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POLICY PAPER

**From EU-Japan-US Trilateral to a Plurilateral
Initiative on Subsidies**

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Abstract

Geo-economic tensions, notably associated with the rise of China, and global collective action problems – climate change; the COVID-19 pandemic – call for international cooperation to revise and develop rules to guide both the use of domestic subsidies and responses by governments to cross-border competition spillover effects. Current WTO rules dividing all subsidies into prohibited or actionable categories are no longer fit for purpose. Piecemeal efforts in preferential trade agreements configurations offer a basis on which to build but are too narrow in scope. Addressing spillover effects of subsidies could start with G20 countries launching a work program to mobilize an epistemic community concerned with subsidy policies, tasked with building a more solid evidence base on the magnitude, purpose and effects of subsidy policies. The aim of such an effort should be to extend trilateral deliberations on industrial subsidies held by the EU, Japan and US in 2018-2019 into a negotiation with China and a broader group of WTO members to establish a plurilateral agreement on new rules of the game.

Keywords

Subsidy policies; spillovers; international cooperation; G20; WTO.

Introduction*

The international trading system is in a state of transition. The economic and political environment has changed drastically even since the successful completion of the Uruguay Round in 1993. In this environment, while still providing a wide range of exceptionally useful services to its members, the World Trade Organization (WTO) seems increasingly to be struggling for relevance. The frontier issues in trade policy fit awkwardly in current WTO jurisprudence. Subsidies constitute a particularly difficult issue area: they are widely used and often consistent with the teachings of welfare economics as efficient instruments to pursue domestic goals, but they may also give rise to sizable international spillovers, and due to their linkage to domestic policy and politics, and the way these vary across countries, simple rules to address the spillovers seem generally problematic.

In this paper we focus on problems in developing simple subsidy rules. We start with a brief discussion on the extent of the issue, which is followed by some comments on efforts in the direction of reforming subsidy rules. One important such effort was the 2018-19 trilateral initiative by the EU, Japan and the US to identify ways to strengthen existing multilateral (WTO) disciplines on the use of subsidies. The process resulted in a suggestion to expand the list of prohibited subsidies in the WTO to include subsidies and subsidy-like activities of state-owned enterprises (SOEs) and outlaw open-ended financial guarantees, support provided to insolvent or failing companies with no credible restructuring plan and preferential pricing for inputs.¹ The fact that these three major trading powers decided to talk to each other was a positive feature of the initiative. While rule-drafting exercises that build on disciplines negotiated by these three players in recent preferential trade agreements (PTAs), notably the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP), the United States-Mexico-Canada Agreement (USMCA) and the EU-Japan Economic Partnership Agreement, appear to be pragmatic responses to changed circumstances, they lack legitimacy because China was (and is) not at the table.

We argue that the EU and Japan should work with like-minded countries, including the United States, to launch an effort that includes China and a broader group of countries to establish a plurilateral agreement to address the spillover effects of subsidies. This can build on the 2018-19 trilateral deliberations among the EU, Japan and the US on industrial subsidies but cannot simply start from what emerged from those deliberations. This is not only because it is unlikely that China will accept what the trilateral perceives to be needed, but because China (and other large emerging economies) may disagree on whether specific policy measures constitute a potential problem for the global trading system. Any process aimed at rulemaking must start with establishing robust evidence on the type and size of subsidy-related programmes used in major jurisdictions and the degree to which they create serious negative international spillovers. That is, a basic input for the design of new rules should be analysis that establishes a strong presumption that the magnitude of the spillovers associated with specific types of tax-subsidy instruments is large. This basic input was missing in the EU-Japan-US trilateral discussions on subsidy rules, which were largely pursued by trade officials and trade lawyers and were not informed by robust evidence and economic analysis.

* We are grateful to Stefanie Rickard for her comments on the conference draft. This paper draws on previous work in Hoekman and Nelson (2020) and Nelson (2021).

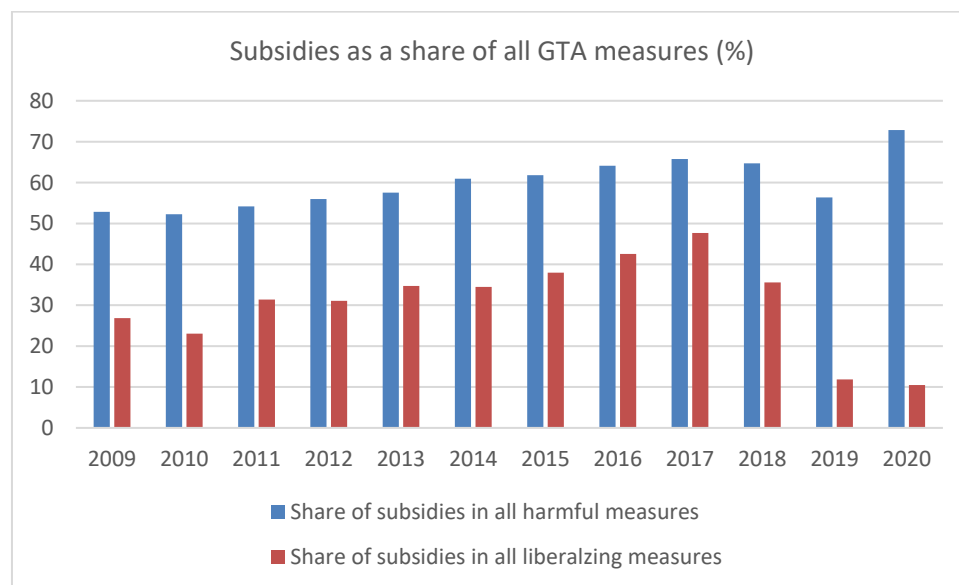
¹ See, e.g., Joint Statement on Trilateral Meeting of the Trade Ministers of the United States Japan, and the European Union, 9 January 2019. Available at <https://ustr.gov/about-us/policy-offices/press-office/press-releases/2019/january/joint-statement-trilateral-meeting>. The last statement of the trilateral group can be found at https://trade.ec.europa.eu/doclib/docs/2020/january/tradoc_158567.pdf.

1. Subsidies are a big current problem in international trade

As of the end of 2020, over 20,000 trade-related measures were included in the Global Trade Alert (GTA) database, ranging from tariffs and quotas to antidumping and investment measures (policies affecting the ability of and/or cost for foreign firms to establish or maintain a commercial presence in a country). Of these, three-quarters were trade distorting and a quarter reflected actions to liberalise trade. By far the largest share of trade-distorting measures took the form of subsidies to production or measures to support exports (Figure 1).

The GTA distinguishes several subsidy categories, including state aid/production support and export support measures (including tax rebates and concessions). The most frequently observed firm-specific state aid measures are public sector loans or loan guarantees and tax or social insurance relief. Taken together, subsidies accounted for over 50 percent of all trade-related measures implemented between 2009 and the end of 2020, with the share in 2020 having risen to over 70 percent.² The G7 group of industrialised countries accounts for the greatest share of subsidies granted, but large emerging economies also use subsidy instruments, with China accounting for a major share of the total. Subsidies tend to account for a relatively small share of total trade-related policy measures imposed by lower-income developing countries. Insofar as subsidies are used by low-income countries they tend to target exports, suggesting a policy focus on promoting exports as opposed to protectionism (Hoekman, 2016).³

Figure 1: Subsidies as a share of all trade policy instruments (total, 2009-2020)



Source: GTA website: <http://www.globaltradealert.org/>.

² Note that the metric here is a simple 'count' of measures, not of the value of the support implied by a measure or their effects. Given that state aid/subsidies are often substantial in value terms, the implied share of subsidies vs. other trade-impacting policies may be a downward-biased measure of the economic significance of such instruments.

³ The WTO prohibits export subsidies, except in the case of agriculture, which is subject to specific commitments laid out in the Agreement on Agriculture, and in the case of developing countries with a per capita income of less than US\$ 1,000. The observed pattern of export subsidy use after 2008 may in part reflect the greater leeway for low-income countries to use export subsidies.

The GTA data help understanding of the EU, Japan and US trilateral discussions on industrial subsidies but make it clear that the ‘subsidies problem’ extends beyond China. Importantly, they illustrate that in a fundamental sense the trilateral effort misunderstood the core problem of subsidies in the same way the current WTO subsidy regime does. There is no disagreement among WTO members on the potential negative spillover effects of export subsidies, domestic content rules or their intention to interfere with competition among firms from different national jurisdictions. The difficult problem with subsidies relates to spillovers from policies that are not, or are not obviously, intended to affect trade. This problem is compounded by the rapid growth of the Chinese economy and its state-capitalism model.

2. The ‘China problem’— – Embedded Liberalism with a Non-Liberal Key Player

Faced with the manifest failures of the classic liberal regime, both domestically and internationally, in the inter-war years the governments of core countries (all democratic capitalist political economies) began to experiment with more active intervention in the economy.⁴ These experiments involved some mix of what we now call Keynesian macroeconomic policy, substantial welfare state expenditure, the active participation of unions in private and public decision-making and increasingly active competition policy. Because of the very different experiences of the late 19th/early 20th centuries and the differing circumstances in the early post-war years, these countries developed very different political economic systems (see Hall and Soskice, 2001; Huber and Stephens, 2001). The US was committed to creating an international order of democratic capitalist nations as a bulwark against the Soviet Union and as a foundation for peace in Western Europe (Gaddis, 2005; McKenzie, 2020). This required both a commitment to broadly liberal norms (Mavroidis and Sapir’s “liberal understanding”) but sufficient policy space for each national variety of capitalism to pursue its distinctive national goals. It is not clear to us that the International Trade Organization (ITO) at that time could have supported both a liberal understanding and very different national policy commitments. By contrast, the GATT was able to do just that. With its key focus on border measures, the GATT, and for that matter the WTO, involves a minimal level of reduction in domestic policy space for its members.⁵

Since the completion of the Uruguay Round and the creation of the WTO, the system has experienced major shocks. In particular, the emergence of complex value chain production as a major driver of world trade and the rise of China as an economic and political power seem problematic. Among other impacts, globally sourced production requires more than a reduction of barriers at the border. Firms require the kind of stable production environment that they came to expect in domestic regimes. That is, they require predictability and broadly market conforming policies. At the same time, while the GATT has been able to accommodate small non-market economies in the past, China is very different. First, China is not small, it is a major

⁴ Andrew Shonfield’s (1965) classic *Modern Capitalism* provides an excellent contemporary view of the mindset of this era. Eichengreen (2007) presents an up-to-date analysis that is completely consistent with Shonfield’s analysis. To get an idea of just how radical these arrangements were relative to the earlier period, it is interesting to read Part III of Schumpeter’s (1942/1975) *Capitalism, Socialism and Democracy*, “Can Socialism Work?” and realise that what he means by ‘socialism’ is the same thing that Shonfield and Eichengreen describe as developing in the early post-war years.

⁵ Unlike the signatories of the Havana Charter, none of the original twenty-three GATT signatories qualified as a “socialist” economy.

trading nation and a major beneficiary of the (embedded) liberal trading system. Second, China is manifestly a non-market economy and a non-democratic political system in which the state and the Communist Party are actively involved in the economy at every level. Third, China's huge domestic market makes it a target for production aimed at serving that market and, given a presence in the Chinese market, an attractive location for major parts of globally sourced production.

For some analysts, these differences with respect to the existing core members of the international liberal economic order mean that China cannot be incorporated as a member of the system in good standing. The idea is that there can be no agreement on common purpose between countries with these differences. The fallacy of this reasoning is that the common purpose relates to the international regime itself. And here there is no reason why the current core cannot find an understanding of common purpose. That said, the differences we have just mentioned make it clear that such a regime will not be a marginal adjustment of the current rules. This is a very real challenge, but it is not clear to us that it is a challenge bigger than many of the changes the liberal system has already absorbed.

We have just argued that the framers of the post-war order were dealing with radically new domestic political-economic environments that differed quite widely among the initial members of the GATT. Part of the story is the US, as hegemon, pushing for this new order primarily for geo-strategic reasons. But this would not have succeeded without a broadly common sense of purpose beyond agreement on Cold War geopolitical goals, and this sense of purpose was quite dramatically different from the classic liberal order based on minimal intervention and automaticity in macroeconomic adjustment. In particular, in addition to liberal norms like liberalisation and non-discrimination, sovereignty norms were also built into the system via such norms as the right to pursue safeguards (broadly construed) and the use of a principle supplier rule and reciprocity in negotiation (part of what Krugman called the mercantilist method of pursuing liberalisation, Krugman, 1991). The end of the Cold War and the decline in the hegemonic capacity of the US meant some renegotiation but the foundational commitment to national sovereignty, with wide variance in (broadly capitalist) economic structures, continued more or less unbroken until 2016.

China is neither a democracy nor a capitalist economy, but the government (and the Communist Party) must still seek political legitimation, in part by delivering strong economic performance. In fact, given the lack of input legitimacy (elections, free lobbying, free press, open public discourse etc.), its reliance on economic performance (output legitimacy) is rendered even more important. While certainly not fully capitalist, China's very strong economic performance over decades is underwritten by very widespread use of markets, and this orientation to markets can only be called capitalist.⁶ As a result, China's growth has relied on international trade on essentially liberal terms. While this certainly does not mean that China will soon, or ever, be a capitalist democracy, it does mean that China needs a robust global market and the right to access that market on the same terms as the capitalist democracies do. That is, it seems quite plausible that China would be supportive of a liberal trade regime that works for itself and its trade partners. Ruggie's work on the early post-war years (to the early 1980s) would seem to suggest that such a regime must, minimally, find a way to deal with SOEs and the subsidies (explicitly and implicitly) associated with them.

The WTO Agreement on Subsidies and Countervailing Measures (ASCM) was conceived to provide a framework for dealing with subsidies among capitalist democracies. Although conflicts over Airbus and Boeing reveal that the ASCM is a less than perfect framework, it is

⁶ This is true in much the same way as trade along the silk road during the 13th and 14th centuries proceeded under fully capitalist principles, but in a world that was in no way capitalist at either end of that trade route.

one that does not really work for China. This became evident in WTO disputes regarding whether Chinese SOEs – and subsidies provided to them or by them to downstream firms – were captured by the ASCM. Rulings by the Appellate Body that SOEs may not be – and should not automatically be equated to – ‘public bodies’ for the purposes of the ASCM disciplines were one reason why the US took action to force the Appellate Body to cease operations (Ahn, 2021).⁷ A distinct feature of the CPTPP and USMCA – which were inspired by US dissatisfaction with WTO Appellate Body rulings – is a focus on ownership and control in defining the coverage of subsidy disciplines.

3. Subsidies, Spillovers and Trade

It should be clear that all governments have many policy goals that can be best addressed with a subsidy of some type, e.g. environment, education, regional development, income distribution. All of these policies involve perfectly legitimate applications of government resources, and many (most) are not intended to interfere with trade or, at least with the same implication for the analysis in this paper, have purely domestic intent.⁸ By ‘legitimate’ we should understand not just that they are widely understood to be ‘acceptable’ policies but that the pursuit of them is essential to the legitimization of the relevant national (or subnational) governments. Apart from explicit export subsidies, which are already banned by the ASCM, there are good economic reasons for rational governments to prefer the use of subsidies in the pursuit of these objectives.⁹

Standard general equilibrium reasoning in economics tells us that significant policies (whether the target of the policy is domestic or international) will be likely to have international spillovers. *Nota bene*: if there are not significant international spillovers there is no reason for WTO involvement regardless of what the programme involves. This, of course, makes agreement on how to measure spillovers an issue of first-order importance. Hoekman and Nelson (2020) argue that this is an area where a collective effort by all the core nations in the trade regime, very much including China, would benefit from collective capacity building.

Consider three barriers to systematic (i.e. black letter) subsidy rules that derive from the economics of subsidies. Unlike border measures, the meaning of policy, the full nature of spillovers and the mechanisms generating policy are not clear. We will consider each in turn.

‘Purpose’ is always a tricky business, and careful readings of history and chapeau language get us only just so far. As we have already noted, the environment of world trade has changed dramatically since 1947, and even since 1994. For the purposes of this paper, it is not clear what that sort of information means to China, other than as an indicator of what worked in a

⁷ It is frequently taken for granted that new rules are needed, but whether that is indeed the case has been questioned by some scholars. For example, Zhou et al. (2019) argue that new rules on subsidies provided by SOEs may not be needed because the unique challenges created by China's state capitalism can be appropriately addressed by the WTO's existing rules on subsidies coupled with the specific obligations China made in its accession protocol. A case can be made that more and more effective use of WTO dispute settlement based on existing rules would have helped to clarify the extent to which new rules are needed. In the event, with the removal of the Appellate Body a dispute settlement-centred strategy is no longer available to WTO members.

⁸ I.e., be applied on a ‘national treatment’ basis. Of course, some of these policies can comprise hidden protection, but despite the widespread belief among trade economists we believe this is not a common motivation for product regulation. The application of game theoretic reasoning to such cases is almost always presented without any systematic supporting data and is more an attempt to move policy discourse from the domain of domestic economic policy to the domain of trade policy.

⁹ This is one of the many useful messages from the theory of economic policy. For analysis of the theory of economic policy as it applies to trade policy, see Corden (1997); or Bhagwati *et al.* (1998).

different era. There was a time when ‘liberal understanding’ was primarily an understanding that the government should avoid intervention in the market. This goes back at least to the great thinkers of the English and Scottish Enlightenment and was the dominant understanding from then until the inter-war years. We have already seen that there is no current government, nor any serious political party, that would agree with that definition. The GATT/WTO’s attempt to balance interdependence and sovereignty is an international reflection of this reality. The ‘liberal understanding’ now involves a commitment to broadly market conforming institutions and policies aimed at managing the relationship between an economy that runs on broadly traditional liberal terms and a democratic civil society that finds many outcomes and policies associated with traditional liberalism problematic. The fundamental problem with China is that this is in no way a reasonable characterisation of its political economy. At the gross level, this might not be much of a problem insofar as the central role of economic performance in the output legitimacy of the state and Party make China a potentially reasonable partner in the traditional GATT/WTO system. But it is precisely this difference that makes finding common ground on domestic policies with significant international spillovers much more difficult.

Border policies such as tariffs, quotas, etc. are easy to measure and mean pretty much the same thing regardless of domestic political arrangements. Subsidies in support of domestic policies are a very different thing. In one country, a subsidy of green energy may be an environmental policy with an element of regional development; in another, it may be an environmental policy with an element of income distribution (or industrial policy, or national security policy ...). This is already a very difficult problem for countries that share some version of the modern ‘liberal understanding.’ The standard analysis of the theory of economic policy assumes that this meaning is embedded in an objective function the meaning of which is clear to all participants, and, as has already been noted a couple of times, this is a reasonable assumption for the case of border measures. Even among democratic capitalist political economies this can be difficult. It is widely argued that differences in attitudes to risk across national civil societies lead to states reflecting those preferences – science-based presumption versus precautionary principle.¹⁰ However, when it comes to the role of SOEs and subsidies, the conflict becomes more pointed. There are numerous SOEs in major sectors of the US and European economies: health, education, power generation, *et cetera*. There is no doubt that these interventions distort prices and outputs away from market outcomes both domestically and internationally. This is what they are for, and the theory of economic policy provides an analytical structure for understanding and guiding these policies. However, they all clearly derive from domestic priorities and are widely understood to be legitimate applications of state capacity.¹¹

The Chinese case is very different. The relationship of the state and the Party to both the economy and civil society have evolved far from the disastrous forms of the Great Leap Forward and the Cultural Revolution, but this is more in the nature of a disembedding the economy in ways that retain the fundamentally socialist commitments in the economy and the authoritarian structures of politics. The state and the Party in China assert a formal directive/guardianship role that extends to every level and sector of the economy, which is fundamentally inconsistent with even a broad reading of the embedded liberal understanding of a capitalist political economy (Wu, 2016). Subsidies and SOEs play an essential role in this structure. Unlike the Chinese case, SOEs in the EU cannot coordinate and are subject to competition policy. There is no finessing this fact: asking the Chinese state to give up this

¹⁰ Vogel (2012, pp. 31-34) describes how the US and Europe switched stances on the relative emphasis on the precautionary principle in policy.

¹¹ Again, the economics and politics of them will differ wildly among democratic capitalist political economies and, given the pattern of spillover and/or the relationship to WTO law, can still produce sharp conflicts.

structure is tantamount to asking China to become a completely different kind of political economy. Fundamental notions of sovereignty that underlie the current international system in general, and the WTO in particular, simply rule this out. If it were not clear for the system without China, the addition of China makes a black letter law approach to the issue of subsidies far too inflexible to be practical. But China's status as a rising geopolitical power also makes a 'diplomatic' approach risky as every conflict over subsidy policy can easily become embedded in broader geopolitical issues.

In addition to a lack of clarity on the meaning of a policy, e.g. trade vs. domestic, first best vs. second best *et cetera*, measuring and evaluating spillovers in many of these domestic cases is very difficult. For most border measures, the effects are almost fully carried through prices.¹² This makes measurement, and therefore comparison, relatively easy and so aids negotiation and adjudication. Domestic policies may have substantial non-price elements (i.e. political or social) and these are unlikely to be comparable across countries even in relatively well-specified policy disputes.¹³ Even for a country as different as China, both it and its trading partners can negotiate/adjudicate relatively clearly about border effects, but when it comes to tracing domestic effects the price-carried information may be deeply misleading about both the intent and the impact of policy.

Closely related to the previous point is that border measures are usually generated from political processes and institutions whose sole purpose is to generate these border measures (and other trade-related policies). These institutions are filled with people who deal with very similar problems, often in direct interaction with people doing the same job for other governments. This is certainly not the case for domestic policies. First, legislatures are much more likely to play a major role in domestic policy-making and, as Shepsle (1992) pointed out years ago, "Congress is a they, not an it" so Congressional intent is a deeply problematic concept. Even in the bureaucracy, the processes and structures that generate, say, an environmental policy are likely to be very different across countries. This, of course, is partly to blame for the different meanings of domestic policy across countries, but it also makes attributing intent much more difficult in general. The fact that democratic capitalist institutions are relatively open may not go far in assessment of intent. That is, people with very different skill sets, knowledge and political influence will be determining these policies and that will make finding common ground problematic. The Chinese political system, in part simply because it is not democratic, is not open in the way that those of the other core members of the trading system are. This renders the problem even more severe.

4. Elements of Extant WTO+ Regimes

A liberal trading regime, like a national democracy, needs to balance efficiency and legitimacy. Because civil societies remain fundamentally national, the core participants in the creation and maintenance of any such order are nation states, and recognition and protection of sovereignty therefore remain central to international trade regimes. Moreover, because the 'true' objectives of subsidy policy will be unobservable, cross-national differences in institutions and politics will limit the scope for strictly applied 'hard' law. The aim should be to construct a system that avoids the uncertainty and arbitrariness of a purely 'diplomatic' approach while not attempting to construct a 'judicial' approach

¹² This is the core of the currently dominant approach by economists to the WTO (Bagwell and Staiger, 2002).

¹³ As a technical matter, if the objective function of the policymaker and the structure of the underlying political economy is known, shadow prices can be derived. In practice this knowledge is so inaccessible as to render this fact little more than a curiosity.

that seeks to change the political-economic system of the country. These two aims seem inconsistent, but this is the balancing act supporting democratic capitalism in widely differing nation states in the EU and other ‘deep’ integration agreements. In all these cases, the tensions between legitimation and efficiency, especially as enhanced by the need to cooperate across different varieties of capitalism, require flexibility and trust.

Three examples of regimes that go beyond the WTO in balancing legitimation/sovereignty and efficiency are relevant when rethinking international rulemaking on subsidies. Consider first the US. We often think of the US, especially in the context of international trade, as a single unified jurisdiction. However, the US is very much a federal system. The *commerce clause* (Article 1, section 8, clause 3) in the US Constitution states that the US Congress has the power to “To regulate Commerce with foreign Nations, and among the several States, and with the Indian Tribes.” In addition, the *dormant commerce clause doctrine*, which has long been established in Supreme Court jurisprudence, asserts that, unless Congress explicitly legislates a state right to discriminate, state and local laws that discriminate in interstate commerce or place an undue burden on that commerce are unconstitutional.¹⁴ However, in the case of business subsidies and cases where the state or local government is a “market participant,” discrimination is considered legitimate (Coenen, 1998). As a result, there is significant latitude to engage in ‘subsidy competition’ and there is substantial heterogeneity in the use of subsidies across the US states, including to address market failures (e.g. California being much more activist than many other states). This has led to the interesting situation in which subsidies provided by the state of Washington that are legal under US law have been the object of WTO disputes.¹⁵

Unlike the US states, the members of the EU are fully sovereign nations. However, from the start one of the core aims of the European integration project has been to promote intra-EU exchange through the creation of an integrated ‘single’ market and limit state intervention in this exchange. Subsidy regulation in the EU is determined by treaty and overseen and enforced by supranational bodies: the European Commission and the European Court of Justice. EU member states may not act against perceived violations by another member. Instead, enforcement is centralised.

EU disciplines on ‘state aids’ are part of a broader framework of competition policy and pertain to both governments and firms. A key focus of regulation is the functioning of the single market: ensuring free trade within the Union. Four criteria apply for state aid to be illegal: (i) state resources lead to (ii) a selective advantage for a firm or activity that (iii) distorts competition and (iv) affects trade between Member States. These criteria also apply to undertakings to which Member States have granted special or exclusive rights, i.e. SOEs.¹⁶ Certain types of support, including regional aid, assistance for SMEs, R&D, broadband infrastructure, energy and the environment, are deemed to not distort competition in the EU market but need to be notified (and may be challenged by the European Commission). Agreeing to a set of subsidies unlikely to cause spillover concerns helps focus attention on the

¹⁴ This principle has come in for increasing criticism in recent years. In particular, justices Scalia and Thomas have argued against it as a principle in Supreme Court decision-making (Tushnet, 1990, Sachse, 1999).

¹⁵ E.g. United States, ‘Measures Affecting Trade in Large Civil Aircraft — Second Complaint,’ WTO, WT/DS353. See Ossa (2017) for an economic assessment of state-level subsidy competition in the US.

¹⁶ Gutiérrez and Philippon (2019) argue that European market regulation has become more pro-market than that of the US in recent years. Philippon (2019, pp. 134-135) argues that state aid rules negotiated among sovereign nations in the EU lead to DG Competition being more independent than national regulators facing domestic political pressure, i.e. the Department of Justice or the Federal Trade Commission. Part of his argument is that “economic analysis became more prevalent, in particular with the creation of the position of Chief Competition Economist in 2003” (Philippon, 2019).

subsidies that are more likely to have harmful trade spillover effects. A public services provision (Art. 106 TFEU) specifies that undertakings “entrusted with the operation of services of general economic interest or having the character of a revenue-producing monopoly” are subject to the general competition rules insofar as their application does not obstruct the performance of their public tasks.¹⁷

An effects-based approach is used in enforcement. A balancing test is applied that asks whether the state aid aims to address a market failure or an objective of common interest, induces changes in the incentives for recipients to change their behaviour in a way that meets the aim, induces negative distortions of competition or trade, and about the balance of its effects (Neven and Verouden, 2008). This approach is fully consistent with the theory of economic policy. The aim of the approach is to “shift the argumentation from legal and accounting battles towards a battle over the impact of the aid on markets and ultimately on consumers ...[contributing]...towards the effectiveness of European state aid control.” (Friederiszick *et al.*, 2006, p. 626).

The EU is of course *sui generis*. More commonly observed approaches to international subsidy regulation define common rules for subsidies that are self-enforcing: each government bears the burden of enforcing commitments made by partner countries and can do so by (re-)imposing measures to offset an illegal foreign subsidy. Such cooperation can take the form of ‘deep’ PTAs such as the CPTPP and the EU-Japan Economic Partnership Agreement or sector- or activity- specific inter-governmental agreements. Examples of the latter are the OECD Export Credit Arrangement and the G20 Global Forum on Steel Excess Capacity (GFSEC) established at the 2016 G20 summit.¹⁸ This forum’s mandate, which was supported by the OECD Secretariat, included producing and sharing reliable statistics on production capacity and measures of excess capacity across major steel producers and identifying measures to reduce global production. The forum provided a platform for the exchange of data on steel capacity and information on policies, including support measures, thus improving the information base and transparency of the relevant policies implemented by major steel producing countries. The forum included governments and industry, the latter being a key source of information on production and investment trends. The forum reported to the G20 Ministers annually during 2017-2019 and met at least three times a year during this period.¹⁹ Such inter-governmental arrangements seek to constrain the ability of governments to undo market access commitments through regulatory policies (in the case of PTAs) or to limit the scope for a race to the bottom in a policy area by enhancing transparency through exchange of information and dialogue (OECD, G20).

¹⁷ TFEU Art 107(3) lists measures that may be considered to be compatible with the internal market, including (i) aid to promote the economic development of areas where the standard of living is abnormally low or there is serious underemployment....(ii) aid [...] to remedy a serious disturbance in the economy of a Member State; and (c) aid to facilitate the development of certain economic activities or of certain economic areas, where such aid does not adversely affect trading conditions to an extent contrary to the common interest.

¹⁸ See <https://trade.ec.europa.eu/doclib/press/index.cfm?id=2077>. Blonigen and Wilson (2010) discuss the economics of subsidies and excess capacity.

¹⁹ The Forum was established at the end of 2016 for a three-year period. In October 2019, China and Saudi Arabia decided not to continue participating for another 3-year period. China argued it had done more than its fair share by “slash[ing] total steel production capacity by more than 150 million tonnes since 2016, or 114 per cent of the global steel capacity cut ... and ... redeploy[ing] 280,000 steel workers, which is more than the combined deployed number of steel workers in the US, the EU and Japan.” See <https://www.scmp.com/economy/china-economy/article/3034753/global-steel-forum-scrapped-china-says-it-has-done-more-its>. Other countries agreed to continue to interact and exchange information on steel-related policies and monitor production capacity in 2020-22, with the forum continuing to be supported by the OECD secretariat and operating as an open platform to support this engagement.

Most extant PTAs have provisions on subsidies (Rubini, 2020). Often these mirror those found in the WTO.²⁰ Only a quarter of all PTAs go beyond the ASCM and include provisions specifying that certain types of subsidies are not considered to be trade-distorting. Most of these are EU PTAs. These subsidies generally pertain to public services, regional aid or environmental protection. Rather than being actionable, the approach taken is to call for consultations if such measures are deemed to have detrimental spillover effects. Conversely, a small share of PTAs go beyond the ASCM by including more subsidies in the prohibited category, e.g. by specifying that state guarantees and support for insolvent or ailing companies are prohibited (e.g. EU PTAs) and banning the provision of state support on non-commercial terms for the commercial activities of SOEs (CPTPP).²¹

Surprisingly, it is not uncommon for national treatment obligations to appear to apply to subsidies, although this is more common in older PTAs than those negotiated recently. Rubini (2020) calculates that the share of PTAs in which national treatment applies to subsidies fell from some 70 percent in pre-1995 PTAs to about 30 percent in post-2010 PTAs. In parallel, the share of PTAs with CVD provisions increased from a third in pre-1995 PTAs to almost 90 percent in post-2010 PTAs. Less than half of all PTAs have notification requirements for subsidies, while roughly a fifth have established deliberation mechanisms to address subsidy concerns. Interestingly, a non-trivial share of PTAs (19%) include provisions calling for cooperation between parties to act against export subsidies granted by non-signatories.

Deep(er) PTAs have also adopted approaches to deal with SOEs. In the EU, competition law and state aid disciplines pertain to SOEs as they are regarded like any other undertaking. Moreover, the EU has implemented a competitive neutrality framework that goes further than ensuring competition law and policies apply to the behaviour of SOEs as well as private firms. This framework, which is consistent with the OECD Guidelines on Corporate Governance of State-Owned Enterprises, focuses on identifying and removing competitive advantages of SOEs with respect to taxation, financing costs and regulation (Capobianco and Christiansen, 2011). The framework complements the explicit inclusion of subsidies in EU competition policy disciplines. EU PTAs often replicate the language of Art 106 TFEU mentioned above, specifying that entities charged with public interest tasks are subject to competition rules if it does not preclude them from performing their public service obligations.

Less far-reaching integration agreements often contain specific provisions requiring SOEs to operate on a commercial basis and prohibit anti-competitive behaviour. The CPTPP imposes non-discrimination obligations, requires them to act on a commercial basis and prohibits the provision of non-commercial assistance (subsidies) that has adverse effects or injures the interests of another party. Subsidies to SOEs, both direct fiscal transfers and indirect subsidies, are actionable and signatories must publish data on extant SOEs and measures to assist them (Kawase and Masahito, 2018). Two-thirds of the 283 PTAs assessed by Rubini and Wang (2020) include language requiring SOEs to behave in accordance with commercial considerations. In practice, making this meaningful will involve assessments of whether SOEs have hard budget constraints. Not surprisingly, some 70 percent of extant PTAs with SOE provisions include subsidy disciplines that apply to SOEs. More surprisingly, only a little over a third that include SOE provisions have notification requirements, and only 10 of the 283 foresee collaboration in generating information on the operations of SOEs (Rubini and Wang, 2020).

²⁰ What follows draws on Rubini (2020).

²¹ Both EU PTAs and the CPTPP subsidy discipline exclude activities of SOEs associated with providing public services in their domestic markets.

As Kurtz and Gong (2021) argue, the China-EU Comprehensive Agreement on Investment (CAI) is particularly salient in any assessment of the potential scope for agreement in the WTO on strengthening disciplines on subsidies and SOEs. The CAI guarantees China's right to pursue its own economic model and adopts a definition of "covered entity" which is broader than the standard ownership-based definition of SOEs encompassing undertakings over which the State "has the power to legally direct the actions" of an enterprise [EU-China, 2021, Art. 3bis(1)(a)(b)]. The entities covered are required to act "in accordance with commercial considerations" and in a non-discriminatory fashion when buying or selling goods and services. The CAI breaks new ground compared to the WTO by requiring transparency of service subsidies²² but does relatively little to enhance the transparency of subsidy policies and excludes this area from dispute settlement.

5. Thinking about moving forward on subsidies

The current set of rules on subsidies are not functional for a system which includes China as a core member (it is not clear whether they are particularly functional for a system that includes the US, the EU and Japan). China's size, its domestic political economy and its attractiveness as a commercial partner all make the business of creating a relatively liberal set of rules that support trade among countries that are heterogeneous in their domestic political arrangements difficult. That said, it is not the case that these are problems that need to be fixed or 'responded to' by the triad of the EU, Japan and the US. They are facts in our current international commercial environment. Treating China as a problem is a barrier to finding a solution, not a useful definition of the situation. Therefore, given the case that provided the occasion for this paper, we are particularly interested in rules and institutions related to domestic subsidies that have significant international spillovers. The emphasis on SOEs reminds us that subsidy policy is difficult in part because of differences among the political economic structures of members of the WTO. Finding a way to incorporate China as a core member of a reorganised system for dealing with subsidies is important for the triad, as it is for China.

There are at least three elements that any 'solution' should embody: incrementalism (in particular, capacity building via epistemic communities); avoiding both too much formalism ('black letter law') and too much 'diplomacy' (power politics); and multilateralism. By 'incrementalism' we do not refer to the structure of rules. In recent cases dealing with US countervailing duties on China, the Appellate Body has tried to reassure WTO members that its interpretation of the ASCM still provides plenty of flexibility to apply CVD measures against Chinese firms, but these decisions have left none of the parties happy (see the discussion in Mavroidis and Sapir, 2021, pp. 79-88). The implication of the previous two sections is that the rules on subsidies require a fundamental rethinking. No one is going to be satisfied with incremental evolution of future jurisprudence. Subsidies have become increasingly important (see the GTA data reported in Section 1 above) and the burden of the previous section is that political and economic differences among members will render that approach deeply unsatisfactory. The question is how we can move toward a fundamental rethinking.

A useful first step would be to start developing the sort of epistemic community that exists in competition policy (Eisner, 1991, Wilks, 2005). This is a group of people that share a common set of values, causal beliefs and facts about the world, and criteria for evaluating these facts (Haas, 1992). They need to be people with legal and economic expertise and sophistication about policy context. One place to start would be a common programme

²² CAI, Section III (Regulatory Framework), Arts. 8(1)-5).

developing a body of applied theory and data specifically on the comparison of domestic subsidy regimes and the magnitude and form of spillovers from these regimes. An essential part of such a system would be a strengthened system of subsidy notification.

The second desideratum is finding a way to avoid both the Scylla of too much formalism and the Charybdis of too much 'diplomacy.' The aim here is to find an institutional framework that takes advantage of, and encourages, the emergent epistemic community. We have no strategy for achieving this goal, but we do have an exemplar: the treatment of specific trade concerns in the Sanitary and Phytosanitary (SPS) and Technical Barriers to Trade (TBT) subcommittees. Careful studies of these mechanisms suggest that they provide organised but informal conflict resolution (Horn *et al.*, 2013; Karttunen, 2020). While SPS and TBT are manifestly less fraught policy areas than subsidies, for all the reasons developed above, with a moderate amount of goodwill and a recognition of the mutual benefit of avoiding Scylla and Charybdis, this seems a plausible (if perhaps excessively hopeful) direction for development.

As an example of the sort of thing that might be embodied in such a system is an attempt to recover some of the content of the non-actionable subsidy category that was included in the original ASCM. The idea was that subsidies supporting regional policy, environmental policy and research and development policy would be non-actionable, but this part of the agreement (Article 8) expired in 2000. Part of the problem was the attempt to fix in law the non-actionable status of such subsidies. As part of the approach sketched here, we might imagine an attempt to agree on 'presumption boxes.' That is, participants in such a system might agree that regional policy, environmental policy and research and development policy (and others) are in a green box. Unlike the ASCM, the participants only agree on a presumption that these are politically and economically legitimate, but that that presumption can be overturned for a variety of reasons. That is, the process of informal conflict resolution would start from this presumption and proceed to a discussion based on it. Discussion of such measures could draw on experience in raising 'specific trade concerns' in WTO committees by a government regarding the measures of another government. This has become a staple agenda item for committees dealing with product regulations (TBT and SPS) but also, to a lesser extent, in other policy areas subject to WTO rules. A characteristic of the approach is that it is a form of formal dispute settlement 'avoidance.' The idea is that discussion among the parties that are concerned about a matter to clarify intent and potential trade effects and identify potential ways of reducing them often may suffice to address a concern. Conversely, allocation of a subsidy to a red box would create a presumption that the subsidy is illegitimate, but this presumption could also be overturned via argument about economic and/or political need. Allocation to an amber box would imply no presumption. Unlike black letter law, this approach does not involve fixed categories and recourse to formal dispute settlement mechanisms. Unlike 'diplomacy,' it provides structure and predictability.

Finally, the aim should be to approach a multilateral regime for subsidies. Such a regime requires participation by the EU, Japan, the US and China, but the ultimate goal would be broad-based participation by most if not all trading nations. The failure of the Doha round and the manifest current significance of subsidy policy should make it clear that this is not an argument for constitutional reform of the WTO and neither is it an argument for a full-blown attempt to negotiate a new multilateral regime. Instead, a (again hopefully) plausible way forward is via some form of plurilateral agreement in the WTO (Hoekman and Mavroidis, 2015; Hoekman and Sabel, 2019). On the one hand, by keeping such a structure inside the WTO, as are the specific trade concerns considered above, the system would have access to expertise and institutional support in the WTO. On the other hand, subsidies, as described above, would seem to be more complex than the usual cases considered for this application and it may be difficult to achieve consensus on such an agreement. Therefore, ultimately, arranging this sort of structure outside the WTO might become necessary. If this is the case,

it would be important to permit easy access via adopting whatever norms and rules define the epistemic community around the subsidy issue.

Without going full ‘Cordell Hull’ and asserting that trade is a (‘the’?) foundation of peace, it does seem worthwhile to note that a liberal international political economy has the signal virtue relative to any known other arrangement of powers that it can accommodate a rising power without systemic collapse (into war at the limit). The GATT/WTO system has weathered a number of such systemic changes. Liberal domestic political economies permit peaceful transfers of power. It would be unconscionable for the original core to allow Mavroidis and Sapir’s (2021) liberal understanding to collapse at just the moment when it can provide its greatest service to the international system.

Conclusion

Subsidies have become a major source of tension in the trading system. Addressing perceived negative spillovers generated by domestic subsidy programmes, whether they are intentional or not, has become an urgent geo-political (geo-economic) matter. The 2018-19 EU-Japan-US trilateral discussions on how to bolster WTO subsidy rules illustrate the salience of the subject for these three major traders. They were also arguably a sub-optimal initiative because of the way they were designed, essentially as a top-down, politically driven and non-transparent exercise by trade officials (negotiators) with limited if any analytical input and very little in the way of transparent and open consultations with stakeholders. The trilateral process did generate suggestions for a reform of subsidy rules, building on the types of provisions included in recent trade agreements negotiated by the EU, Japan and the US. The results of the deliberations provide a basis for these three WTO members to put forward suggestions as part of the ongoing effort to reform the WTO and revitalise the deliberation and negotiation functions of the organisation.

What is needed is a work programme that encompasses China and brings together interested WTO members to compile information and analyse existing subsidy programmes in systemically important economies. A first step would be to organise a platform for such activity, creating a dedicated working party spanning different WTO bodies concerned with subsidy matters, including those where no rules currently exist but subsidies are an important policy instrument, notably services. One concrete action that could be taken by the trilateral group – the EU, Japan and the US – would be to table a paper with their proposals for discussion by interested WTO members. Such a process of deliberation could then prepare the ground for a negotiation on new rules for subsidies and SOEs. Such a negotiation should be conceptualised as a plurilateral effort along the lines of the ‘joint statement initiatives’ launched in 2017 at the 11th WTO Ministerial Conference. Agreement among all 164 WTO members is not necessary as most WTO members’ subsidy policies do not create systemic spillovers. What is necessary is that the major trade powers – China, the EU, Japan and the US – participate in any such plurilateral initiative.

A plurilateral agreement on subsidies offers the prospect of a solution within the multilateral WTO legal order containing the unilateralism that was the hallmark of the Trump Administration. At the time of writing, it is still unclear how the Biden Administration will approach these matters, but Biden has made it clear that large and comprehensive new trade agreements are not a priority. A plurilateral agreement on industrial subsidies negotiated under WTO auspices offers a path forward.

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