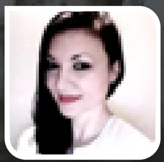
TRANSNATIONAL SUBSIDIES: ACHILLES' HEEL FOR FOREIGN INVESTMENT, TRADE, AND COMPETITION

BY GEORGIANA POP & ANA AMADOR[1]



1 Georgiana Pop is a Senior Economist and Global Competition Lead Expert at the World Bank, and Ana Amador is an Associate at Curtis, Mallet-Prevost & Mosle LLP and a consultant at the World Bank. The views and opinions expressed in this article are those of the authors and do not need to reflect the views or positions of any entity they represent.

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In the recent years, the discussion around transnational subsidies is gaining momentum, and there is some debate about of how these government interventions should be regulated. The present article discusses the notion of transnational subsidies, the existing gap in the international regulation, and the initiatives adopted to discipline transnational subsidies to minimize trade and competition distortions. At the same time, it questions whether these regulatory initiatives lead to increased protectionism and undermine the expansion of trade in low- and middle-income economies.

Since the global financial crisis of 2008, subsidies became the most significant form of government intervention in the global trade arena, having surpassed tariffs and non-tariff measures.[2] More than half of global trade in goods occurs in products and markets in which at least one subsidized firm operates, according to recent estimates.[3] Globally, subsidies target agriculture, manufacturing, including motor vehicles, machinery, ships, and electronics as well as R&D and energy.[4] Grants represent more than half of subsidy programs, followed by tax incentives, and loans.[5] The European Union ("EU"), the United States ("U.S."), and China accounted for 75 percent of measures in place across a wide range of countries.[6] Subsidies by these large economies that are also significant global trade players can have large cross-border effects in many economies around the globe.

Because subsidies grant recipient firms a comparative advantage over their non-recipient competitors in the international and domestic markets that is not necessarily associated with efficiency, subsidies are generally controlled to safeguard effective international trade, competition, and the efficient management of fiscal resources. Rules governing the granting of subsidies to limit their unintended consequences can be introduced, either as part of the competition rules or as pro-competitive regulation aimed at avoiding discriminatory treatment in favor of certain market players.[7] The literature noted few takeaways on the impact of subsidies on trade and competition. Besley & Seabright (1999) found that aid is less likely to distort competition if the aid is granted to a few firms with no significant market power.[8] Aghion, Cai, Dewatripont, Du, Harrison & Legros (2015) found that aid provided to many firms in a sector with low degree of concentration would enhance innovation and productivity growth.[9]

I. WHAT IS A TRANSNATIONAL SUBSIDY?

Scholars define a transnational subsidy as "a subsidy granted to a benefit recipient manufacturing the product at issue outside the country of the granting government."[10] The notion of transnational or foreign subsidy is broad and covers direct grants, loans, guarantees, tax measures, preferential procurement conditions and government ownership or control.

II. AN INTERNATIONAL LEGAL FRAMEWORK THAT GENERATES DEBATE ON THE TREATMENT OF TRANSNATIONAL SUBSIDIES

Subsidies are regulated under the World Trade Organization ("WTO") Subsidies and Countervailing Measures ("SCM") Agreement. The definition contains three basic elements: (i) a financial contribution (ii) by a government or any public body *within the territory* of a Member (iii) which confers a benefit. All three elements must be satisfied for a subsidy to exist. It is unclear whether the term "*within the territory*" refer to the granting body - i.e. any public institution, sub-national governments, and state-owned entities - or the location of the recipient of the financial contribution.[11] The WTO acknowledged this gap back in 2004, when it addressed the applicability of the subsidy discipline to international assistance by multilateral institutions.[12]

2 IMF, OECD, World Bank, and WTO (2022) "Subsidies, Trade, and International Cooperation."

3 *Ibid.*

4 *Ibid.*

5 *Ibid.*

6 World Bank (2022), "Unfair Advantage: Distortive Subsidies and Their Effects on Global Trade."

7 See, for example, the Code of Conduct agreed between provinces and territories of Canada and the legislation introduced in Australia to prevent internal relocation of firms motivated by subsidies (Interstate Investment Cooperation Act). For an analysis of both instruments see Kenneth P. Thomas, *Investment Incentives and the Global Competition for Capital*, Palgrave Macmillan 2011, pp. 155-162.

8 Besley T. & Seabright P. (1999), "State aids Making EU policy properly reflect geography and subsidiarity," *Economic Policy*, 14:28.

9 Aghion, P., Cai, J. Dewatripont M., Du, L., Harrison, A. & Legros, P. (2015), "Industrial Policy and Competition," *American Economic Journal: Macroeconomics*, 7:4, October.

10 Marc Benitah, The Wto Law of Subsidies, a Comprehensive Approach, 605 (Wolters Kluwer, 2019).

11 The Appellate Body in US – *Countervailing Measures (China)*, para. 4.42 defined the notion of "government" as encompassing "*both the government in the 'narrow sense' and 'any public body within the territory of a Member.'*" Thus, the Appellate Body referred to the financing authority in interpreting "within the territory." Yet, the Appellate Body has not gone as far as to confirm that transnational subsidies fall under the scope of the SCM Agreement.

12 See WTO, Note by the Secretariat, WT/WGTDF/W/22 (March 16, 2004) at para. 21.

There is a lively debate and limited consensus as to whether the WTO SCM Agreement apply to transnational subsidies and, if it does, to which extent. While some scholars consider transnational subsidies can be assimilated to international assistance to multilateral institutions, thus falling outside the scope of the SCM Agreement, others interpret "within the territory" as referring to the granting authority, with no territorial limitation as to the recipient. In the middle, some commentators consider that transnational subsidies should be subject to the WTO SCM Agreement only if the constitute "prohibited subsidies"[13] (i.e. financing is contingent in law or in fact on export performance), but not when they constitute "actionable subsidies"[14] (i.e. subsidies that are not prohibited, but can be challenged either through dispute settlement or countervailing measures due to their negative impact on trade).[15] Because most of the subsidies fall under the category of "actionable subsidies" (e.g. production subsidies), this interpretation would leave outside the scope of the WTO SCM Agreement most of transnational subsidies, unless the petitioner provides evidence that the measure is *de facto* tied to export (although not stated in law as an eligibility criteria).

Some countries including the U.S. and the EU economies have taken advantage of this regulatory gap to develop legislative initiatives and enforcement actions tackling the distortions generated by transnational subsidies.

III. BOTH SIDES OF THE ATLANTIC ACTED, BUT HOW CAN THE NEW RULES AIMING TO DISCIPLINE TRANSNATIONAL SUBSIDIES IMPACT LOW- AND MIDDLE-INCOME ECONOMIES?

A. United States

Since the 1980s, the U.S. has traditionally excluded transnational subsidies from countervailing regulations. Under 19 Code of Federal Regulations (C.F.R.) § 351.527 a subsidy does not exist if the Secretary of Commerce determines that the program is funded "by the government of a country other than the country in which the recipient firm is located."

This situation, however, is shifting following the introduction of two proposed bills in June and December 2021.[16] The draft bills (S.1187 - Eliminating Global Market Distortions To Protect American Jobs Act of 2021 and H.R.6121 - Eliminating Global Market Distortions to Protect American Jobs Act of 2021) propose empowering U.S. Commerce Department to countervail subsidies offered to producers and exporters in the country under investigation granted by a government located elsewhere.[17] The subsidies would be accumulated with those offered by the country targeted under investigation in instances where the country "*facilitates*" the provision of subsidy.[18]

In addition, the draft America Creating Opportunities for Manufacturing, Pre-Eminence in Technology, and Economic Strength ("COMPETES") Act of 2022, also proposes allowing Commerce to investigate cross-border subsidies and strengthening circumvention investigations.

None of these bills have been enacted into law.[19] In the meantime, the U.S. is using enforcement actions including anti-circumvention instruments (i.e., trade measures targeting practices consisting in completing or assembling products in a country different to the one targeted by an anti-dumping ("AD") or countervailing duty ("CVD") order). Specifically, anti-circumvention instruments are being used to target: (i) foreign manufacturers that process Chinese subsidized inputs,[20] and (ii) subsidiaries of Chinese firms established abroad. The circumvention instrument

13 Article 3 SCM.

14 Article 5 SCM

15 See William Alan Reinsch & Sparsha Janardhan, Center for Strategic and International Studies ("CSIS"), Crossing the Line, International subsidies (January 14, 2022), (with references to Gary Horlick, Gustavo Hernandez, and Crochet & Hegde, https://www.csis.org/analysis/crossing-line-transnational-subsidy.

16 The draft bills proposed to amend Section 771 of the Tariff Act of 1930 (19 U.S.C. 1677) (adopting the SCM Agreement definition of "subsidy") to encompass "transnational subsidies." S.1187 - Eliminating Global Market Distortions To Protect American Jobs Act of 2021 §301.

17 H.R.6121 - Eliminating Global Market Distortions to Protect American Jobs Act of 2021 §201.

18 Although the bills are not specifically targeted against China, the summary of the bill by the Congressional Research Services mentions that the initiative "would allow Commerce to ensure that the countervailing duty laws apply to China's Belt and Road Initiative subsidies, which benefit China-based or China-operated firms operating in countries outside of China." https://www.brown.senate.gov/imo/media/doc/eliminating_global_market_distortions_to_protect_americans_jobs_act_section-by-section.pdf.

19 The COMPETES Act of 2022 was substituted by United States Innovation and Competition Act of 2021.

20 The use of the circumvention authority has been expanded, as it targeted initially slight modifications or assembly of parts in third countries. *See*: Victor Crochet, International Economic Law and Policy Blog, Guest Post: The Imitation Game: Recent Developments on Transnational Subsidies and Anticircumvention in Europe and the United States. (Mar. 16, 2022),: https://ielp.worldtradelaw.net/2022/03/guest-post-the-imitation-game-recent-developments-on-transnational-subsidies-and-anticircumvention-i.html.

was amended in September 2021.[21] It requires simplified investigation compared to AD, CVD, and permits extending non-market economy treatment to trade originating in market economy countries.[22]

This has implications for other high-income and low- and middle-income economies. For example, in December 2021, the U.S. Department of Commerce ("USDOC") found that imports of welded oil country tubular goods ("OCTG") completed in Brunei or the Philippines using inputs manufactured in China are circumventing the antidumping and countervailing duty orders on OCTG from China.[23] The circumvention case on solar modules and cells produced in Cambodia, Malaysia, Thailand, and/or Vietnam with input "minimally processed"[24] from China has been in the spotlight, after the U.S. Department of Labor finding relating raw material (polysilicon) to forced labor.[25] [26]

In addition, in ***mergers*** involving foreign government subsidies, the U.S. Federal Trade Commission and the U.S. Department of Justice may determine whether the acquisition, if consummated will violate antitrust rules. Specifically, on December 29, 2022, President Biden signed into law the "Consolidated Appropriations Act, 2023," which includes the Merger Filing Fee Modernization Act of 2022. As such, any person submitting a filing that received a subsidy from a "foreign entity of concern" must disclose information about those subsidies during the notification process. Thus, there is still reliance on instruments from traditional antitrust regulation addressing the cross-border subsidies in the context of M&A, although the notion of "person of concern" brings-up elements of national security.[27]

B. The European Union

The EU has targeted transnational subsidies in countervailing investigations initiated against the recipient country ***in the context of international trade policy.*** For example, the EU has instituted countervailing measures on imports of certain woven and/or stitched glass fiber fabrics originating in Egypt in 2020.[28] The merchandise was manufactured by Jushi Egypt and Hengshi Egypt, two Egyptian subsidiaries of the China National Building Materials Group, a Chinese SOE. Jushi and Hengshi manufactured the merchandise in the Suez Economic and Trade Cooperation Zone ("SETC Zone"), a special economic zone which was jointly established by the Government of China ("GOC") and the Government of Egypt ("GOE"). The European Commission found that the GOE agreed to support the zone not only through tax breaks, but also agreed to the GOC providing financial assistance.[29]

More recently, the EU imposed countervailing duties on imports of stainless-steel cold-rolled flat products originating in India and Indonesia (March 15, 2022).[30] The European Commission assessed cooperation between Indonesia and China for the development of the Morowali Industrial Park run by the China's Shanghai Decent Investment (Group), the holding company of Tsingshan Group. The European Commission concluded that China provided preferential financing to Indonesia for production, and that the pooling of resources by China and Indonesia provided a specific benefit to the firms operating in the Morowali Industrial Park.[31]

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21 19 Fed. Reg. 52300.

22 *Ibid.*

23 Oil Country Tubular Goods From the People's Republic of China: Final Affirmative Determinations of Circumvention, (Nov. 26, 2021), (86 Fed. Reg. 67443).

24 USDOC press release, Department of Commerce Issues Preliminary Determination of Circumvention Inquiries of Solar Cells and Modules Produced in China (Dec. 27, 2022), https://www.commerce.gov/news/press-releases/2022/12/department-commerce-issues-preliminary-determination-circumvention.

25 U.S. Department of Labor press release, US Department of Labor adds polysilicon from China to "List of Goods produced by Child labor or forced labor." (Jun 24, 2021), https://www.dol.gov/newsroom/releases/ILAB/ILAB20210624.

26 See Senator Brown comments on proposed bill Eliminating Global Market Distortions to Protect American Jobs Act, ("This bipartisan bill will strengthen our antidumping and countervailing duty laws to challenge China's unfair trade practices and protect American jobs in sectors that are important to Ohio."), https://www.brown.senate.gov/newsroom/press/release/brown-legislation-strengthen-trade-laws-protect-american-workers.

27 The notion of "entities of concern" includes (i) entities owned or controlled by a person subject to the jurisdiction or direction of China, Russia, Iran, or North Korea; (ii) foreign terrorist organizations; (iii) persons targeted with asset freezes by OFAC ("SDNs"); (iv) entities involved under the Espionage Act; Export Control Act, Atomic Energy Act found to have been involved in an activity detrimental to national security.

28 Commission Implementing Regulation (EU) 2020/776, OJEU, (Jun 15, 2020), L 189/1; Commission Implementing Regulation (EU) 2020/870, OJEU, (Jun. 24, 2020), L201/10.

29 See commentary by Congressional Research Service, Trade Remedies, Countervailing duties (Aug. 23, 2021), https://crsreports.congress.gov/product/pdf/R/R46882#:~:-text=Countervailing%20duty%20(CVD)%20laws%20provide,produced%20in%20the%20United%20States.

30 Commission implementing Regulation (EU) 2022/433, OJEU (Mar.16, 2022), L 88/24.

31 In both cases, the European Commission rejected the Government of China contention that by countervailing Chinese support, the EU was in contravention of the SCM Agreement. The European Commission argued that the terms "by a government" need to be interpreted inter alia in light of Article 11 of the ILC Articles on State Responsibility for Internationally Wrongful Acts ('ILC Articles'), according to which "conduct can be attributed to a State 'if and to the extent that the State acknowledges and adopts the conduct in question as its own.'"

In both cases, the European Commission examined whether the conduct of a foreign government should be attributed to the exporting country as providing those subsidies indirectly via the foreign government, as agreed by both governments. When a demonstrable, explicit link is established between the exporting country and the foreign government granting the subsidy, the exporting country is considered accountable for having actively sought, acknowledged, and adopted as its own such subsidies for the benefit of products produced in the exporting country. While both cases have been appealed to the General Court,[32] one of them has been appealed to the WTO. The latter might bring the first opportunity for a panel to interpret the applicability of WTO SCM to transnational subsidies.[33]

The EU has also designed ***initiatives aiming to safeguarding EU internal market***. The EU initiative is the first of this kind in the world. Specifically, in 2022, it adopted the Foreign Subsidies Regulation ("FSR") addressing the negative impact for the EU internal market of financial contributions granted by non-EU governments to firms active in the EU.[34] The FSR entered into force on January 12, 2023,[35] and introduces three main tools for disciplining foreign subsidies:

· *Control of mergers and acquisitions*: Compulsory *ex ante* notification of mergers and acquisitions involving a financial contribution by a non-EU government, where the acquired company, one of the merging parties or the joint venture generates an EU turnover of at least €500 million and the transaction involves a foreign financial contribution of more than €50 million.

· *Control of foreign public procurement*: Compulsory *ex ante* notification of bids in public procurement processes involving a financial contribution by a non-EU government when the estimated contract value is at least €250 million, and the bid involves a foreign financial contribution of at least €4 million per third country; and

· *Control on all other market situations*: The Commission can start a review on its own initiative or at the request of an interested party for smaller-sized concentrations or public procurement procedures.[36]

The implementation of the FSR[37] raises several questions. For instance, given the extensive notion of "financial contribution" it may be difficult for firms to map the exact financial support. Firms are also required to conduct a market economy test to check whether the financial contribution provided an advantage to the recipients. In addition, parties need to indicate any potential distortive effect in the internal market, and the benefit to the parties' business in the EU.[38] If a foreign subsidy is found to distort the single market, the European Commission has the power to impose structural and non-structural redressive measures, or accept commitments to remedy the distortions (e.g. divestment of certain assets or prohibition of a certain market conduct). Failure to notify[39] under the two *ex ante* mechanisms may result in a penalty amounting to 10 percent of the aggregate turnover, whereas the provision of incorrect, misleading, or incomplete information may lead to fines equaling 1 percent of the global turnover.

This EU initiative has been criticized for being considered too protectionist.[40]

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32 The two European Commission decisions have been challenged before the General Court of the European Union ("GC"). The EU issued judgment in case in case T-480/20 - *Hengshi Egypt Fiberglass Fabrics and Jushi Egypt for Fiberglass Industry v. Commission*. The General Court sustained the Commission Regulation and concluded that the terms "within the territory of a country" under Article 1.1 SCM Agreement "do not preclude the possibility of concluding that the financial contributions may be attributed to the country of origin or export of the product concerned."

33 Request for consultation by Indonesia, Anti-dumping and countervailing duties on stainless steel product from Indonesia, (Jan 26, 2023), WT/DS616/1, https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/DS/616-1.pdf&Open=True.

34 The European Commission further published a Draft Implementing Regulation, laying down the procedural rules related to the application of the FSR. See also Regulation (EU) 2022/2560 of the European Parliament and of the Council of 14 December 2022 on foreign subsidies distorting the internal market, OJ L 330, 23.12.2022, p. 1–45.

35 The FSR will start applying from July 12, 2023, and the notification requirement will enter into force on October 12, 2023.

36 The level of information that the parties will have to provide to the Commission is extensive, including a summary description of the deal or tender, information about the parties, detailed information about the financial contributions received in the past three years, information about the bidders, etc.

37 See https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/13602-Distortive-foreign-subsidies-procedural-rules-for-assessing-them_en.

38 The Commission has large investigative powers that mirror the ones under merger control, including request for information to the parties (and to third countries contracting authorities), conducting interviews, inspections within and outside the territory of the Union, impose fines on entities failing to cooperate or provide the requested information.

39 The new notification requirement under the FSR will impact the timetable that parties may have initially projected for concluding a deal. In addition, the parties will need to deal with risk allocation as the application of FSR may result in the prohibition of concluding the deal.

40 Sherman & Sterling, EU takes another big protectionist step as new foreign subsidies regulation comes into force, (Jan 20, 2023), https://www.shearman.com/en/perspectives/2023/01/eu-takes-another-big-protectionist-step-as-new-foreign-subsidies-regulation-comes-into-force#:~:text=The%20EU%20Foreign%20Subsidies%20Regulation,granted%20by%20non%2DEU%20countries.

IV. WHERE DO WE GO FROM HERE AND ARE THERE RISKS TO BE AWARE OF?

Globally, there is still room for clarifying what transnational subsidies are, and how their distortive effects can be tackled from a policy and regulatory perspective.

First, at the WTO, there is an opportunity to clarify whether transnational subsidies are covered under the WTO SCM. This is offered by the recent case at the WTO regarding the anti-dumping and countervailing duties on stainless steel product from Indonesia.[41] However, the case might never reach the report stage.

Second, it is questionable whether every export subsidy can fall under the WTO SCM or only prohibited export subsidies. In addition, there is no practice as to what can amount to a transnational export subsidy. So far, the practice in the EU has targeted subsidies to Chinese subsidiaries established in free economic zones and oriented towards export. On the other hand, the increased investment (especially foreign investment) in a country can lead to the development of an industry and increased foreign trade. If transnational subsidies are associated with foreign investment, low- and middle-income countries might not even be aware of the perils of being targeted by transnational subsidies investigations. This is also because there is no tested evidence on what mechanisms can be put in place by a low- or middle-income country within the framework of bilateral investment negotiations to avoid the risks of being targeted by transnational subsidies investigations.

Third, there is a question as to the target of transnational subsidies enforcement: should it only address China countervailing practices? Should it be directed against projects in the Belt and Road Initiative ("BRI") as a mechanism through which China asserts global economic leadership and control of core technologies and supply chains? Should it target Non-Market Economy countries or other countries? The U.S. in its Filing Fee Modernization Act also targets entities in Russia, Iran or North Korea based on "national security" claims. Thus, there is a risk of political use of the enforcement against transnational subsidies, particularly in a context where the notion of national security combines military, political and economic policy considerations.

Fourth, it is important to reflect on the regulatory framework that can better address the distortive effects of transnational subsidies. The U.S. and EU regulatory initiatives and enforcement activities take elements from different areas of law, notably trade defense (countervailing and circumvention investigations), merger control, and foreign investment law. In this respect, there is a risk that regulators attempt to use existing instruments to address the potential distortive effects of transnational subsidies which cannot capture their complexities. As an example, the exercise of gathering information in a merger control review in the EU is relatively straight-forward. The same fact gathering exercise is more complex for firms in low- and middle-income economies, or subsidiaries participating in public procurement processes which might not have visibility on the subsidies received by the parent company. Further, firms might not associate M&A or participation in public procurement with the obligation to disclose subsidies from foreign governments. Similarly, remedies (structural, behavioral) that mirror the ones under merger control might not be as effective to tackle the potential distortionary effects of transnational subsidies.

Finally, there is also a risk that low- and middle-income economies receiving foreign investment are not always keeping pace with the regulatory changes and practice occurring in high-income economies, such as those in the U.S. or EU. These regulatory initiatives might have a decisive impact on exporting firms in low- and middle-income economies and their ability to connect to new markets and integrate into global value chains. Moreover, low- and middle-income countries might not contemplate the introduction of similar oversight mechanism on foreign investment, which if subsidized might distort domestic trade and competition.

In a context where unilateralism has gained momentum, low- and middle-income economies risk being excluded from the debate on transnational subsidies and their potential effects on their external trade. The international financial institutions, such as the World Bank can engage in dialogue with countries implementing initiatives that aim at tackling the distortive effects of transnational subsidies as well as with low- and middle-income economies receiving foreign investments. This is particularly important to seek avenues that can address low- and middle-income economies' foreign trade expansion and mitigate potential negative effects associated with increased protectionism.

41 WT/DS616.

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