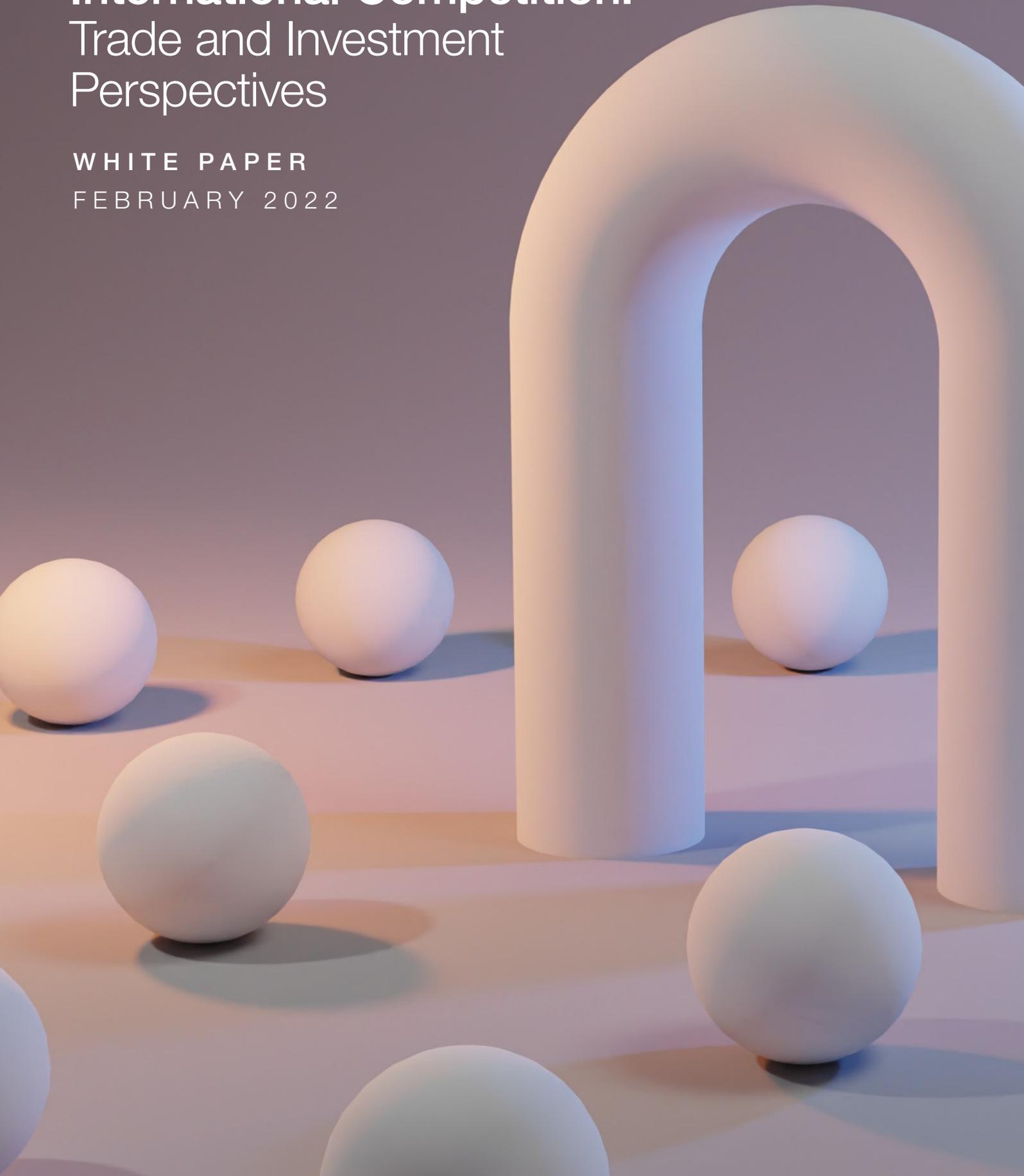


Industrial Policy and International Competition: Trade and Investment Perspectives

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Preface



Børge Brende, President,
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Attitudes to the role of the state in the economy are changing. The COVID-19 pandemic and associated lockdowns and restrictions have accelerated this. Governments have invested in developing vaccines and treatments, supported households and firms, taken stakes in struggling strategic companies and intervened to ensure the supply of essential goods. As economies move towards recovery, governments will have a role to play in encouraging investment, creating jobs and ensuring equitable growth.

Climate change has provided another compelling rationale for increased government involvement to ensure markets price-in negative environmental externalities and technological solutions are commercially viable.

International cooperation is essential in tackling these global challenges. Trade tensions and unilateral retaliation erode trust and undermine multilateralism. Yet multilateral disciplines are needed to address the cross-border spillover effects created by state intervention. Existing rules go some way in doing this, but the fact that they have not been updated to account for new economic rationales for intervention, growth models and economic realities is a source of trade tensions.

This paper recognizes an opportunity to reopen the discussion among countries on how international trade and investment rules should address level-playing-field concerns, while promoting transparency and allowing for public policy objectives. Clarity on the direction of policy-making in this regard will be crucial in securing business confidence. This conversation must be inclusive of the perspectives of developing and least-developed countries. These countries, as well as many disadvantaged communities within all societies, are being left behind on the road to recovery. Limited social security systems, healthcare, digital infrastructure, access to vaccines and government spending capacity contribute to this.

The issues addressed in this paper are of significance not only to trade negotiators, but also policy-makers in the areas of investment, competition, finance and revenue. A coherent, government-wide approach will improve the effectiveness and transparency of government intervention, while limiting the negative impacts on other economies and societies.

Executive summary

International rules need to be revised to better deal with the spillover effects of government interventions in national economies.

All governments intervene in their economies to some extent – whether through subsidies, the operation of state-owned or controlled undertakings, government procurement policies that favour domestic players, the use of trade remedy measures or investment-screening regimes. International trade and investment rules seek to manage the spillover effects of these interventions on other markets, balancing legitimate interests.

Disagreement among countries regarding the extent to which international rules should discipline these interventions is one of the sources of ongoing trade tensions. Yet, as all governments increase their intervention, whether in the context of the COVID-19 pandemic and recovery, securing critical supply chains or environmental imperatives, there is an opportunity to engage in a balanced, inclusive conversation about how to update the rules. This must include issues of concern to developing and least-developed countries.

This paper outlines the existing rules, areas of debate and priorities for reform for a broad set of industrial policy measures. It aims to encourage more in-depth conversations among trade and investment negotiators about the way forward. This paper also summarizes key issues for senior business representatives. Specifically, it calls on countries to revise international rules or guidelines:

- To establish criteria to recognize “good” subsidies that are non-actionable (allowed); revise the list of prohibited subsidies; introduce guidelines for temporary crisis-support measures; and include agricultural and service-sector subsidies in the scope of reforms
- To develop criteria for identifying when public undertakings act in accordance with commercial considerations; and improve corporate governance standards for state-owned or controlled enterprises
- To re-examine the coverage of SOEs and developing countries in the Government Procurement Agreement
- To provide clarity and methodologies on investment-screening measures by updating the 2009 Organisation for Economic Co-operation and Development (OECD) Guidelines
- To agree to limits on unilateral actions and retaliation; and clarify rules on countervailing duties on “transnational subsidies”

The paper makes a strong call for better data and analysis of government measures. Timely, accurate and complete notifications are an important aspect of this, as are initiatives by international and non-governmental organizations to collect and present data in useful formats.



Introduction

Tensions between national economic systems have arisen, but so have opportunities to reassess international rules.

Current trade tensions are the result of various underlying issues. Some argue that existing international rules and enforcement mechanisms fall short in limiting distortions and providing firms with a level playing field globally. Yet disagreement exists on the extent to which international trade rules should allow diversity in national economic systems. Should these rules enforce convergence towards a single (market-based) economic model and discipline deviations, or should they act as an interface when tensions arise between countries with diverse models and institutions?¹

Against a background of economic nationalism and the COVID-19 pandemic, all states have become more interventionist – providing subsidies and loans to businesses and sectors and income support to individuals, buying equity stakes in leading companies and procuring medical supplies in large

quantities. It remains to be seen when and to what extent crisis-induced measures will be removed. Given this shifting dynamic, an opportunity emerges to reassess international trade rules and their constraints on domestic measures that affect the terms of trade.

Even outside of crises, there is often a strong rationale for industrial policy approaches, namely sustained productivity growth, diversification, inclusive development, employment creation and green transitions,² as well as justifications for state intervention to tackle market failures and implicit distortions.³ State intervention is common, though it is found in different forms and to varying extents in different economies. International rules should focus on addressing the harmful spillover effects of these interventions.

Rationale for international disciplines as new industrial policy becomes more commonplace

Policies designed to stimulate dynamic activities can both reinforce and counteract market forces and their allocative effects. There is some agreement that state planning and public investment alone cannot act as the driving force of economic development. It is also increasingly accepted that there is an important role for government policies to encourage further restructuring, diversification and technological dynamism.⁴

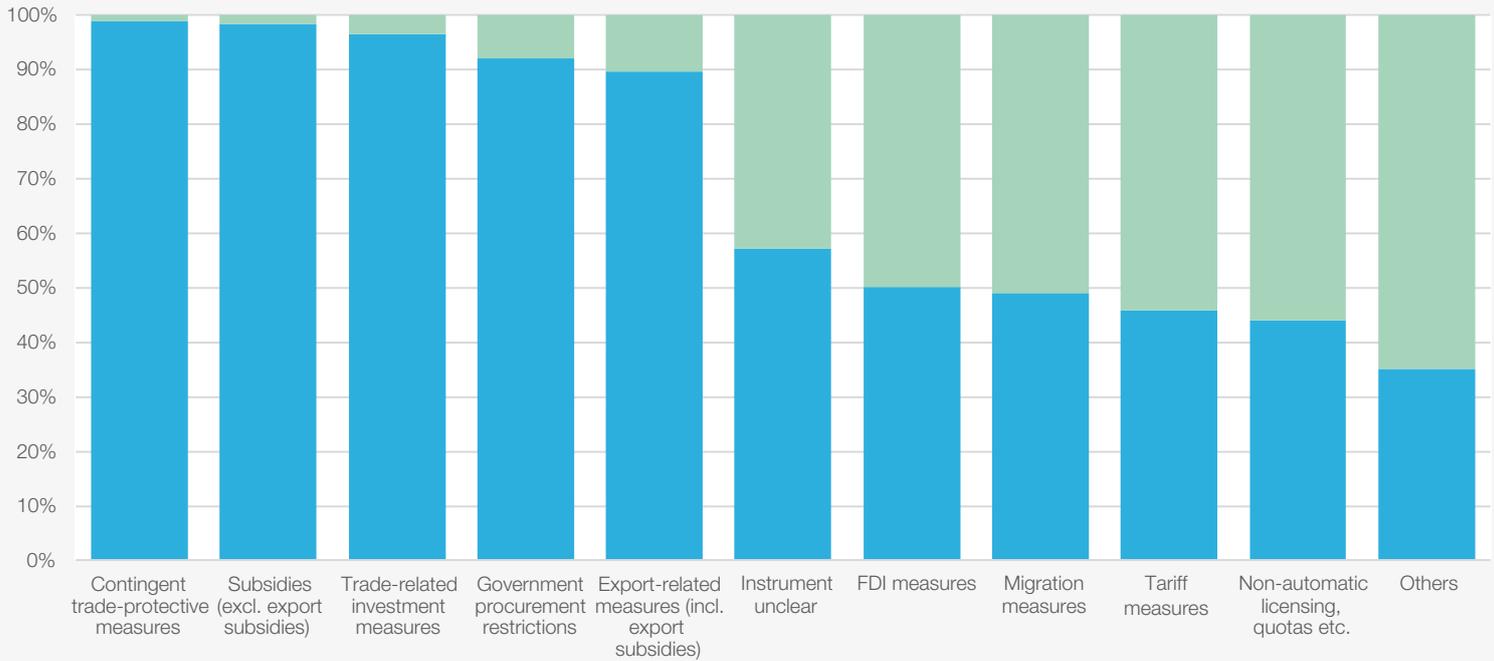
Some middle ground has opened up between the two extreme ideological positions of unbridled market forces and over-interventionist state planning. This calls for a more nuanced approach to regulating international trade and controlling domestic economic policies when they have negative spillovers that may upset legitimate market expectations and undermine the benefits of trade agreements. There is therefore a strong argument for ensuring legal disciplines are in place to address government policies that have such effects, while recognizing development needs.

Taking stock of rising intervention

Increasingly over the past decade, state interventions and economic nationalism in the international trade arena have gained popularity.⁵ The Global Trade Alert reports that, since November 2008, more than 32,500 protectionist policy interventions have been implemented globally,

outnumbering the 6,900 trade-liberalizing ones.⁶ This is in contrast to the globalization trends that dominated previously, beginning in the second half of the 20th century, involving the adoption of free-market principles and removal of trade barriers to provide the conditions for open and fair competition.

FIGURE 1 | Protectionist vs. liberalizing policy interventions



Source: Authors' calculation based on the Global Trade Alert dataset (accessed 6 December 2021)

■ Protectionist interventions ■ Liberalizing interventions

Economic nationalism has gained momentum, particularly since the trade war between the US and China in early 2018 and the start of the COVID-19 pandemic in 2020. Other factors include the need to respond to national security concerns, address liquidity shortages, achieve environmental and consumer protection objectives, support vulnerable sectors, tackle unfair trade practices by foreign competitors, bring “back” jobs and mitigate investment risks. While some measures are necessary and legitimate, others primarily serve political expedience or the preferences of interest groups.

The COVID-19 pandemic amplified trade protectionism, leading many governments to turn

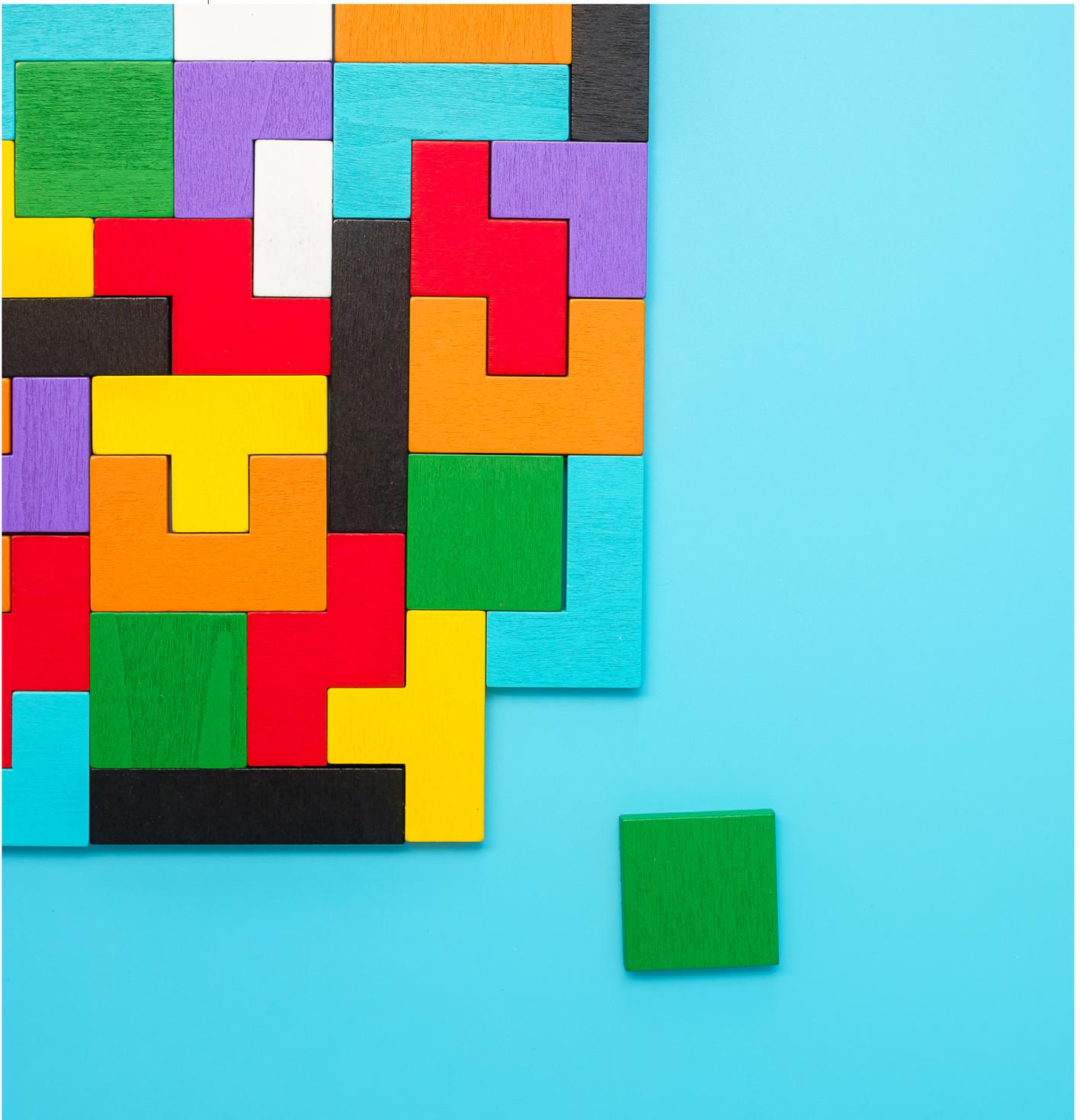
further inward.⁷ The extent and type of intervention vary according to the level of development, interests and resources of each country. Developed economies generally provide more generous fiscal incentives and recovery packages, apply expansionary monetary policy and use various trade-policy instruments such as subsidies and foreign investment screening.⁸ In many cases, these trade measures prioritize local economic players at the expense of their trading partners.

In response to COVID-19, additional spending and foregone revenue in G20 countries are equivalent to 9.5% of their combined GDP. Another 9.4% has been injected to boost liquidity through loans, equity and guarantees.⁹

1

Instruments of industrial policy

This section details the state of play and areas of debate in various industrial policy instruments.



1.1 Subsidies

Overview

According to World Trade Organization (WTO) law, subsidies are financial contributions by governments and public bodies that confer benefits to individuals and firms.¹⁰ They may take the form of direct payments, tax cuts or rebates, controls on the price of goods or inputs in a way that benefits the producer and so on. Subsidies can be used to fix market failures – for instance, supporting the production of a good that is undersupplied in a market due to a shortage or because positive externalities (benefits to third parties or society at large) are not accounted for.

Given the vast sums that governments spend on subsidies, they are more frequently used in richer industrial and emerging economies.¹¹

OECD reports suggest that subsidies need to be understood in the context of value chains, as upstream support has the effect of supporting

downstream production. Distortions from government support are widespread in certain sectors, including agriculture, fossil fuels, fisheries, aluminium and semiconductors.¹²

Subsidies for fossil fuel production remain significant despite ongoing pledges to eliminate them by G20 nations responsible for 80% of CO₂ emissions.¹³ The financial burden of these subsidies was estimated at \$55 billion. This could potentially be used for clean-energy research, innovation or other social benefits. Subsidies to the energy sector are expensive and undermine environmental objectives. When global energy subsidies reflect the full range of environmental costs, they were estimated to be \$5.3 trillion in 2015, or 6.5% of global GDP. These subsidies were largest in China, at \$2.3 trillion, followed by the US, at \$700 billion, and Russia and India, at about \$300 billion each.¹⁴

International trade rules on subsidies

As subsidies can distort domestic and international markets and undermine market access, they are addressed in international trade rules. However, WTO subsidy disciplines, contained in the General Agreement on Tariffs and Trade (GATT),

the Agreement on Subsidies and Countervailing Measures (SCM Agreement) and the Agreement on Agriculture (AoA), have not been updated significantly since these agreements were concluded.

BOX 1 WTO subsidy rules

Non-agricultural goods: The SCM Agreement disciplines the use of subsidies and of countervailing measures that offset the negative effects of subsidized imports. Only subsidies that are “specific” to an industry, company, a group of industries or companies or to a region are subject to disciplines, as these are considered more trade-distortive. Specific subsidies are prohibited when they are contingent on export performance or on the use of domestic content. Specific subsidies are actionable; that is, another member can retaliate with countervailing duties if the subsidies cause adverse effects to that member. Subsidies that are not specific are non-actionable. Article 8 of the SCM Agreement identified certain additional subsidies that were permitted – for research activities, disadvantaged regions and adapting existing facilities to new environmental requirements. However, this provision has since expired.

Agricultural goods: Green Box measures are domestic support actions that are considered less trade-distortive and thus are allowed. These include research programmes and direct payments to producers decoupled from production decisions.

Additional measures are exempted from reduction commitments – certain developmental measures in developing countries, certain direct payments under production-limiting schemes and support given over the year that is below a *de minimis* level of total agricultural production of that particular product. Amber Box measures, such as price supports, are considered trade-distorting and subject to reduction commitments (if applicable) and cannot exceed *de minimis* levels. A ministerial decision in 2015 eliminated export-subsidy entitlements for developed and (as of 2018) developing countries.¹⁵

Services: In GATS Article XV, members recognize that subsidies can have distortive effects on services trade and undertake to enter into negotiations for new rules to avoid these effects, including countervailing procedures. Negotiations started in 1995, but little progress has been made. However, subsidies to service providers are still “measures by Members affecting trade in services” (GATS Article I:1) and so are subject to most-favoured nation and other rules in the GATS.

European Union (EU) state aid rules generally prohibit measures by member states that threaten to distort trade and competition within the EU. However, they recognize that, in some circumstances, government intervention is necessary for a well-functioning and equitable economy, and they provide policy space for objectives such as regional economic development, support for small and medium-sized enterprises (SMEs) and environmental protection. In general, all short-term schemes must be approved by the Commission, except for small amounts falling under the *de minimis* rule. The Commission has considerable powers to investigate, assess and remove unlawful state aid. However, this does not apply to EU member states' medium-to-long-term official export financing.

Nevertheless, in many respects, EU rules are more stringent than WTO subsidy disciplines. Notably, EU rules consider subsidies to both goods and services to be generally unlawful, unless small or

exempted. They require prior approval and allow not only states but also businesses and individuals to claim remedies. Significantly, the Commission can also require illegal state aid to be paid back. The Commission evaluates the effectiveness of these rules, currently with regard to energy and environmental subsidies, as well as strategically important technologies and value chains.¹⁶ State aid should be both targeted and appropriate to address market failures. In addressing the negative fallout from the COVID-19 pandemic, the European Commission temporarily allowed member states to adopt additional state aid measures to support affected businesses, including direct grants, tax advantages, subsidized guarantees, and loans and export credit insurance.¹⁷

The EU-China Comprehensive Agreement on Investment (CAI), which has not been ratified by the European Parliament, includes extensive notification obligations on subsidies, including those granted in listed service sectors.¹⁸



Areas of debate

State capitalism and subsidization

Some have argued that WTO disciplines, including China-specific provisions, are adequate to deal with the challenges of Chinese state capitalism, but rigorous enforcement is needed.¹⁹ In 2017, the US, EU and Japan announced trilateral cooperation to eliminate distortive and protectionist practices.²⁰ In 2020, they agreed on certain ways in which WTO rules could be strengthened to deal with industrial subsidies.²¹ These included expanding the list of prohibited subsidies,²² treating un-notified subsidies as prohibited and providing a separate methodology in countervailing duty cases for non-market economies. However, agricultural and services subsidies and trade defence measures need to form part of the conversation, if holistic reform is targeted.

In June 2020, the European Commission adopted a white paper outlining the legal instruments it plans to enact to address the distortive effects of foreign subsidies: (1) generally in the single market; (2) in the acquisition of EU companies; and (3) in EU public procurement processes.²³ In May 2021, the Commission adopted a proposal for a regulation of foreign subsidies distorting the internal market.²⁴

Subsidies in times of crisis

The SCM Agreement is particularly significant in crises such as the 2008 financial crisis and COVID-19 pandemic due to the large subsidies and bailouts that many governments have delivered. Such subsidies may violate trade rules as there is limited legal leeway to defend them. However, they are seen by many governments as necessary to stabilize the economy during emergencies.

Previous economic crises engendered protectionist and distortionary measures, many of which have persisted. For instance, in the aftermath of the 2008 financial crisis, while protectionist tariffs were largely avoided, many governments supported domestic exporters through export incentives.²⁵ Approximately \$211 billion in medium-to-long-term official export financing was provided in 2017.²⁶ Increasingly, these activities lie outside existing instruments such as the OECD Arrangement on Officially Supported Export Credits.²⁷

Exporting companies typically need to obtain loans, guarantees or insurance to cover the sale and safe delivery of their goods and services to overseas markets. If the commercial sector is unable or unwilling to provide this export financing, governments often provide “additionality” as lenders of last resort through publicly funded export credit agencies (ECAs). Globally, ECAs finance an average of about 12% of their countries’ domestic exports,²⁸ providing significant fuel to the international trading system.²⁹

China is by far the largest medium-and-long-term (MLT) export credit provider worldwide, with \$33.5 billion in 2019, far ahead of its followers Italy and Germany, with approximately \$11 billion each. Chinese official export credit support has risen gradually over the past two decades, but in 2019

it dropped for the first time, by approximately \$5 billion. Export credit agencies (ECAs) are officially designed to mitigate the risks of commercial insolvency, potential political unrest and other factors. China has two official ECAs and a multitude of other government institutions that provide export and trade-related finance in support of China’s policy and commercial goals. The two official ECAs of China are the Export-Import Bank of China (China EXIM) and the China Export and Credit Insurance Corporation (Sinosure).

China is not obliged to comply with the OECD Arrangement on Officially Supported Export Credits, which sets minimum standards for export credits and is intended to guarantee that competition is driven by price and quality and not by the extent and conditions of state support.

Source: Authors

Recognizing ‘good’ subsidies

One of the fundamental difficulties with international subsidy regulation is distinguishing between “good” and “bad” subsidies.³⁰ There is a growing call for rules to fill this gap. Crises such as the COVID-19 pandemic and climate change have demonstrated the need for explicit conferral of policy space to enable governments to address legitimate public policy concerns. This requires carefully drafted exceptions based on clear criteria that would preclude other countries from taking action or applying trade remedies.³¹ Until then, it is not possible to legally distinguish between those subsidies that are vital to fulfil legitimate policy objectives and those that governments use to support certain firms or industries to give them an unfair advantage over international and domestic competitors.

Limited disciplines on services subsidies

As explained in Box 1, there are limited disciplines on services subsidies, and there has been no tangible progress in negotiations, both for political economy considerations and because of the intrinsic nature of services. Airlines, tourism, hospitality and other services receive subsidies³² in the context of COVID-19 and these are likely to continue. Even prior to the COVID-19 pandemic, the EU was looking to include “fair competition” clauses in its bilateral air transportation agreements, including strict limits on the types of subsidies allowed.³³

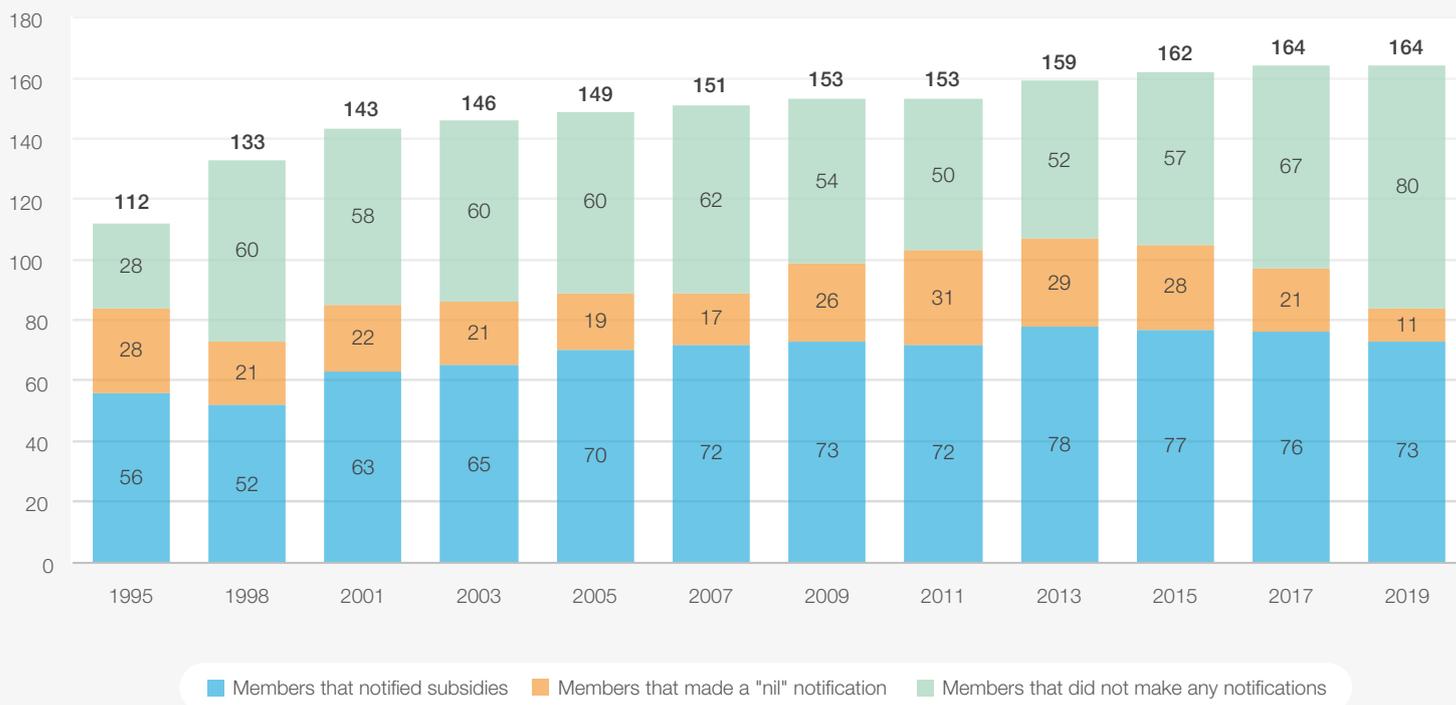
The need for better data and reporting

The difficulty in undertaking comprehensive assessments of subsidies is that governments do not routinely report their subsidy measures, despite the reallocation of vast sums of taxpayer money to subsidize selected businesses or sectors. This lack of transparency and the complexity of commercial realities make it difficult to unequivocally identify or quantify the impact of subsidies.

The OECD has published reports on government support in OECD and some non-OECD countries for certain sectors, but not all. The Global Trade Alert database provides independent monitoring and analysis of a variety of measures.³⁴ However, additional data and analysis are required on the kinds and quantities of support governments provide to their firms and how effective they are.³⁵

The WTO SCM Agreement requires that all members submit a new and full notification of all specific subsidies relating to all goods sectors provided by any level of government every three years, with updating notifications due in the intervening years.³⁶ If members consider that they have not provided any specific subsidies, they are required to notify this in the interest of transparency. Notification does not prejudice the legal status of any notified measure.³⁷ Unfortunately, as Figure 2 indicates, the number of members that have failed to make a notification has risen sharply, as WTO membership has increased.

FIGURE 2 | Status of compliance with subsidy notification obligations under Article 25.1 of the SCM Agreement (1995–2019)



Source: WTO Document G/SCM/W/546/Rev.12. Committee on Subsidies and Countervailing Measures – Notification Provisions under the Agreement on Subsidies and Countervailing Measures. Data as of 31 March 2021

Not only is the notification of subsidies in the WTO chronically low, but it is also based on the trade of goods produced in one country and sold to another. This cannot account for the complex competition impacts, both positive and negative, in the context of international value chains.³⁸ These impacts need to be understood.

Vulnerable players' positions and expectations

Developed countries have many more fiscal resources to support their producers than do developing countries. The G7 group of industrialized countries accounts for the greatest share of subsidies granted, while large emerging markets tend to implement more trade-related investment and price-control measures.³⁹ Subsidies account for a much smaller share of total measures imposed by low-income developing countries and tend to target exports.⁴⁰

Subsidies influence world prices, encouraging producers to produce and export more than they otherwise would. In agriculture, the OECD estimates a yearly average of \$536 billion in direct support to farmers from 54 countries (all OECD members, EU countries and 12 emerging economies).⁴¹ This reduces world prices and the incomes of farmers in developing countries.

In 2019, the US federal government provided the highest level of farm subsidies in 14 years, largely without congressional action. Loss of Chinese

markets for soy due to the trade war prompted \$28 billion of government trade-related aid to US farmers over 2019–2020. This sum is larger than the 2008 US automotive industry bailouts, which were debated before Congress and were not the result of a trade war. NPR analysed US Department of Agriculture payment records up to July 2019 and found that more than 70% of aid money went to 100,000 people, without any public benefit requirements attached.⁴² The EU also heavily subsidizes its farmers and is the second largest exporter of agricultural produce. Producer subsidies in agriculture, which increase the prices received by farmers above prices for imported food products, also reduce incentives for improving efficiency. In the EU, these subsidies were estimated to average 20% of gross farm receipts in 2014–2016.⁴³

The need for communication and coordination

Removing or reforming subsidies is difficult for governments to sell at home as it can raise prices, hitting businesses, consumers and households. This requires governments to communicate why some subsidies come at the expense of more equitable public spending, better competition and more efficient producers. Detailed reform plans are necessary to indicate clear and staged exit strategies to remove unnecessary or harmful subsidies and improve efficiency and innovation in the long term. Social support and other flanking mechanisms are required to protect those most displaced and vulnerable to the impact of these changes.

\$536bn
in farm support
per year in 54
countries

Moreover, removing subsidies domestically requires cooperation with other governments. The incentive to reform unilaterally is greatly reduced if other governments continue to support their industries to be internationally competitive at the expense of

domestic producers. Never has there been a better time for governments to work together to notify, monitor and control harmful subsidies that have negative spillovers domestically and abroad.

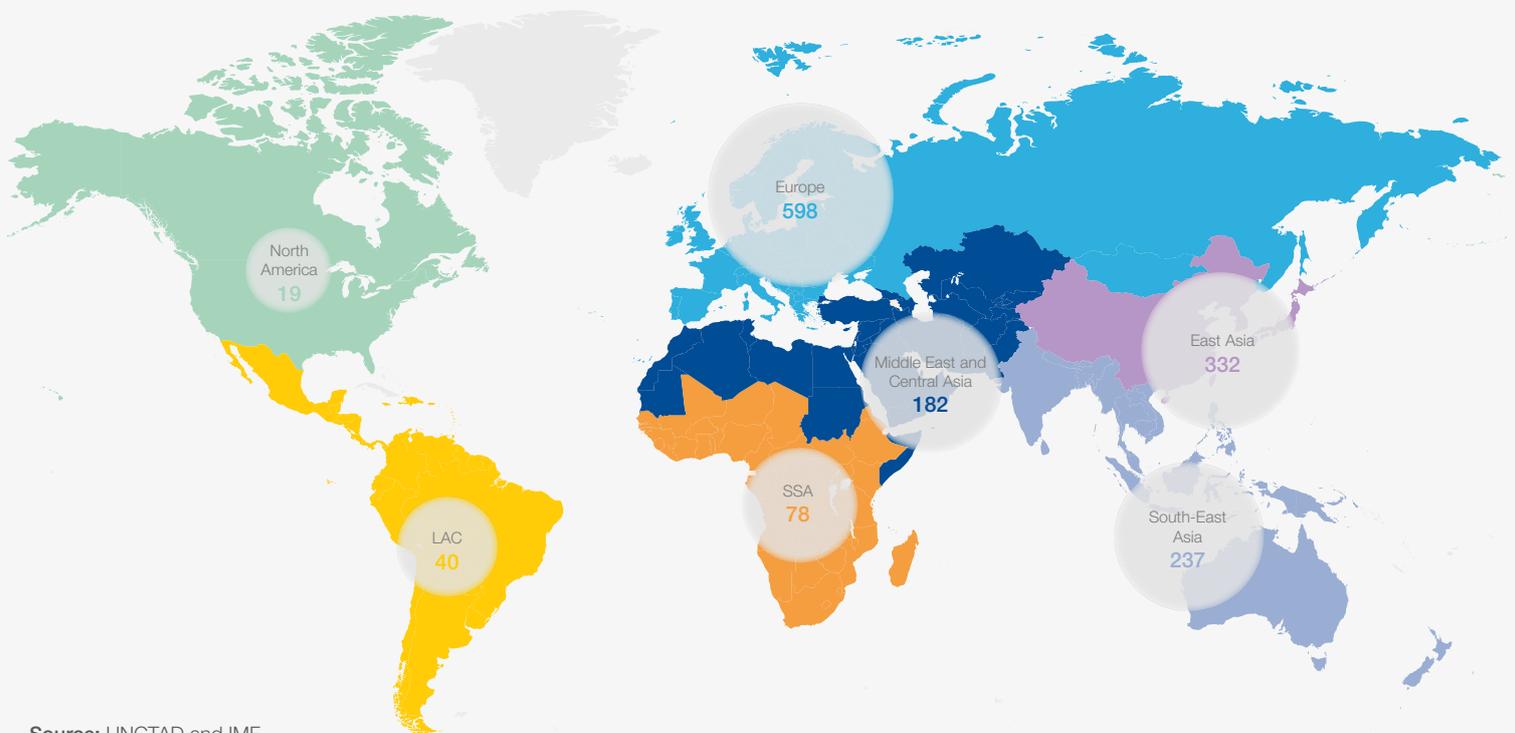
1.2 State ownership and control

Overview

Governments have run commercial ventures for millennia, generally to raise revenue. Now, state-owned enterprises (SOEs) aim to provide citizens' public utilities, services or goods or an important commercial service that the private sector was not fulfilling. However, SOEs that engage in commercial competition with private firms are of increasing interest to trade negotiators for potential negative spillovers and trade and investment-distorting effects. The competition-distorting behaviour of SOEs may no longer affect only domestic markets but also international trade. Government subsidies in the form of cheap loans and tax cuts to SOEs are a particular concern,⁴⁴ but so, too, are the financial advantages such enterprises give to other firms in the economy.

SOEs have also grown significantly in size and number. They are responsible for 55% of infrastructure investments in emerging and developing countries and their assets amount to \$45 trillion (equivalent of half of global GDP).⁴⁵ OECD economies have SOEs primarily in upstream and strategic sectors, notably in the energy, rail transport, financial services and telecom sectors.⁴⁶ China's Belt and Road Initiative (BRI) improves connectivity between China and countries in Asia, Africa, Europe, South America and even the Pacific. Chinese SOEs contract about half of BRI projects by number and more than 70% by project value. SOEs affect China's BRI policy through internal references and policy reports, while themselves receiving policy guidance from the government.⁴⁷

FIGURE 3 Number of SOEs per region



Source: UNCTAD and IMF staff calculations (in Gaspar et al., 2020)

There is evidence that SOEs differ from private firms not only in their internationalization capacities but also in the fact that they are often motivated by national strategic and geopolitical objectives, despite adverse market reactions.⁴⁸ SOEs face challenges in respect to corporate governance, risk

management, technology adoption, managerial appointments, employment efficiency, price-setting, procurement policies, wages and dividend distribution. OECD Guidelines on Corporate Governance of State-Owned Enterprises provide advice to governments on effective management.⁴⁹

International trade rules

GATT Article XVII (State Trading Enterprises)⁵⁰ and its Understanding, General Agreement on Trade in Services (GATS) Article VIII and the SCM Agreement contain relevant provisions, as does China's accession protocol. These rules require state trading enterprises to operate on the principle of non-discrimination and on a commercial basis. However, with the rise of global value chains, globalization and the opening-up of WTO members' markets, the possible trade- and investment-distorting effects of SOE participation in international trade have moved into the limelight,⁵¹ alongside the gaps and lack of clarity regarding the existing WTO rules. These rules do not sufficiently reflect and incorporate the different types of SOE or the varying degrees of control and involvement that governments can have over SOEs.

The GATT 1994 working definition of "state trading enterprise" includes two requirements: (1) "granted exclusive or special rights or privileges, including statutory or constitutional powers"; and (2) "in the exercise of which they influence through their purchases or sales the level or direction of imports or exports". GATS Article VIII is narrower, applying only to monopoly suppliers and exclusive service suppliers. The SCM Agreement applies to a "financial contribution by a government or any public body". It is unclear which SOEs qualify as public bodies, with the appellate body requiring the entity to be vested with governmental authority.⁵² The OECD SOE Guidelines are clearer in referring to control, defining an SOE as an enterprise "where the state has significant control, through full majority, or significant minority ownership".⁵³

As a result of these gaps, some countries maintain that further rules are needed when SOEs are engaged in commercial competition. The concern is not the existence of SOEs, but the need to ensure a level playing field in markets where SOEs compete with commercial businesses. If SOEs possess competitive advantages, they could undertake anti-competitive business practices that unfairly affect private firms and undermine competition domestically and cross-border.

Some recent free trade agreements, including the United States-Mexico-Canada Agreement (USMCA) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), contain disciplines to that effect.⁵⁴ Chapter 17 of the CPTPP is the first comprehensive and detailed set of disciplines on SOEs, applicable to trade in goods, as well as services and investment, which have been outside the purview of the WTO. The CPTPP explicitly defines SOEs and requires parties to disclose certain information regarding their SOEs. These transparency rules are designed to encourage good corporate governance. However, certain types of organization and activity are exempt from the rules, and individual CPTPP parties have claimed exemptions, particularly for subcentral entities.⁵⁵ As a result, the CPTPP SOE rules remain narrow in their scope and contain many exceptions and country-specific non-conforming measures.⁵⁶

The CAI uses the term "covered entities", defined broadly in terms of ownership and control, and requires that covered entities act according to commercial considerations and provide non-discriminatory treatment.⁵⁷



Areas of debate

Government ownership and control in crises

The COVID-19 pandemic has led to increased government ownership and control of firms. Germany's €9 billion bailout of Lufthansa came with a 20% government stake in the airline.⁵⁸ Italy nationalized Alitalia as part of its bailout.⁵⁹ Post-crisis, governments may divest rapidly and reprivatize firms, exit more gradually in response to changes in market conditions and asset prices or accept lasting state ownership in some sectors.⁶⁰ Yet an International Monetary Fund (IMF) study found that, as of 2017, only a few countries had completely divested public holdings provided to address the 2008 crisis.⁶¹

The OECD recommends relying on independent valuations of investments and divestments to ensure objectivity. Governments should consider equity stakes only in firms whose financial distress is a result of the crisis and which are too important to fail because their loss would cause, for example, systemic instability or a high level of job losses.⁶² Strict recovery plans for the firms benefiting from equity injections and set conditions for exit are advised. Clear statements of the rationale for state ownership at the outset can help facilitate exit when those conditions no longer exist.⁶³

Behaviour vs. ownership

Some argue that what is significant is how an entity behaves, rather than its ownership structure. The focus should therefore be on "publicly controlled undertakings" instead of "state-owned enterprises". If this is accepted, further research is needed to set out objective criteria to determine when an entity acts in a way that is not in line with commercial interests.

For instance, recent research by Tan and Davis looks at Chinese import data disaggregated by firm ownership to examine how SOEs and private firms reacted to lower tariffs. It demonstrates that, after China's entry into the WTO, tariff cuts had a larger effect on private firms than on SOEs in China. While, for most industries, SOEs show a commercial orientation similar to that of private firms, this was not the case where strategic goods targeted by industrial policy constitute a large share of bilateral trade.⁶⁴ The authors explain that the Chinese economy cannot be easily classified as either fully market-oriented or non-market-oriented. Importantly, state ownership alone does not dictate non-commercial orientation in trade. This implies that trade negotiations should focus on targeted industrial policy rather than state ownership or broader categorizations of market vs. non-market economies.

Privately owned and controlled entities may also act on non-commercial terms, responding to indications from governments. Equally, privately owned companies may be "state-favoured", with privileged access to public funds and infrastructure.⁶⁵

1.3 Government procurement

Overview

Government procurement refers to goods and services purchased by agencies for governmental purposes and not meant for commercial sale or resale. Procurement policies have long been used as industrial policy tools, using the considerable purchasing power of governments to help promote domestic industry. Examples include the nascent aircraft and advanced chemical industries in the US in the early 20th century.⁶⁶

While government procurement amounted to 11.8% of GDP on average in OECD countries in 2017, it tends to be more pronounced in times of

economic crisis when its relative size increases compared to GDP (by 1.5 percentage points between 2007 and 2009, for instance). Following its peak in 2009, public procurement spending in OECD countries declined and then remained constant, both as a percentage of GDP and in terms of general government expenditures (29.1% in 2017). Health represented the largest share of public procurement spending in 2017 (30% in OECD countries), followed by economic affairs (16.3%), education (11.7%), defence (10%) and social protection (10.2%).⁶⁷

International trade rules on government procurement

Government procurement is exempted from the national treatment obligation of the GATT (GATT Article III: 8 [a]) and of the GATS (GATS Article XIII). This allows countries to favour domestic companies in procurement laws and practices unless they are party to the WTO's plurilateral Government Procurement Agreement (GPA) or to certain regional trade agreements (RTAs). The GPA, which serves as a model for RTAs, sets out detailed rules that apply to the procurement specified by each party in its schedules to the agreement. The 1994 GPA was revised in 2012 and covers 48 WTO members, with seven more actively engaged in negotiating accession. It aims to open government procurement markets among the parties, estimated at \$1.7 trillion annually.⁶⁸ Most large emerging markets remain outside the agreement, while China, Brazil and Russia are negotiating accession.

WTO GPA market access commitments extend bilaterally to individual GPA parties, covering those government entities listed in each party's schedule, to all goods and construction services (unless explicitly excluded) and to services specified by each party above a particular value threshold.⁶⁹ These commitments are based on strict reciprocity. This means that each party negotiates individually with every other party to arrive at an agreed market

access opening across their procurement markets. As a result, the coverage of the GPA is partial; markets are strategically opened, and exclusions taken to protect domestic suppliers and promote public policy objectives. Australia's schedule, for example, excludes any form of preference to benefit SMEs and measures for the health, welfare and economic advancement of Indigenous people.⁷⁰

Since 1996, GPA membership has more than doubled, from 21 to 48 WTO members, but it still constitutes slightly less than one-third of WTO membership. Apart from Brazil, all of the countries engaged in GPA accession negotiations are fulfilling commitments they made when they became WTO members.

RTAs play an increasingly important role in the expansion of international procurement commitments.⁷¹ Prominent examples are the CPTPP and the EU's negotiation of RTAs with Canada, Japan, Singapore and the United Kingdom, and RTAs with Viet Nam and Mexico. However, the US accepted Canada's opting out of the procurement chapter in the USMCA, the first US RTA not to apply any procurement obligations to a party.

\$1.7tn
GPA parties'
annual public
procurement

Areas of debate

Buy-local and domestic content requirements

On 25 January 2021, President Biden issued a "made in America" executive order⁷² that, among other things, directs the Federal Acquisition Regulatory Council to propose amendments to tighten domestic content requirements in government procurement, introduces stricter review of waivers of buy-American laws and requires an assessment of whether the foreign product's low cost is in significant part due to dumping or subsidization when considering a waiver.⁷³

The desire to protect domestic markets is not unique to the US. The Regional Comprehensive Economic Partnership (RCEP), signed by the 10 members of the Association of Southeast Asian Nations (ASEAN) plus China, Japan, Korea, Australia and New Zealand, includes a modest government procurement chapter focused on transparency, without extending existing market access commitments.⁷⁴

EU seeking reciprocity in procurement market access

The EU and other GPA parties, with the US as the exception, generally allow any country to participate in their GPA-covered procurement regardless of whether that country has opened reciprocal procurement. This creates a "free-rider" concern by taking away the incentive to bring their own

procurement under international disciplines.⁷⁵ To address this lack of reciprocity and the need for a level playing field, in May 2021 the Council of the European Union issued a revised proposal for an International Procurement Instrument,⁷⁶ first developed in 2012 and revised in 2016.

The instrument would allow the EU to close procurement or impose penalties when countries discriminate against EU companies in their procurement. The US approach is to prohibit federal agencies from purchasing from countries that are not GPA or RTA partners or least-developed countries, with certain exceptions.

Government procurement and SOEs

Negotiations on China's accession to the GPA, which began in 2007, have raised the issue of how SOE procurement practices must be dealt with under the rules. China's 2019 (sixth revised) negotiating offer, while an advance,⁷⁷ nevertheless received a negative response – particularly because of its very limited offer of approximately 20 SOEs. In 2017, in addition to the 75 giant SOEs listed in the Fortune Global 500, there were more than 150,000 SOEs in China.⁷⁸

China's negotiating position again highlights the weaknesses in the WTO framework for regulating SOEs discussed above: non-selectively labelling all SOEs as "public bodies" within the meaning

of the SCM Agreement is seen by China to be “detrimental to the institutional framework for fair competition”.⁷⁹ China regards its SOEs as independent legal persons that base their decisions on their commercial interests. Nevertheless, Chinese SOEs also engage in activities on behalf of the state through appropriate authorization.

Transparency in procurement

A focus on transparency could be a strategy to expand international rules on government procurement that would attract and apply to all WTO members. In 1996, a Working Group on Transparency in Government Procurement was established by members to conduct a study on transparency in government procurement practices and develop elements for inclusion in an agreement, but it has not met since 2003.

Certain changes have made revisiting the issue timely and appropriate. Countries have had more experience with transparency, and there is much evidence supporting the need for transparency to improve economic governance and deter corruption. New e-procurement tools could make compliance with transparency requirements much easier to meet.

Common transparency requirements across countries would facilitate participation by suppliers engaged in foreign procurement markets, without the need for market access commitments. As such, renewed pursuit of this issue could also contribute to the revival of the WTO’s negotiating function.

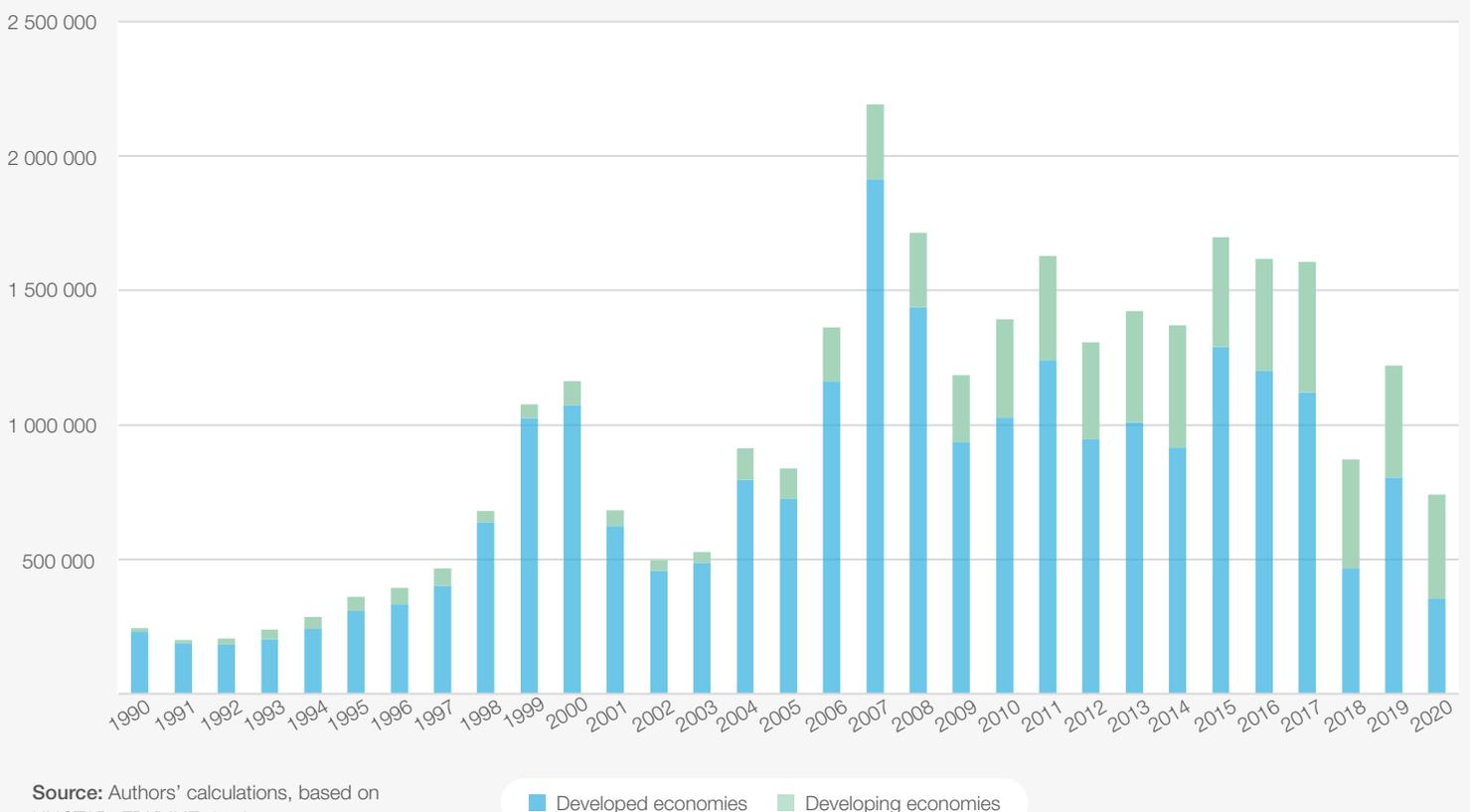
1.4 Investment screening and controls

Overview

Since the early 2000s, developing economies have become not only important recipients of foreign direct investment (FDI) but also significant outward investors. Developing countries have increased their share in global outward FDI (OFDI) flows from 5% in 1990 to more than 52% in 2020 (see Figure 4). Asian countries have become a major source of OFDI, contributing three-quarters of the total OFDI made by developing economies. Developing-country OFDI stocks have also increased as a

share of total FDI stocks, although at a slightly slower pace compared to OFDI flows. Chinese OFDI stocks have increased 75-fold to \$2.1 trillion in the past two decades.⁸⁰ China’s strategy to move the country from a manufacturing-driven to an innovation-driven economy is demonstrated in its OFDI flows composition, which has gone from targeting mainly the primary sector towards services in the past two decades.⁸¹

FIGURE 4 Outward foreign direct investments



Source: Authors’ calculations, based on UNCTAD, FDI/MNE database

The changing OFDI landscape has sparked concerns in many countries regarding certain foreign investors seeking to acquire control of or influence in domestic firms, with repercussions for critical technologies, infrastructure, inputs or

sensitive information, or where security or public order may be put at risk. This is especially the case when foreign investors are state-owned or controlled, including through financing or other means of direction.

Areas of debate

Investment screening in strategic sectors

Some countries have long controlled or screened foreign investments in critical technologies and infrastructure and beyond. More recently, as many as 31 governments have introduced or reformed their FDI investment-screening policies on national security grounds, including the US, EU and Australia.⁶² In the US, the inter-agency Committee on Foreign Investment in the US (CFIUS) is authorized to review certain transactions involving foreign investment in the US and certain property transactions by foreign persons to determine the effect of such dealings on US national security. The 2020 CFIUS final regulations now require a CFIUS filing and can review certain investments in US critical technology businesses (including some non-passive minority investments) and for most foreign-government-related investors making investments in US businesses involved in: (1) critical technology; (2) critical infrastructure; or (3) sensitive personal data.

The EU Foreign Direct Investment Screening Regulation,⁶³ which entered into force on 11 October 2020, establishes a mandatory information-sharing system between the European Commission and EU member states. While not mandating the establishment of investment-screening mechanisms in EU member states, it allows better coordination and the development of procedures for member states and the EU Commission to react quickly to FDI concerns.⁶⁴ Consequently, foreign investors are facing more scrutiny as the exchange of information is broadened to the European Commission and other member states. This means longer review periods as other member states provide their comments and the Commission issues its opinion.

Under the new EU FDI screening regulation, the European Commission has the power to issue a non-binding opinion if an investment poses a threat to the security or public order of more than one member state or an investment is likely to affect projects or programmes of EU interest. The EU strategic projects are listed in the annex of the FDI screening regulation and currently include EU programmes for energy, transport and telecommunications networks; the defence and security sectors; space, surveillance and tracking; and research, innovation and fusion energy.

Following the outbreak of COVID-19, several EU member states tightened investment regulations and introduced restrictive requirements for the acquisition of share capital in domestic companies in areas of strategic importance such as energy, pharmaceuticals and communications by non-European entities.⁶⁵

Investment screening of subsidized acquisitions

The European Commission has also proposed legislation that would allow screening of foreign investments into the EU that benefit from foreign subsidization. The EU's current FDI screening regulation allows screening if the investor is directly or indirectly controlled by a foreign government, significant funding by that government being only one factor.⁶⁶ There is increased concern in the context of the COVID-19 pandemic that state-backed, foreign-owned entities will purchase ailing domestic firms. Sovereign wealth funds and SOEs that claim to operate on a commercial basis have taken issue with the new rules.



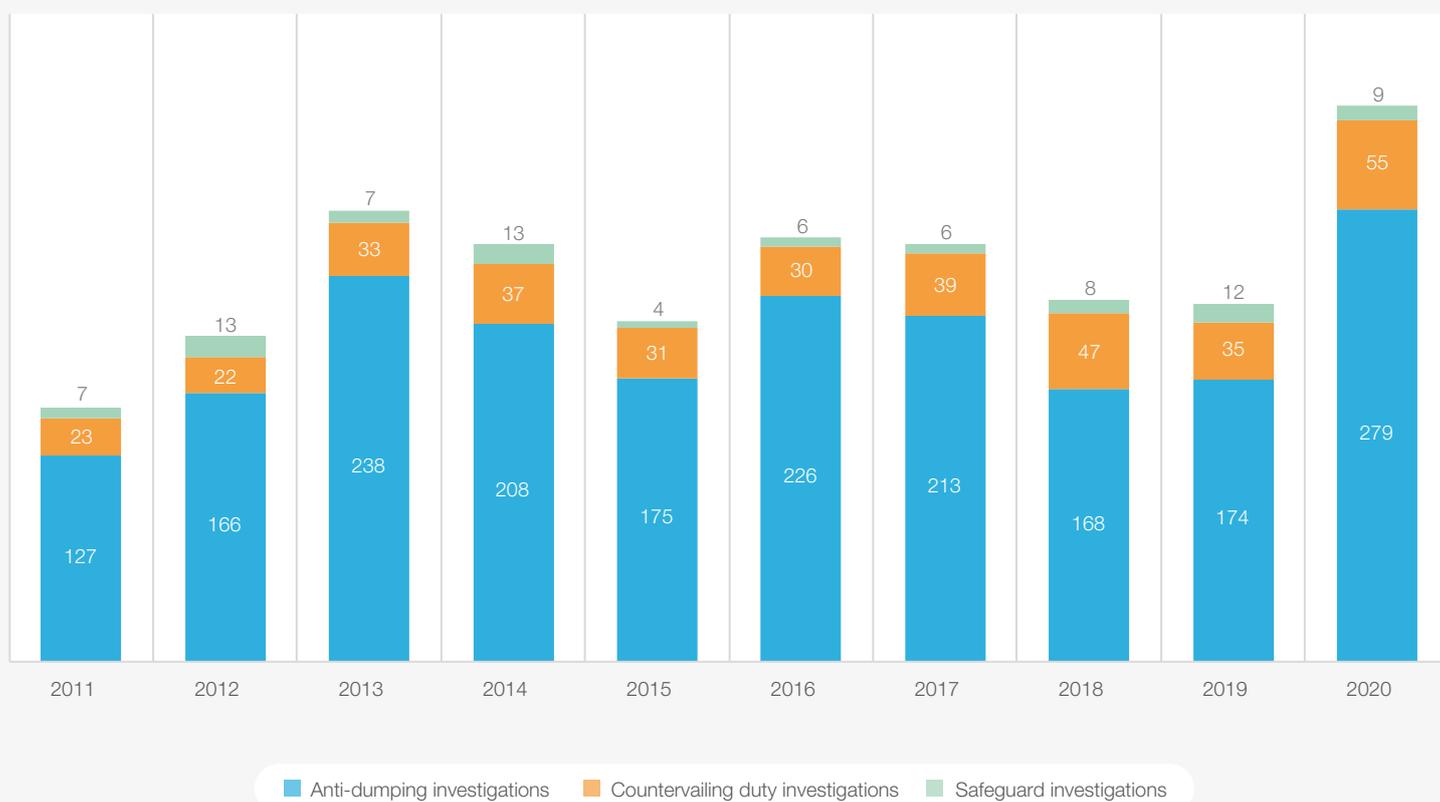
1.5 Trade remedies

Overview

Trade remedy actions protect domestic industry against foreign subsidization (countervailing measures), sudden surges in imports (safeguards) and the unfair dumping of low-priced imports (anti-dumping measures). An increase in the use of these measures may be a concern, particularly during the US-China trade war and COVID-19 pandemic, as they compound economic uncertainty and instability. It is foreseeable that governments become more susceptible to domestic political pressures for import protection in these circumstances. Some argue that trade remedies should not be considered protectionist when they counter unfair trade practices.

Although G20 trade remedy investigations were on the decline after 2013, they rose dramatically in 2020, with the vast majority being anti-dumping (AD) cases. During 2020, there were 279 AD investigations initiated by G20 members, an increase of 60% compared to 2019. Metal and steel products account for the largest share of AD investigation initiations. Most of the recent cases were filed by India, followed by the US, while China continues to be the main target of a significant share of AD measures in general, predominantly on metal products.

FIGURE 5 Trade remedies: total investigations initiated by G20 members by type of trade remedy



Source: Authors' calculations, based on the WTO reports. Data as of 28 October 2021



International trade rules

Countries have enacted domestic laws that set out how to conduct trade remedy investigations and apply measures in accordance with the WTO's Anti-Dumping Agreement, Agreement on Safeguards and the SCM Agreement. They may challenge other countries' trade remedy measures through

the WTO's dispute settlement mechanism. They are prevented from applying trade remedies outside of these agreements and the GATT.⁸⁷ Some countries still perceive the current rules as insufficient in providing them with fast and effective remedies.

Areas of debate

Non-market economy treatment

In AD cases, a dumping margin (the difference between a "normal value" and the export price) is calculated to determine how high the AD duty on imports should be. The normal value is usually the domestic price of the product or the cost of manufacturing it in the exporting country. However, when that country is considered a non-market economy (NME), domestic prices and costs can be ignored as being too distorted. Alternative methodologies, which typically lead to a higher normal value and hence higher duties, may be adopted.

WTO members disagree on whether the rules in China's accession protocol require that it be treated as a market economy from December 2016. Some granted it this status earlier, as Argentina, Brazil and New Zealand did in 2004. China brought cases against the EU and US in December 2016 for continuing to consider it an NME but has since suspended proceedings.⁸⁸

In 2017, the EU introduced a different approach by adopting two sets of new legislation on trade defence instruments (TDI), known as "TDI methodology" and "TDI modernization".⁸⁹ The new rules abandon the differentiation between market economy and NME status when assessing dumping margins, allowing for so-called mixed normal value calculations. The concept of significant distortions permits the use of alternative methodologies in the absence of market economy conditions. Other differences between the EU's old rules and the new legislation include elements regarding who is eligible to file an AD complaint, the investigation timetable, the burden of proof and the imposition of provisional measures. With regard to the burden of proof, the Commission now has to provide evidence that "significant distortions" exist and that they affect price formation mechanisms before being able to apply constructed normal values. Moreover, the new methodology incorporates the possibility of prices not being determined by market forces in the exporting country; for instance, when the costs of raw materials are distorted due to government interference.

The main criticism of the EU's legislation comes from China, which expressed deep concerns that the "significant distortion" concept for calculating normal value would damage the WTO's AD legal system and increase uncertainty for exporters. China sees this new methodology as incompatible with WTO rules and obligations to apply a non-discriminatory approach to all members.⁹⁰ Similar concerns were expressed by Argentina, Kazakhstan, Bahrain, Russia and Oman. Argentina argued that both the AD agreement and GATT rules, as well as the WTO rulings on the EU's anti-dumping measures on biodiesel, confirmed the need to use domestic prices as the basis for determining normal value.

In July 2020, a preliminary ruling by China's Ministry of Commerce was released in an AD investigation into imports of n-propanol from the US. This found that a non-market situation existed in the US energy and petrochemicals sector, allowing the investigating authority to disregard cost data provided by the US companies and use facts available to construct normal value.⁹¹

Countervailing duties against subsidies in third markets ('transnational subsidies')

In June 2020, the EU applied countervailing duties against imports from Egyptian firms exporting to the EU, subsidized by the Chinese government.⁹² This is the first time the EU has imposed countervailing duties on imports subsidized by one country (China), but arriving from a third country where the subsidies in question were put in place (Egypt). It remains unclear whether WTO rules cover subsidies given to producers outside the territory of the government applying them. WTO rules limit the ability of members to counteract subsidies beyond what is allowed under the SCM Agreement. In the context of the BRI and increasingly unregulated official export financing, this scenario of "transnational subsidies" may become more common.⁹³

2

The way forward

This section outlines priority issues for intergovernmental discussion in the near and long term.



2.1 Improving international rules

The trading system has always had to reconcile different economic models – as it did in the 1980s during the Uruguay Round between the former European Communities, Japan and the US. There is political momentum from different constituencies for updating international rules – whether in the

cause of economic revival and development, climate change mitigation or achieving a level playing field.⁹⁴ These issues are hard to tackle bilaterally. This section sets out the concerns for governments to address.

Subsidies

Recognizing “good” subsidies:⁹⁵ Revisit the list of non-actionable subsidies to better cover situations where government funding is needed to address a market failure. This may require the development of a measure to assess whether the subsidy helps bring the price of the goods or services closer to a socially optimal level, and whether the recipient could have reasonably obtained the investment, loan or other funding in private financial markets etc. This is urgently needed to tackle issues of common concern.

Japan identifies some additional forms of subsidy to be prohibited, but these could be discussed, challenged and built upon.

Crises: Provide guidelines on the kinds of economic stimulus that governments expect to provide during financial and economic crises and how these can be best designed to be “targeted, proportionate, transparent and temporary”,⁹⁷ including with built-in reviews and expiry dates. Discuss how to determine the “market benchmark” during an economy-wide crisis.⁹⁸

Prohibited subsidies: Consider whether the list of prohibited subsidies⁹⁶ should be expanded to other types of subsidy that are particularly trade- and investment-distorting, while providing limited benefits to the domestic economy. The trilateral agreement between the EU, US and

Agricultural and services subsidies: Do not limit reform efforts to industrial subsidies, as this undermines demand for a level playing field and particularly harms developing countries.

State ownership and control

Ownership vs. behaviour: Develop transparency tools and criteria to determine whether an SOE is acting on commercial terms and to what extent and under which circumstances it can be treated on an equal footing to private firms, building on the “Santiago Principles”,⁹⁹ for instance.¹⁰⁰ Equally, identify when privately owned and/or privately controlled firms are acting on government directions and on non-commercial terms.

Corporate governance: Develop a shared code that could bring countries’ domestic practices closer to the OECD’s Guidelines on Corporate Governance of State-Owned Enterprises, taking into account developing-country capacity and interests and the principles of competitive neutrality.¹⁰¹

Government procurement

GPA coverage: Explore the case for expanding developing country membership in the GPA and re-examine the coverage of SOEs under the GPA.

Transparency: Revive the working group for a multilateral agreement on transparency in government procurement in the WTO.

Investment screening and controls

Guidelines: Consider updating existing OECD guidelines adopted in 2009¹⁰² as a non-binding recommendation and make efforts to expand adoption beyond 41 adherents.¹⁰³ Expanded guidelines could cover:

- Clarity on whether national security includes economic security, food security and other aspects beyond defence
- How to treat foreign investments by SOEs and sovereign wealth funds; how to determine

- whether they are acting on a commercial basis and whether to exempt those from screening rules
- What types of investment-screening measures are understood to be reasonable and proportionate; how to ensure investment controls are not disguised protectionism
- How to design investment-screening mechanisms and rules to provide investors with more certainty and information on how to navigate domestic processes, possibly including a list of “trigger” events that would give rise to review
- Advice on an (expedited) judicial review of screening mechanisms; inclusion of other parts of government in the decision; and self-imposed time limits for the review to be conducted following the investment or information received regarding a change in circumstance

Such additions need to consider principles of customary international law, current discussions on investment regime reform and the reality of increased state involvement in investment.

Trade remedies and unilateral action

Market economy status: Consider offering China market economy treatment, as a growing number of countries are doing, in return for reforms in the areas of subsidies and SOEs.

Agree to limits on unilateral action: Clarify the legality of unilateral measures to defend domestic economic interests and set limits to ensure unilateral retaliation is not formalized as the norm. Restore

the WTO Appellate Body to remove the incentive for governments to resort to unilateral enforcement.

Clarify rules on countervailing duties on “transnational subsidies”: Specifically clarify whether WTO rules permit countries to retaliate through countervailing duties against subsidies given to producers outside the territory of the government applying them.

2.2 Enabling transparency

More complete and timely data and analysis of industrial policy measures is needed to understand how uneven the playing field actually is, the effects on the domestic and international economy and how different measures interact with, counter and reinforce each other. International and research organizations must be supported in independent evidence collection and analysis.

Notification requirements: Incentivize notification¹⁰⁴ and understanding of the trade and investment effects of measures. Increase funding and training for notification and reporting in developing and least-developed countries, based on digitalizing and automating notification processes.

Technological solutions: Increase support for existing initiatives tracking government measures affecting trade, such as the Global Trade Alert; develop technological solutions to facilitate country notifications and reporting.

Cross-policy coordination: Increase coordination and understanding across ministries and agencies – including finance, trade, competition, agriculture, investment and industry – to help ensure that domestic measures do not compromise international commerce.

Accelerated and expanded globalization trends have brought the world closer together than ever, yet the COVID-19 pandemic has pushed countries farther apart. It has led countries to focus on taking care of their own, instead of using this challenge as an opportunity to join forces and find collaborative solutions to promote certainty worldwide for all economic players. Making sure that the pendulum has not swung too far towards decoupling and policies of extreme self-reliance is entirely in stakeholders’ interests. If nationalistic measures advance without the necessary control and supervision of the global trade community, they will undermine important achievements attained over decades.

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