13 May 2019.

⁸ As outlined in detail by the 'Global Trade Alert' series of reports published since 2009. See <https://www.globaltradealert.org/reports>

⁹ For a policy-orientated weighing-up of debates over S&DT see Humphrey (2019) 'How can LDCs Ensure they Continue to Benefit from Special and Differential Treatment in the WTO?' <https://iit.adelaide.edu.au/system/files/media/documents/2019-07/IIT%20PB03%20SD%20Treatment.pdf>

¹⁰ New Zealand's Ambassador and Permanent Representative to the WTO David Walker, was appointed in January 2019 to lead an Informal Process aimed at finding 'workable and agreeable solutions to improve the functioning of the Appellate Body' (WTO/JOB/GC/222). On November 28, 2019 Ambassador Walker outlined specific principles designed to address the six U.S. concerns, but failed to persuade the US to change course on its plan to block new appointments to the Appellate Body, thereby preventing its continued functioning.

¹¹ One need only read a May 2020 White House report titled 'United States Strategic Approach to the People's Republic of China' to understand how far the relationship has moved into competitive territory. The opening paragraph captures the essence of this shift: 'The CCP's expanding use of economic, political, and military power to compel acquiescence from nation states harms vital American interests and undermines the sovereignty and dignity of countries and individuals around the world'. Available at: <https://www.whitehouse.gov/articles/united-states-strategic-approach-to-the-peoples-republic-of-china/> (accessed 26/06/20).

¹² As outlined in Nicholas Lardy's (2019) *The State Strikes Back: The End of Economic Reform in China?* Peterson Institute for International Economics.

The US now exhibits bipartisan support for viewing China's economic rise within a competitive strategic lens, while the EU has labelled China a 'systemic rival promoting alternative models of governance'¹³, thus adding an overt competitive political dimension to its economic relationship with China. Japan's political leaders have long promoted a China-plus-one investment model to ensure Japan does not become overly reliant on trade with the country¹⁴. China, in its turn has become increasingly confident in its political and economic system¹⁵, such that reforms viewed as specifically targeting key components of its political economy, for example SOEs, are likely to meet strong resistance. Consequently, strategic, political and competitive elements motivate both reform agendas, necessitating a nuanced political economy process to begin moving towards a landing zone for reform.

Diverging Reform Agendas

It is worth comparatively assessing the respective agendas further. China's position on trade remedies is instructive of the gap between it and the Trilateral Cooperation on key issues. Where the Trilateral Cooperation sees abuse of industrial subsidies provision and market distortion as a major issue, China instead focusses on what it views as an abuse of the application of countervailing measures as well as price comparisons in anti-dumping proceedings. Where the Trilateral Cooperation sees a need to expand the current list of prohibited subsidies in Article 3.1 to deal with non-market practices, China instead seeks to reinstate and expand provisions on non-actionable subsidies. Where the Trilateral Cooperation targets SOEs, China argues for consideration of special situations of developing Members and public interest. Where the Trilateral Cooperation is silent on the market-distorting effects of AMS entitlements in their agricultural subsidies, China calls for their full elimination.

In combination, the Trilateral Cooperation members and China account for almost half of global trade in goods and services¹⁶, so their agendas for WTO reform must be the foundation of any realistic set of proposals. Nevertheless, their current agendas are far apart in orientation, contain opposing policy recommendations (see Annex 1), and have been gestated in an increasingly tense geopolitical environment. In that light there is a need to develop the reform discussion in a manner that avoids a Trilateral Cooperation vs China standoff.

Getting to a Landing Zone

Two points stand out with regard to formulating a realistic path forward for key reforms based on the above agendas.

First, given the oppositional nature of the policy recommendations a broader reform package will likely be needed to enlarge the scope for negotiating trade-offs. This would provide the basis on which a reduced but still worthwhile set of reforms could be negotiated. This approach of widening the scope, thereby allowing all major parties to secure some of their offensive negotiating interests while also conceding some of their defensive interests, underpinned the Uruguay Round — the last successful major multilateral trade negotiation¹⁷. Along the way agriculture, and agricultural subsidies, were brought within multilateral disciplines notwithstanding the initial reluctance of major agriculture subsidisers, notably the EU. The specific device employed in the Uruguay Round was the 'single undertaking', meaning that 'nothing was agreed until everything was agreed'. While the 'single undertaking' mechanism can be a

“ The growing view that rivalry between nations has moved from the domain of economics to the domain of political economic systems means that strategic, political and competitive elements motivate both reform agendas—thereby necessitating a nuanced political economy process to begin moving towards a reform landing zone. ”

useful tool, it should also be noted that the failed Doha Round also proceeded on the basis of a single undertaking. Thus matching the mechanism to the context is key. In the current geopolitical environment it is our view that negotiations designed to achieve industrial subsidies reform will likely need a more flexible approach.

That said, the possible architecture of a deal on industrial subsidies reform is taking shape. Specifically, it is likely to draw on the Agreement on Agriculture's colour-coded 'boxes'¹⁸, corresponding to a spectrum of non-trade distorting subsidies to most trade distorting subsidies. This would most likely focus on the ASCM, by expanding the coverage of prohibited subsidies, while re-establishing the expired permissible subsidies such as those supporting regional development, research and development, and environmental management. At the same time tighter disciplines governing the usage of countervailing duties are likely to be on the table.

Second, if any of the proposed reforms are to result in meaningful re-writing of WTO rules more players need to be interpolated into the process. The G20 is the best starting point. Given that industrial subsidies (Trilateral Cooperation) and agricultural subsidies (China) reform feature prominently across the agendas we focus on those, although the proposal could be replicated for other issues. Because of the current gridlock in the WTO, initially a plurilateral process is envisaged, based on developing a three-prong approach which, if successful, could feed into a broader WTO reform agenda:

- The G20 should establish a **subsidies reform sub-committee**. This would be comprised of senior trade and finance ministry officials, as these officials have responsibilities to cover trade and industrial policy, financing of such policy, as well as the wider policy dimensions that arise with subsidies. The remit of the sub-committee needs to be multi-year and not tied to the Presidential rotation of the G20, as working through reform packages that are technically complex, as well as economically and politically sensitive will be slow. The aim here would be to devise a plurilateral path forward that could eventually feed into a WTO reform agreement.
- To stay connected to an eventual WTO reform agenda, intra-G20 meetings should be **replicated in Geneva**. Here G-20 members based in their respective WTO delegations would have regular meetings with regard to the subsidies reform agenda. The benefits of this approach are twofold. First, it will ensure that G20 discussions are informed by broader WTO reform considerations being worked out in Geneva. Second, informal liaisons with non-G20 WTO members who are interested in subsidies reform

¹³ European Commission report, 'EU-China – A strategic outlook', March 2019.

¹⁴ Enderwick, Peter, 2011 'A China-Plus-One Strategy: the best of both worlds?', *Human Systems Management*, 30: 85-96.

¹⁵ Kerry Brown, 'China's exceptionalism rewrites the Western political playbook', *The Economist*, Jun 13, 2018, <https://www.economist.com/open-future/2018/06/13/chinas-exceptionalism-rewrites-the-western-political-playbook> (accessed 22/06/2020).

¹⁶ 'World Trade Statistical Review 2019', World Trade Organization, Geneva, Switzerland.

¹⁷ The authors would like to thank the participants of an Institute for International Trade webinar (July 2020) on industrial subsidies reform for highlighting the historical salience of agriculture reform during the Uruguay Round as an instance when seemingly unlikely reform was realized through diplomatic persistence and creative process management.

¹⁸ Green, blue, and amber, respectively. For more context consult the World Trade Organization's explainers, available at https://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm3_e.htm. Accessed 11th August, 2020.

negotiations can be engaged in an ongoing manner, with an eye towards eventual broader reforms. However, the caveat is that given the problems with gaining consensus at the WTO, this second element is a ‘best endeavour’ activity that ought not to hold up the G20 plurilateral initiative. One way to bridge this potential divide could be for willing WTO members to agree to a ‘joint statement initiative’; that could be incubated by the G20 process.

- US-China relations, in particular, are currently in a fraught state of high tension¹⁹. The need for politicians to appear ‘tough’ towards their respective opponents in public has increased as the bilateral relationship has deteriorated. Their positions on subsidies reform, and WTO reform more generally, are likely to become entrenched in opposition to one another in the current political mood. As a consequence, establishing **back-channel diplomacy** may be beneficial under the circumstances. This would have the benefit of allowing engagement away from the glare of the media, and the need for ‘tough talk’ that plays to the public gallery. Back-channel discussions can also help overcome a trust deficit by allowing informal yet structured communication to help better define the expectations of each party, help each party understand the nature of the others’ domestic constraints, and identify possible avenues for realistic trade-offs. The dangers of back-channel diplomacy include the potential for confusion if managed poorly, since it involves simultaneous but distinct tracks of discussion. It can also generate public backlash through leaks, or because unexpected results are generated for which the public has had no prior indication. Despite these issues, a well-managed back-channel process could be a useful tool for constructive engagement between the US and China at this current juncture.

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1. ANNEX 1: TRILATERAL GROUP AND CHINA REFORM AGENDAS



TRILATERAL POLICY RECOMMENDATIONS

1. Expand list of prohibited subsidies
2. Reverse ACSM burden of proof for very large subsidies
3. New clause of serious prejudice to interests of WTO members for subsidies that distort capacity
4. Stronger subsidy notification incentives
5. Restore original textualist understanding of ‘public body’

CHINA’S POLICY RECOMMENDATIONS

1. Expand list of non-actionable subsidies
2. Eliminate developed countries’AMS entitlements for agricultural subsidies
3. Improve trade remedies rules
4. Improve rules on security exception to prevent misuse
5. Tightening rules on unilateral measures inconsistent with WTO obligations



¹⁹. Already tense relations between China and the US have deteriorated rapidly during 2020, as the Trump administration claimed the PRC withheld information on covid19 that would have allowed early containment. The US has also revoked Hong Kong’s special trade status due to Beijing’s new security law being enacted. China has reacted strongly to these actions, stating respectively that there is no evidence of withholding information on the virus, and that the US should not interfere in what China views as internal policy vis-à-vis Hong Kong. Rhetoric on both sides is far from polite, and contributes to an increasingly distrustful and uncooperative mood.

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