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How to Stop the Global Subsidies Race

-- *Speaking Notes* --

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-- *SPEAKING NOTES* --

Good afternoon and thanks to Cato for including me in this timely panel discussion. The views I will express this afternoon are mine alone, not reflective of any client positions, and fall under three headings. First, as requested by the organizers, I will provide some reactions to today's presentation by Scott Lincicome. Second I will share some of my own thoughts on improving subsidy control – what might work, what probably will not work, and how U.S. leadership can make a difference. And then third, I will – time permitting – offer a few comments on discrete proposals that have surfaced for adding new anti-subsidy mechanisms into existing US law.

I. Reactions to Lincicome Presentation

Scott's "Countervailing Calamity" paper has a lot of important insights, and I want to begin by noting several points on which we agree.

- We agree that there are too many subsidies everywhere. Scott's selected tour of U.S. subsidization hits three "A"s – agriculture, alternative energy and autos. Indirectly, by critiquing official export credits, he hits a fourth "A" – aerospace. There is of course a lot of U.S. subsidization elsewhere in the alphabet, starting with B (remember the battery consortium?) and on from there. It would be an interesting parlor game for budget geeks to try to identify one for each letter.

- We agree that these subsidies are generally bad news and bad policy. I was interested to note, however, that Scott's critique pulled up short at one point where I expected it would plunge forward. Specifically, his "subsidies-are-a-pox" discussion included good observations about waste, rent-seeking and crony capitalism.[1] But it omitted a seemingly-important punch line: a government that subsidizes less *requires less revenue*. If all these aid measures were really just a matter of government handing out freebies, that would be bad but not calamitous. But of course, freebies aren't really free. Government is more present in all of our lives – not only because it is doling out resources, but because it has to obtain those resources in the first place.

[1] This is a good point to disclose that I have been involved in some of the subsidy-related rent-seeking behavior that Scott rightly denounces. I once helped a client seek a share of a limited pool of Energy Department loan guarantees. And on a more personal note, in 2009 I did a "cash for clunkers" exchange. (Scott says these transactions cost Uncle Sam $24 thousand apiece. I would like to know where the other $21 thousand in my deal went, as I got an enhancement of roughly $3 thousand on the gas guzzler I traded in.)

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- We agree on some other broad points – for example, that U.S. leadership on subsidy discipline is indispensable and currently too timid, and that existing subsidy control tools can be used to better effect than is presently happening. And we seem to agree that subsidy discipline becomes more important as trade liberalization advances. In other words, subsidies can cause more mischief on the other side of a thin border than a thick one.

- And we agree about a final, wonky point: the need for caution in making comparisons and calculations that lump together subsidies in grant form and subsidies in other forms. Far too often, both in journalism and in political debate, these efforts to mix apples and oranges are botched. Scott's paper is admirably careful and rigorous in this respect. (There was a wonderful "spin room" moment after last night's Presidential debate. During the main event, Governor Romney, citing top-line budget figures, had assailed the Obama administration's "profligate" spending including Energy Department loan financing. Afterwards, an Obama surrogate tried valiantly to explain that the subsidy element in the loan programs was not the total amount loaned but something considerably smaller. Subsidy geeks watching at that moment may have experienced some brief satisfaction, but I doubt anyone else did.)

So where does Scott's analysis go astray? We have two main areas of disagreement.

First, Scott seems to believe, but I do not, that CVD enforcement in the United States has generally been an abomination. His bill of particulars includes two big issues: the application of the CVD law to products exported from countries classified for antidumping purposes as "non-market economies," and the U.S. system's refusal to cabin CVDs through application of the so-called "lesser duty rule." He also cites four narrower items related to the Commerce Department's analysis of subsidies: the interpretation of the term "public body"; the use of out-of-country "benchmarks"; the (supposedly lax) application of the "specificity" test; and the attribution of subsidies in cases featuring producer networks with "cross-ownership." I will resist – pending Q&A at the end of our session – the urge to dive into the weeds on each point but disagree with Scott on all of them. And I find it an odd thesis to assert, as Scott does, that gutting our CVD remedy is part of a strategy for achieving improved subsidy discipline. Indeed, the very relevance of CVD enforcement to a discussion about subsidy control is debatable. Even if spared the ravages recommended by Scott, and left in its current incarnation, the CVD remedy today can only play a minor role in subsidy control. It may be true that, as Professor Jackson has opined, CVD enforcement can actually help to deter subsidization. But this is a side benefit and one that the CVD system delivers, at best, incompletely. (Maybe there is a legislature somewhere on earth, where a proposed subsidy could be voted down based on concerns that some slice of it might, someday, be offset through extra duties imposed at the border of an importing country. I have spent a good deal of time reading transcripts of legislative debates in a fruitless search for precisely such nuggets.)

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Our second area of disagreement has to do with the causes of lapsed U.S. leadership. Scott blames over-subsidizing and over-countervailing – in other words, he contends that by becoming a profligate subsidizer itself, and by massively over-using its CVD remedy, the United States has managed to destroy its credibility in the field of subsidies and subsidy control. I do not read the record that way. I do not believe the recent economic stimulus measures (even with the auto component) did much to change the United States' overall profile as a subsidizer. And with that longstanding profile (neither constant sinner nor perfect saint), the United States has in the past been willing to advocate, and even be the world's leading advocate, for restraint on industrial subsidies. Nor do I see CVD enforcement as having disabled Uncle Sam's megaphone where subsidy control is concerned. Rather, I attribute the decline in U.S. leadership to a hopefully-temporary bout of Post-Traumatic FSC Disorder or "PTFD." This refers to the first really major WTO dispute involving U.S. subsidies. The U.S. loss in that case, and the ensuing process of finding a legislative solution to stave off trade retaliation, were so harrowing as to make our Treasury Department lastingly (I would say pathologically) skittish when it comes to subsidy rules. One result is that the United States has been unable to press hard for real advances in subsidy control and has declined to support *any* new discipline on subsidies conferred through a tax system. More because of that case than because of any fundamental change in values and interests, the United States has lost – I hope temporarily – its taste for increasing discipline. And so it has stepped back a bit from the ramparts, where unfortunately no one else is stationed.

I do not want to overstate the size of that step backward. The United States did introduce (and did put a bit of muscle behind) some discipline-enhancing proposals in the Rules Negotiating Group of the Doha Round. One of these would have established a new "quite dark amber" categorization within the ASCM, similar in certain ways to the expired provisions of ASCM Article 6.1. One can question how much this reform would really have bolstered discipline, but at least it pointed in the right direction. Some experts have suggested that if it were in force as part of the WTO rulebook, this proposal would have made the U.S. auto bailout a WTO-prohibited subsidy measure. But it wound up attracting too little political help from the EU – whose commitment to multilateral subsidy discipline is also known to wax and wane – and real blockage from China. It is also important to credit U.S. anti-subsidy enforcement actions, even in the auto sector where our hands are now unclean. We aren't *against* subsidy discipline, or even against all advances in subsidy discipline. We just don't prioritize this issue in the way we used to – a subtle shift that regrettably has big consequences because of the indispensable and lonely role Uncle Sam historically has played in this field.

II. Improving Subsidy Control

I would now like to back up and try to answer, on a clean slate, the same question Scott sought to tackle: how to improve control of all these (wasteful/harmful) subsidies. Most of my suggestions emerge from my field of expertise – international trade law and policy. That is not meant to imply that trade officials

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have primary competence, or bear primary responsibility, for keeping the fiscal behavior of governments on a sane and reasonable path.[2] Still, trade negotiators over the years have tried – if only because they had no other choice – to fashion some limited guardrails to discourage that which is the most insane and most unreasonable. It's not a bad place to start.

- *Getting better mileage out of ASCM notifications*. The potential utility of WTO-based notification and surveillance, as a source of discipline, has never been fully realized. While some Members have tried to set a good example with timely and detailed notifications, the general pattern has been one of non-adherence, especially for sub-national aid. The recent U.S. "counter-notifications," aimed at India and China, have been laudable but also rather depressing in what they reveal about the insufficiency of *regular* notification. This is an area where Members could do better if they were willing. It would not require a formal amendment of the WTO Agreement to introduce at the Committee level some meaningful, negative consequences for under-notifying.

- *Avoiding shrinkage of the prohibited (export-contingent) category*. The "prohibited" category is enormously important to the overall discipline provided by the ASCM. The Large Civil Aircraft cases may eventually provide a counter-example, but so far the Part II prohibition is the only part of the ASCM subsidy control scheme that has proven to work decently. And by far the most meaningful prohibited category is the export-contingent category. There are threats to the integrity of that category, threats that should alarm subsidy hawks of all ideologies. The Appellate Body ruling in *EU – Large Civil Aircraft* (addressing Airbus subsidies) requires, for finding subsidies contingent on *anticipated* export performance, an analysis that often will be impossible as evidenced by the inability to use it in the very case in which it was announced. And the debate over proposals to apply the U.S. countervailing duty law to currency subsidies has provided even more grounds for alarm. Opponents of that initiative have argued that even when the overwhelming majority of a subsidy flows to exporters, for whom exporting is both a necessary and a fully sufficient condition to receive it, export contingency cannot possibly exist.

- *In agriculture – escaping the trap of color-coded boxes*. Trade negotiators expend huge efforts on establishing "modalities" which are supposed to facilitate the subsequent conduct of actual negotiations. When it comes to agriculture subsidies, the modality now in use is itself a source of difficulty. I won't belabor the details here, but would be glad to cover this in Q&A if anyone

[2] For a useful summary of efforts – and the limited effectiveness of those efforts – to curb one sectoral subsidy arms race on pure bang-for-the-buck grounds, *see* "Subsidies for Moviemakers: Disappointing Results Lead to Second Thoughts" (AZCapitolTimes.com guest opinion Sept. 28, 2012), *available at* http://azcapitoltimes.com/news/2012/09/28/subsidies-for-moviemakers-disappointing-results-lead-to-second-thoughts/.

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so desires and would direct interested readers to some prior written musings on the subject.[3]

- *In services – agree on disciplines*. Rules for subsidies in the services sectors were an item of unfinished business at the end of the Uruguay Round. They remain in that same status today. Like many parts of the rulebook originally developed for trade in goods, subsidy control concepts and definitions are difficult to apply to services trade – but not impossible. The biggest hurdles have already been surmounted, by those who achieved similar "translations" of the national treatment and MFN principles and thereby produced the GATS. And experience within the EU state aid regime shows that it is possible to negotiate, and then enforce, disciplines on trade-distorting subsidies in the services sectors. There will have to be a few sector-specific caveats (e.g., for financial and audio-visual services) in any services subsidies pact, just as there are on the goods side (agriculture, aerospace). The task is nonetheless manageable, and it should not remain in limbo on the multilateral "to do" list.

- *In new rules fashioned to deal with State Capitalism.* Trade negotiators have traditionally pursued disciplines on the treatment of – and on the behavior of – state-owned enterprises (SOEs) in a scatter-shot fashion. Subsidy rules touched one facet of the problem, national treatment rules a second, and government procurement rules a third; there have also been commitments on ensuring that SOE purchasing (when it cannot be characterized as government procurement) is based on commercial considerations. Now, negotiators in various settings (most notably the Trans-Pacific Partnership) are testing a more integrated approach in which "SOE disciplines" effectively becomes a category unto itself. Much of the discussion involves regulatory advantages accorded to SOEs and the products/services they sell. But these discussions also provide an opportunity to tighten discipline on *fiscal* advantages. Progress in this respect would be welcome, as aid within the state-owned and state-invested sector has long been one of the worst subsidy sore spots.

The above are largely paint-within-the-lines proposals, maybe somewhat heretical in relation to agriculture but generally calling for faithful application of rules already agreed and straightforward progress in initiatives already launched. I was prepared to rest, today, on this safe list. But then it occurred to me that I really ought to take up Scott's challenge and try to generate a new idea for how the United States can burnish its subsidy discipline *bona fides* and reassert leadership in this field. Such an idea came to me yesterday.

So: with the caveat that it is at present half-baked, and invoking the safety of the "think-tank" setting where we have gathered today, here is my big idea. Being in the nature of an autonomous reform, it does not require any difficult international negotiations. I am provisionally calling it a "braking mechanism for subsidies."

[3] These are both presentations given at events organized by the Global Business Dialogue. See http://www.tradewinsllc.net/publi/Ag-Subsidies-GBD-7-04.pdf; and http://www.tradewinsllc.net/publi/Peace_Clause_GBD_12_03.pdf.

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It begins with the observation that the United States has a front-loaded system for ensuring compliance with commitments made in trade agreements. Usually using Trade Promotion Authority (TPA) legislative procedures, Congress passes, prior to entry-into-force, implementing bills that are supposed to make all adjustments needed at the statutory level. The behavior of government organs is thereafter supposed to follow U.S. law (as amended) rather than directly seeking conformity with international obligations.

This approach works well when what we have committed to do involves cutting a tariff or amending a customs law. But it is an awkward approach to ensuring compliance over time with commitments in the subsidy field, such as the promise not to cause (through the use of subsidies) adverse effects to trading partners. For a given subsidy program, there is no way to know ahead of time what level of payments might result in adverse effects to a trading partner two, five or ten years down the road. Even if U.S. spending holds steady, market conditions may change in such a way that spending which was non-problematic in year two becomes highly problematic in year six. This possibility cannot be addressed up-front. And in fact, when one looks at U.S. trade agreement implementing bills, one does not see any tinkering with spending programs. Spending is handled in totally distinct legislative processes – Farm Bills for agriculture spending, mainly appropriation bills and Continuing Resolutions otherwise. The occasional result is akin to a car on a highway, with the cruise control set at 55mph, moving through occasional 40mph zones and having no one conveniently situated to touch the brakes. There is no nimbleness in our system, when it comes to ensuring continuous adherence to our commitments in the subsidy field.

Hence the proposal: the President could be given braking authority – the ability to scale back spending based on findings that doing so is necessary to prevent an imminent trade agreement breach. To ensure accountability without destroying nimbleness, the President would be required to notify – but not seek permission from – the Congress. This would be a special category of impoundment. I can see no way to extend the principle to subsidies conferred through the tax code, but at least where actual spending is concerned it might work.

That is, it might work if it were constitutional – a detail I have not yet had time to research. That complication aside, I believe this "braking mechanism" would amount to a bold stroke, in terms of U.S. leadership on subsidy control and respect for the (relatively light) disciplines that have so far been negotiated. And it would address a deficiency in our otherwise well-designed (TPA-based) system for honoring trade commitments. It could be tested initially in a Farm Bill, with a view to making it thereafter a regular feature of spending bills that contain subsidies.

III. New U.S. Anti-Subsidy Measures?

In my few remaining minutes, I want to give some attention to the occasional efforts one sees to deploy additional U.S. anti-subsidy measures. By way of background, the U.S. approach to foreign subsidies includes two main remedial

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tools: CVD enforcement and usage of WTO disciplines. These remedies, while broadly accepted, are also frequently unsatisfying in their results and incomplete in their coverage. For example, they do not reach subsidies that distort two of the main types of cross-border commercial flows: flows of capital and of traded services. Further, where these remedies do apply – in disputes over traded goods – CVD offsets can be maddeningly small, and there is no guarantee that subsidies found to be WTO-inconsistent will even be curtailed, much less retracted. As a result, other remedies are proposed from time to time. Examples include:

- *Scrutiny of inbound investment*: When CNOOC some years ago made a hostile bid to acquire assets of Unocal, there were cries that the bid was government-subsidized and should receive stricter-than-normal CFIUS (national security) scrutiny on that account. More recently, Gary Hufbauer, a leading authority on subsidies and anti-subsidy policy, sounded an alarm over subsidized inbound FDI in a study prepared for the U.S. Council for International Business. And in meetings of a State Department advisory panel that reviewed the U.S. bilateral investment agreement (BIT) model text, concerns were raised about subsidized financing of investments made in the United States, particularly those made by foreign SOEs. Some panel members urged that – whether or not national security is implicated – the legal protections of future BITs should not be extended to foreign investors that use subsidized financing when purchasing U.S. assets.

- *Award of counter-subsidies*: Periodically, U.S. companies develop evidence on foreign government subsidies for the purpose of persuading public authorities (federal or state) in the United States to provide more generous aid to *them* – to even the scales.

- *Anti-preferences in public procurement*: There is a view – a minority view inside government, but probably capable of commanding majority support in public opinion – that a bidder's receipt of foreign government subsidies should be counted adversely in decisions about the award of U.S. government procurement contracts. This notion has gotten quite a bit of play over the years in connection with defense procurement and, particularly, the recent competition to supply aerial refueling tankers to the U.S. Air Force.

The pressure to go beyond CVD law and WTO disciplines, and turn to other remedies like the three mentioned above, is understandable. But on inspection these proposed/additional remedies have important defects.

- There is reason to doubt the need for *any* policy response to "subsidized" inbound investment. Experience to date has provided no evidence that subsidization is something to be worried about when capital (as opposed to goods) is coming in across the U.S. border. In general, subsidies to a foreign investor simply drive up the purchase price of assets being sold by Americans. Foreign taxpayers may get a raw deal, but no one in the United States is harmed – at least not in the way that occurs with subsidized

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imports that take business away from competing U.S. producers. Our investment regime has never excluded, or even taken a negative view of, inbound investment by foreign subsidy recipients.

- Counter-subsidies are a poor policy, pointless over the long haul, however tempting they may be in individual circumstances. This is a classic race-to-the-bottom policy, and anyone with even a rudimentary understanding of the famous "prisoner's dilemma" knows that we can do better.

- That leaves the question of public procurement, and whether government buyers should be agnostic or should look askance at foreign-subsidized bidders. An agnostic approach has great appeal: given the huge outlays involved, it is tempting to say that procurement officials should take a ruthlessly value-based approach and leave morality (and industrial policy) for others to worry about. On the other hand, as noted above, the idea that spending/investment decisions made by politicians in foreign capitals could affect the outcome of *any* competition to sell goods inside the U.S. market naturally generates a certain level of discomfort. If subsidies received by a foreign bidder are the subject of anti-subsidy proceedings (such as a CVD case or a WTO dispute), and if those proceedings point toward remedial actions that could interfere with the foreign bidder's ability to fulfill its side of a government contract, then that circumstance should naturally be taken into account by the contracting agency just like any other situation that might affect performance. The harder question is whether, absent such a circumstance, procurement anti-preferences should in principle be added to the toolbox of anti-subsidy remedies. As a legal matter, they probably could be, at least in the defense sector, since military procurement is not covered by existing obligations under the WTO *Agreement on Government Procurement*. But I am not persuaded that traveling this path is a good idea. Discrimination cuts against the grain of existing norms in both international trade and procurement – norms that have evolved for good reasons and have proven their worth over time. There is also the practical question of what an anti-preference would look like – whether subsidized foreign bidders (branded with a "Scarlet S"!) would be excluded from bidding or just scored negatively, and in the latter case by how much. Maybe a carefully tailored version of this proposal – one that would do more good than harm – can be devised. But I haven't seen it yet.

* * *

Thanks for your attention. I look forward to the questions and discussion to follow.