Subsidy Wars

Cooperation and common understanding could dial back trade tensions

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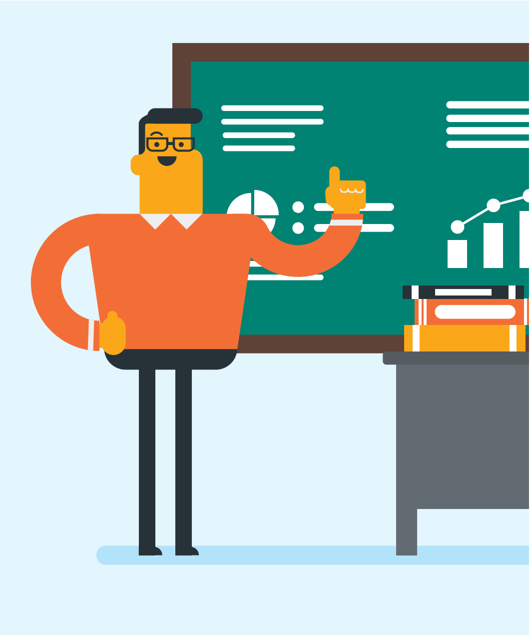

A RAMPING UP OF SUBSIDIES by some of the world's largest economies has contributed to a significant increase in global trade tensions. New subsidies, countervailing duties, and legislation such as the US Inflation Reduction Act, the EU Green Deal Industrial Plan, and the Made in China 2025 strategy have raised concerns about the potential for subsidy wars—subsidy competition that leads to a race to the bottom.

This concern has been bolstered by the way subsidies adopted by one major trading bloc have spurred others to enact their own subsidies within just six months. To defuse and mitigate these worrisome dynamics it is important to understand the fears and goals that lie behind these actions. What drives governments to subsidize their domestic economies? What problems can these subsidies cause? And what can be done to prevent an all-out subsidy war?

Subsidies are a transfer of resources from a government to a domestic entity without an equivalent contribution in return and can take many forms, including direct grants to domestic companies, tax incentives, or favorable terms for financing. Governments use subsidies for several reasons, and their terms are shaped by the goal the government hopes to accomplish.

Governments might want to achieve a national strategic objective or to gain a competitive edge in international markets. Think of production subsidies in high-tech industries such as aerospace and telecommunications, which can be used to ensure predictable or guaranteed supply chains or to protect other national security interests.

Some subsidies lack a clear rationale and may be a response to lobbying or political pressure. Others might be motivated by understandable public policy objectives, such as the need to correct market failures or to respond to national emergencies, from health to climate change. Subsidies for COVID vaccines, when governments intervened to address capacity constraints, are a recent example. Regardless of the rationale, poorly designed subsidies that have a negative effect on other countries can invite retaliatory countermeasures.

What's wrong with subsidies?

The classic economic argument against the use of subsidies is that they cause a misalignment between prices and production costs. In doing so, they can distort markets, prevent efficient outcomes, and divert resources to less productive uses. If subsidies benefit some firms over others, they can snuff out innovation and force efficient firms to contract out work or exit the market altogether. This, in turn, can reduce overall productivity. They also create opportunities for rent-seeking behavior—activities that manipulate the distribution of economic resources to bring positive returns to individuals, not to society—and harm smaller economies that cannot afford to subsidize.

Subsidies can also prop up practices that are harmful to the public interest and have negative environmental and health effects. For example, the world could have cut global carbon emissions by 28 percent and air pollution deaths by 46 percent had policymakers agreed to replace fossil fuel subsidies with an efficient carbon price, according to IMF economists.

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But the impact of subsidies on trading relationships has been particularly fraught. First, subsidies can distort trade and investment decisions in other economies. This is particularly true when they include discriminatory provisions such as a requirement that manufactured goods use components made exclusively or primarily within the country. For example, if Country A grants tax credits to purchasers of widgets whose components are all made in that country, a number of inefficient results are likely: manufacturers may reconfigure supply chains to prioritize domestic partners, foreign producers may relocate production to Country A, and Country A's consumers may develop an unwarranted preference for domestically produced widgets.

Second, subsidies undermine the benefits of past tariff and market-access negotiations that were undertaken in regional and multilateral agreements. This happens most often when subsidies undercut improved market access that flows from tariff reductions. Over time, this can increase perceptions that trade is unfair and can reduce public support for trade.

Third, subsidies may lead trading partners to believe that a government promoted unfair competition and could compel them to react in kind. To take the above example a step further, if Country B, a main trading partner of Country A, determines that its domestic widget industry is being hurt by cheap imports of widgets subsidized by Country A, it might impose countervailing duties to neutralize the effects of the subsidies. Country B could also subsidize its own widget production and introduce measures similar to those of Country A. These reactions could spur Country A to retaliate in kind and lead to an escalating subsidy war.

Can international rules help?

The World Trade Organization (WTO) Agreement on Subsidies and Countervailing Measures (SCM agreement, for short) and its Agreement on Agriculture provide a good foundation for rules governing subsidies that affect trade in goods. The SCM agreement, for example, defines what constitutes subsidies, including those that are prohibited (such as export subsidies and local-content subsidies) and those that can be challenged because they have adverse effects on another country. The agreement also requires governments to notify the WTO of certain subsidies and establishes procedures for unilateral and multilateral remedies, including the use of countervailing measures and WTO dispute settlement.

But the SCM agreement has some important shortcomings. A chief concern is that some forms of state intervention, including subsidies to and provided by state-owned enterprises, are not automatically counted as "subsidies" in the current WTO definition. Such intervention might include providing favorable financing for land or equipment to state enterprises that produce goods for export. Some countries are concerned about how subsidy rules apply to state enterprises and have incorporated into recent trade agreements measures to limit their market-distorting behavior. Such agreements include the Comprehensive and Progressive Agreement for Trans-Pacific Partnership and the agreement between the United States, Mexico, and Canada. Countries have also sometimes failed to notify the WTO when they introduce subsidies. This has contributed to a lack of transparency and sowed mistrust.

Rules are only part of the story, however. A lack of information makes it difficult for policymakers to make informed decisions about subsidy use. There is, for example, no comprehensive analysis of subsidies and their effects. Internationally, there is little guidance on how subsidies can be improved and how to minimize negative cross-border spillovers. Without this information, national policymakers are left with limited tools.

Can a subsidy war be stopped?

The current landscape is challenging. Subsidy disputes and countervailing duty investigations at the WTO have increased steadily since 2010. As governments expand subsidies, tit-for-tat competition among major governments seems likely to continue.

But there may be a path out of this dangerous dynamic. A recent joint paper, "Subsidies, Trade, and International Cooperation," by four international organizations, including the IMF, proposes ways to enhance transparency, provide better analysis, and strengthen cooperation to improve the design of subsidies and limit their harmful effects. Cooperation and common understanding would go far in dialing back tensions and contributing much-needed openness and predictability to global trade. FD

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