

To Regulate, or Not to Regulate? Subsidies for Foreign Enterprises, Climate Change, and Currency Undervaluation¹

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I. Introduction

In response to today's rapidly changing global trade environment, countries have continued to make changes to their policy objectives and instruments to address new and emerging issues such as supply chain restructuring and reshoring, climate change, and currency undervaluation. To this end subsidies have been playing a particularly important role, and are expected to be used more broadly across different sectors in the coming years. While controversies over government subsidization are likely to continue at the international level, the United States and the European Union have proposed at the domestic level to expand the scope of subsidy regulation and to tighten regulation on newly emerging subsidy types bey-

ond the traditional boundaries set by international trade rules. Among a number of the latest developments on subsidy regulation, this Brief intends to primarily focus on (i) transnational subsidies granted by a government to enterprises active in other foreign countries (hereinafter "foreign subsidies"); (ii) green subsidies for climate change mitigation; and (iii) subsidies related to currency undervaluation.

II. The EU's Proposal for Foreign Subsidy Regulation

The European Commission's proposal of May 5, 2021² on foreign subsidies aims to

¹ This is a brief summary of Lee, C., M. Kang, and M. Kim. 2021. "Latest Development in Subsidy Regulation: Foreign Subsidies, Climate Change-related Subsidies, and Currency Undervaluation Subsidies" (in Korean), Long-term Trade Strategies Study Series 21-05, Korea Institute for International Economic Policy.

² European Commission, "Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on foreign subsidies distorting the internal market," 5.5.2021, COM(2021) 223 final, 2021/0114 (COD).

regulate not only distortions caused by subsidies granted to products, but by subsidies related to supply of services, foreign investments, concentrations, and public procurements. Behind the proposal, there were the Commission's concerns that foreign governments could distort fair competition in the EU's internal market by providing subsidies across the border to enterprises established and active in the EU. According to the Commission, the current international and regional disciplines such as the WTO SCM Agreement,³ the EU Anti-subsidy Regulation,⁴ EU state aid law,⁵ the EU Public Procurement Directive,⁶ and the EUMR⁷ have not effectively addressed market distortion caused by foreign subsidies, especially where the beneficiaries of a financial contribution are located beyond the granting authorities' jurisdiction, i.e., within the EU internal market. In this vein the Commission's proposal defines a foreign subsidy as where a third country provides a finan-

cial contribution which confers a benefit "to an undertaking engaging in an economic activity in the [EU] internal market" and which is limited, in law or in fact, to an individual undertaking or industry or to several undertakings or industries.⁸

The proposed regulation provides for (i) a notification-based, *ex ante* investigation for concentrations⁹ and public procurement participation¹⁰ and (ii) an *ex officio* and *ex post* investigation for all other market situations.¹¹ EU undertakings that have received a financial contribution from foreign governments and are involved in a concentration and a public procurement procedure in the EU are obligated to notify all foreign financial contributions received in the three years preceding that notification.¹²

Although it appears that the most immediate target of the foreign subsidy regulation would be China,¹³ it cannot be ruled out at this point

³ WTO Agreement on Subsidies and Countervailing Measures, 1869 U.N.T.S. 14.

⁴ Regulation (EU) 2016/1037 of the European Parliament and of the Council of 8 June 2016 on protection against subsidised imports from countries not members of the European Union, OJ L 176 30.6.2016.

⁵ Treaty on European Union and the Treaty on the Functioning of the European Union (TFEU) [2016] OJ C 202/1, Arts. 107-109.

⁶ Directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC, OJ L 94/65, 28.3.2014.

⁷ Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (the EC Merger Regulation), OJ L 24/1, 29.1.2004

⁸ *Supra* note 2, Art. 2(1).

⁹ *Supra* note 2, Ch. 3.

¹⁰ *Supra* note 2, Ch. 4.

¹¹ *Supra* note 2, Ch. 2.

¹² *Supra* note 2, Arts. 18(3), 28(1).

¹³ See, e.g., European Commission, "Explanatory Memorandum for Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on foreign subsidies distorting the internal market", 5.5.2021, COM(2021) 223 final, 2021/0114 (COD), p. 2, fn. 8 (citing European Court of Auditors' assessment that certain subsidies granted by the Chinese state would constitute State aid if granted by an EU Member State, and that this 'difference in treatment can distort competition in the EU's internal market'); European Commission, "COMMISSION STAFF WORKING DOCUMENT - IMPACT ASSESSMENT - Accompanying the Proposal for a Regulation of the European Parliament and of the Council on foreign subsidies distorting the internal market," SWD(2021) 99 final, 5.5.2021, pp. 11-14 (providing case studies of ChemChina's acquisition of Pirelli and CRRC Zhuzhou Locomotives' acquisition of Vossloh Locomotives as examples of "how foreign subsidies may have distorted the acquisition of EU companies"); and European Commission, "2021 State of the Union Address by President von der Leyen", 15 September 2021, p. 34 (explaining that the Commission proposed a regulation to control distortive subsidies granted by foreign governments to companies active in the EU, under the heading "DEALING WITH CHINA AND RUSSIA").

that the EU's other trading partners, including Korea could also be significantly influenced depending on possible amendment of the text in the final Regulation.

There also remain a number of issues that need to be addressed in the following legislative process, particularly in the trilogues between the Commission, the European Parliament and the European Council. Firstly, the Commission's proposal can be criticized for not being detailed enough to help the affected businesses to prepare the regulation in advance. Secondly, the requirements for triggering the notification obligation are based on whether a financial contribution exists, regardless of the existence of benefits or specificity, possibly leading to additional administrative and economic burden. Thirdly, the proposed regulation covers all cases of financial contributions including those related to inter-company transactions between affiliates,¹⁴ and those received by subcontractors and suppliers.¹⁵ Required to notify all information related to financial contribution received from foreign governments, businesses could be exposed to disclosure of proprietary or confidential information. Lastly, concerning the Commission's excessively broad authority under Chapter 2 of the proposal to investigate foreign subsidies granted in the previous ten years,¹⁶ this Brief submits that an additional mechanism is needed to limit the Commis-

sion's investigative power by reducing the limitation period and adding higher trigger threshold for *ex officio* initiation of investigations.

III. Green but Potentially Countervailable Subsidies for Climate Change

As the Paris Agreement came into force accelerating global collective action to address climate change and many countries have implemented environmental measures affecting their domestic and exporting industries, the interaction or so-called "linkage" between trade and the environment has become increasingly prominent.

For instance, while the largest trading countries such as the U.S. and the EU stress the need to tighten regulations on industrial subsidies,¹⁷ they have granted a substantial amount of subsidies for R&D and domestic production of EV batteries on the grounds that emission reduction in the transportation sector is key in achieving the goal of carbon neutrality by 2050 they have pledged under the Paris Agreement. This shows the dilemma and contradictory position of these countries on green (yet industrial) subsidies for climate change, which may distort competition in the market.

For another example, when countries with an emission trading system or "ETS" provide free allowances, the subsidy problems arise from

¹⁴ *Supra* note 2, Art. 18(3) and (4).

¹⁵ *Supra* note 2, Art. 28(2).

¹⁶ *Supra* note 2, Art. 35(1).

¹⁷ See, e.g., Lee, C. "WTO Industrial Subsidy Regulation: US-EU-Japan Joint Statement of January 2020 and Afterwards", World Economy Brief, vol. 10, no. 10, April 14, 2020.

the trade law perspective. Most countries currently operating an ETS allocate a certain amount of carbon emission for free in order to prevent risks of carbon leakage and to maintain market competitiveness of their carbon-intensive industries. The problem is that the current WTO subsidy rules do not contain provisions for environmental exceptions to these subsidies. Likewise, many countries do not allow these exceptions under their domestic laws. In the case of the United States, in December 2020, the Department of Commerce (DOC) made an affirmative determination in a CVD investigation for certain steel products from the EU that free allowances given selectively to some of the covered installations under the EU ETS are a countervailable subsidy.¹⁸ It is also noteworthy that in December 2021, the DOC made a similar determination with respect to Korea's ETS (K-ETS) in a countervailing duty administrative review for certain steel products from Korea¹⁹ that 100% free allowances allocated only to a part of the covered entities as opposed to 97% free allowances to the rest of the covered entities are a countervailable subsidy.

IV. Currency Undervaluation Deemed to be a Countervailable Subsidy by the U.S.

In April 2020, the U.S. implemented a revised regulation applicable to countervailable subsidies related to currency undervaluation. It has maintained that some of its trading partners intentionally devalue their currencies to provide a competitive advantage to its export industries. Over the years several bills were introduced to impose CVDs on currency manipulation, but failed to pass Congress. Then in 2020, the DOC revised the Code of Federal Regulation (CFR) at the administrative level and laid the basis for CVD imposition against countries where their currency is undervalued due to government intervention.

Following the revision, in May 2021 the DOC made an affirmative determination for Passenger Vehicle and Light Truck Tires from Vietnam (C-552-829) that Vietnam's currency undervaluation is a countervailable subsidy²⁰ while in an investigation on twist ties from China (C-570-132) the DOC decided to postpone the final determination due to procedural reasons and a final determination has yet to be made.²¹

¹⁸ Under the ETS, the EU had granted selectively to some installations more of free allowances (100% compared to the emission amount of the best performing installation) as opposed to the rest of the installations (44.2%). See U.S. Department of Commerce, "Issues and Decision Memorandum for the Final Affirmative Determination of the Countervailing Duty Investigation of Forged Steel Fluid End Blocks from the Federal Republic of Germany," December 7, 2020, p. 49.

¹⁹ See, e.g., U.S. Department of Commerce, Memorandum for Ryan Majerus from Brooke Kennedy, "Decision Memorandum for the Final Results of the Countervailing Duty Administrative Review, 2019: Certain Cut-To-Length Carbon-Quality

Steel Plate from the Republic of Korea," C-580-837, Administrative Review, POR: 1/1/-2019 - 12/31/2019, December 23, 2021.

²⁰ U.S. Department of Commerce, "Issues and Decision Memorandum for the Final Determination in the Countervailing Duty Investigation of Passenger Vehicle and Light Truck Tires from the Socialist Republic of Vietnam," May 21, 2021.

²¹ U.S. Department of Commerce, "Issues and Decision Memorandum for the Final Determination of the Countervailing Duty Investigation of Twist Ties from the People's Republic of China," February 16, 2021.

As the revision was made only recently and there has been only one case where currency undervaluation is determined as a countervailable subsidy, the current DOC's methodologies appear to be still incomplete in many aspects. Notably, some of the changes made to the regulation and the DOC's reasoning in C-552-829 appear particularly problematic and may be open to a legal challenge in terms of compatibility with the WTO SCM Agreement. For instance, grouping all "enterprises that buy or sell goods internationally" as a group of enterprises or industries or a "traded goods sector"²² is too broad an approach to determine specificity, possibly constituting a violation of Art. 2.1 of the WTO SCM agreement. It has also been pointed out that the methodology the DOC resorted to in calculating benefit²³ in C-552-829 could lead to overestimation of the amount of benefits, in violation of Arts. 1.1(b) and 14 of the same Agreement.

V. Concluding Remarks

This Brief has shed light on the latest developments in new subsidy regulation proposed by the U.S. and the EU, in terms of regulation on foreign subsidies, green subsidies for climate change mitigation, and subsidies related to currency undervaluation.

Firstly, as regards the foreign subsidy regulation proposed by the EU, there is concern that it could incur significant compliance costs for affected businesses, as they are burdened to

trace and monitor virtually all financial contribution directly or indirectly from foreign governments for the past three years prior to notification of concentration or participation in public procurements procedures in the EU. In order to minimize risks, affected businesses are advised to prepare a comprehensive database on their supply chains and financing methods related to overseas production and production facilities within the EU or third-country facilities leading to the EU market.

They are also advised to understand that the foreign subsidy regulation is being prepared and will be implemented in conjunction with EU's latest movement to secure regional supply chains. The EU is providing large-scale incentives to encourage internal production of items critical to EU's regional supply chain restructuring. As has been generally witnessed in a number of cases, these incentives are provided on condition that a certain percentage of value or particular items or components be produced within the EU. As a result, client companies that produce finished goods in the EU may prefer companies with local manufacturing facilities in the EU to companies exporting across the border their intermediate goods or components to the EU, so they can receive incentives offered for local production. In addition, in the case of certain industries, if client companies and upstream producers are not logistically close to each other, stable cross-border supply to the EU can become difficult due to border measures such as ADs or

²² 19 CFR §351.502.

²³ 19 CFR §351.528.

CVDs imposed at the EU level. Then the problem occurs when it gets difficult for companies to independently mobilize sufficient financial resources to establish or acquire overseas production facilities in the EU and they receive financial support from the government. For instance, companies could receive preferential finance from state-run banks, or SOEs or state-run banks could directly participate in overseas investment through equity infusion. From the EU's point of view, this can be seen as a foreign subsidy.

Secondly, regarding green subsidies for climate change, the Brief submits that the future direction of international trade rules should be to promote climate change mitigation rather than hinder it. In order to resolve tensions arising from the overlapping climate and trade objectives, it is necessary to seek ways to recognize exceptions for green industrial subsidies in the international trade system. A climate waiver can be one way. It would be also fruitful to consider reintroducing a non-actionable subsidy provision similar to now-defunct Article 8 of the WTO SCM Agreement with or without a sunset clause, or at least establishing a rebuttable presumption in favour of such subsidies.

As regards CVD investigations related to free allowances under the K-ETS it should be noted that the DOC is not saying that a free allowance itself is a subsidy; but an additional 3% free allocation to a *select few* entities is, compared to 97% free allowances granted to *all* of the entire covered entities under K-ETS.

Therefore, as a short-term strategy, it is advised that the Korean government first explore various ways to tweak the system based on the logics the DOC presented in reaching the affirmative subsidy determination, rather than reviewing the overall system in a hurried manner.

For parts of the DOC's reasons that appear less than convincing or without sufficient explanation, the Korean government or companies subject to the CVD investigation may raise a rebuttal or request additional explanation in subsequent administrative reviews, or file a complaint before the U.S. Court of International Trade (CIT). While it would not be easy to refute the DOC's determination when it is directly based on statutes or case law, this Brief suggests there still is room for dispute in areas where the DOC exercises its discretion powers without explicit and detailed guidance in the statutes.

Thirdly, as regards the U.S. efforts to regulate currency undervaluation as a countervailable subsidy, companies that operate in countries where currency is determined to be undervalued in the DOC's investigations will have to be mindful of a possible CVD imposition by the U.S. if they engage in local reinvestment or currency exchange activities in those countries. Unlike most cases where subsidies are limited to specific enterprises or industries, currency undervaluation is related to almost all exporting industries. Therefore, once the DOC makes an affirmative subsidy determination against a certain product by reason of cur-

rency undervaluation of a certain exporting country, there is a potential risk that a similar decision would be made in all of the following CVD investigations on different products exported from that country to the U.S.

Last but not least, efforts are needed to induce the above new types of subsidy regulation to be publicly discussed for a multilateral solution. Since unilateral measures are not based on mutual consent between the countries, even if the objective should be justified, it is difficult to expect meaningful effects in the mid-to-long term. International cooperation is very much needed, in order to effectively respond to cross-border spillover effects these types of subsidies could lead to. Therefore, this Brief suggests that the first priority at this point is to derive a higher minimum standard that all countries can multilaterally agree to with respect to international subsidy regulation. **KIEP**