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## Introduction

In the first quarters of 2016, milk prices in Germany fell to historic lows. The fall was due, among other things, to intensified competition in the EU agricultural market, and to a drop in demand caused by unilateral Russian trade sanctions against certain EU products. A corresponding fall in the income of farmers, while consumers benefited from the lower prices, gave rise to antagonistic reactions by certain societal groups, and triggered discussions about the fairness of market mechanisms and the need for governmental intervention in certain economic sectors. In the words of an editor of a respected German newspaper:

When regarding the decline in milk prices, one could give the cold look, as cold as a milk tank in the dairy, and say: That is what happens in the market economy. Supply and demand determine price. Who cannot beat the cheaper competition, must look for another occupation [...] and don't consumers benefit by the price war in the refrigerated section of super-markets? [...] But the preservation of family agriculture in Germany might for several reasons be in the general interest. Farmers cultivate the cultural landscape. The family businesses are often the last economic, social and political stabilizer in structurally weak areas.<sup>1</sup>

A commentator in the same paper, addressing the role played by the German government in such a moment of sectoral crisis, noted, not

<sup>1</sup> Berthold Kohler, "Das Schicksal der Bauern" *Frankfurter Allgemeine Zeitung* (Frankfurt 05.18.2016) p. 1: "Auf den Verfall der Milchpreise kann man mit der Kälte eines Milchtanks in der Molkerei schauen und sagen: So ist das in der Marktwirtschaft. Angebot und Nachfrage betimmen den Preis. Wer die billigere Konkurrenz nicht schlagen kann, muss sich eben eine andere Beschäftigung suchen [...] Und profitieren nicht die Verbraucher vom Preiskampf in den Kühlregalen der Supermärkte? [...] Aber auch noch aus anderen Gründen liegt die Erhaltung der bäuerlichen Landwirtschaft in Deutschland im Gemeininteresse. Die Bauern pflegen die Kulturlandschaft. Die Familienbetriebe sind oft die letzten ökonomischen, sozialen und auch politischen Stabilisatoren in strukturschwachen Gebiete." Translation by the author.

without irony, that politics usually solves such issues by directing public money to the sector that is in difficulty.

And the politics? It has undertaken the first best option in a crises situation: make millions of government money available. It started with an EU decision last year under the impact of the first price change. This was blamed on the fall of Russian demand as a result of the import boycott from Moscow, but also on the abolition of the milk quota last March. Now, the plan is to pay, through the federal governments, millions to decelerate the exodus of farmers. The word on the streets is of an amount between 60 to 100 million EUR.<sup>2</sup>

The milk price “crisis” illustrates one characteristic of a market-based economy: its facility for distribution of income within a society due to changes in supply and demand and corresponding variation in prices. Although most economists will agree that this process leads to an efficient result overall, some of the affected groups will receive direct benefit, whereas others will lose income. The losers are, however, unlikely to give up without a struggle to obtain public support. If a government values a specific group or economic activity, it would be usual for the state to intervene in the market, often through the use of subsidies.

The governmental use of subsidies to foster domestic economic groups and sectors is as old as it is controversial. In economic theory, there are two major issues regarding the subsidization. The first is that governments might fail to correctly define the problem because of incomplete information about whom, and to what extent, to subsidize. Even when acting on goodwill to address, through subsidy, a legitimate economic problem in their domestic market (like, in the view of some, the survival of milk farmers), such a failure will result in less than optimal investment of resources and losses in overall welfare.

This potential for domestic misallocation of resources might call for domestic regulation demanding, for instance, that careful consideration be undertaken prior to implementation of government intervention. In EU regulation for state aid, for instance, member states are required

<sup>2</sup> Jan Grossarth, “Die Milch macht die müden Bauern nicht mehr munter” *Frankfurter Allgemeine Zeitung* (05.18.2016): “Und die Politik? Sie hat zunächst das Erstbeste unternommen, was sich in einer solchen Notlage anbietet: Millionen Staatsgeld zur Verfügung gestellt. Den Anfang machte ein Beschluss der EU im vergangenen Jahr unter dem Eindruck des ersten Preisknicks. Der wurde erklärt mit dem Wegbrechen der russischen Nachfrage infolge des Importboykotts Moskaus, aber auch mit dem Wegfall der Milchquote im März, die europaweit die Menge begrenzt hatte. Jetzt sollen Millionen vom Bund folgen, ausgezahlt, um den Exitus der bäuerlichen Milchwirtschaft abzubremsen. Von 60 bis 100 Millionen Euro ist die Rede.” Translated by the author.

to notify state aid measures and to secure prior approval by the Commission,<sup>3</sup> thus reducing possible distortions and ensuring that the subsidy is an adequate instrument to achieve its objective.<sup>4</sup>

Another issue in regard to subsidization of domestic groups is the problem of agency accountability.<sup>5</sup> Public resources are scarce, and there is a constant dispute at the domestic level regarding their distribution.<sup>6</sup> Governments inevitably have to choose certain groups over others, thus promoting a redistribution of wealth within the population.

Even with authority to implement redistributive policies, domestic governments may run into issues of accountability<sup>7</sup> related to the tendency of general voters to be disorganized and uninformed. Governments will arguably therefore promote the interests of organized groups, and thus their own, over the interests of the general population.<sup>8</sup>

<sup>3</sup> OECD, Competition, State Aids and Subsidies (Policy Roundtables, 2010) p. 105–07.

<sup>4</sup> Luca Rubini, *The Definition of Subsidy and State Aid: WTO and EC Law in Comparative Perspective* (Oxford University Press 2009) p. 59–62.

<sup>5</sup> Although this is certainly a relevant issue in a domestic context, it is not clear whether they would also solve the international problems, as there might be subsidies that are overall welfare-increasing for a state, and thus possibly desired by rational voters, and still harm producers and exporters in other states. Besides, the focus of the WTO agreements are international problems by nature, and the transparency and monitoring instruments we see in the SCM Agreement should be better understood as a control mechanism to other states or to foreign players, and thus addressing the international problem, rather than the domestic issues raised by subsidies, even though the WTO instruments might contribute to mitigate domestic problems as well. This, however, will not be the focus of this research, which rather emphasizes the contractual elements of the SCM Agreement, as will be detailed below. See Chapter 2.

<sup>6</sup> For instance, domestic groups lobby either not to pay taxes or to be the beneficiary of a governmental policy implemented with public resources.

<sup>7</sup> There are different types of principal agent problems involving the government and different results thereof. Przeworski, for instance, works with three classes of principal agent relations (i) the regulation class, which involves cases between the government and private economic agents; (ii) the oversight class, composed of relations between bureaucrats and politicians; and (iii) accountability class, formed by relations between citizens and governments. Overall, he concludes that public officials, subjected to the pressure of interest groups, “may not know how to or may not want to engage in actions that promote the general welfare rather than their own or that of their private allies” Adam Przeworski, “On the Design of the State: A Principal-Agent Perspective” in Luiz Carlos Bresser Pereira and Peter Spink (eds), *Reforming the State: Managerial Public Administration in Latin America* (Reforming the State: Managerial Public Administration in Latin America, Lynne Rienner Publishers 1999) p. 15–17. Political economic theory, however, recognizes that certain groups are in a better position than others to extract resources from the government budget. Farmers may, for instance, be well organized and politically influential, to the detriment of the welfare of the consumer or general public.

<sup>8</sup> Recall that the welfare of the general voter is also an element of the policymaker’s political function. Therefore, policymakers have to take at least parts of the interest of disorganized voters into consideration when designing a domestic policy. See Section 3.3.4.

Several instruments aim to overcome this problem by encouraging policymakers to consider the interests of disorganized voters. Regulatory measures might, for instance, increase the informed-ness of the general public by requiring transparency, effective monitoring, and mandatory guidelines for the concession of subsidies. Raising the level of information available to interested voters:<sup>9</sup> (i) enables better assessment of the adequacy and efficiency of the subsidy as a means of achieving a determined policy objective; and (ii) increases the cost of an irresponsible action by the policymaker.<sup>10</sup>

National subsidization of domestic groups or sectors also has wider implications for international trade. By giving a competitive advantage to local firms, domestic subsidies often induce changes in corporate behavior that create cross-border spillovers affecting international trade partners.<sup>11</sup> An influential publication recently posed the following questions related to the role of the German government in fostering international business:

<sup>9</sup> Several civil organizations have a goal to raise the information level of voters and the general public. For instance, in the United States, a movement named Good Jobs First attempts to promote accountability by tracking subsidies given to corporations in an attempt to pressure the companies to offer jobs that meet certain quality standards. “Good Jobs First” <<http://www.goodjobsfirst.org>> accessed 29.07.2016. Other similar initiatives with focus on international trade include “Global Subsidies Initiative” <<http://www.iisd.org/gsi/>> accessed 29.07.2016, and “Global Trade Alert” <<http://www.globaltradealert.org/>> accessed 29.07.2016.

<sup>10</sup> For a general overview of the relation of transparency and subsidies, see Andre de Moor, *Key Issues in Subsidy Policies and Strategies for Reform* (Economic Commission for Latin America and the Caribbean 1997) p. 19–20. On the impact of transparency in specific sectors, see, for instance, Doug Koplow and John Dernbach, “Federal Fossil Fuel Subsidies and Greenhouse Gas Emissions: A Case Study of Increasing Transparency for Fiscal Policy” (2001) 26 *Annual Review of Energy and the Environment* p. 361–89; Tracey M Price, “Negotiating WTO Fisheries Subsidy Disciplines: Can Subsidy Transparency and Classification Provide the Means towards an End to the Race for Fish” (2005) 13 *Tulane Journal of International and Comparative Law* 141 p. 165–66; and Tara Laan, “Gaining Traction: The Importance of Transparency in Accelerating the Reform of Fossil-Fuel Subsidies” in Global Subsidies Initiative (ed), *Untold Billions: Fossil-Fuel Subsidies, Their Impacts and the Path to Reform* (Untold Billions: Fossil-Fuel Subsidies, Their Impacts and the Path to Reform, International Institute for Sustainable Development and United Nations Environment Programme 2010) p. 12–14.

<sup>11</sup> The “cross border” effect of governmental measures is not an exclusivity of subsidies. In the milk example above, much of the fall in prices was attributed to a Russian boycott that resulted in a closure of the Russian market to milk produced in Germany. But measures do not need to have the direct objective of disrupting trade in order to spill over in trade partners. Trade-promoting mechanisms may have similar effects.

## INTRODUCTION

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The main question: How strategically does Germany want to operate its foreign policy? Should the federal government, like the French State, offer direct guarantees for companies to take risks abroad? Should Berlin offer companies favorable loans by state banks (KfW) to compete for large projects, as it does Beijing?<sup>12</sup>

The concern of this business-oriented publication was that German companies were losing opportunities, not because of the superior market competitiveness of their foreign contenders, but due to interventions by foreign governments in favor of their domestic firms. The article asserts that by granting export guarantees or credit at lower than market prices, foreign governments were subsidizing their companies to enable the foreign products to be offered more competitively abroad, thus giving the foreign firms opportunity to gain market share and reduce profits by German competitors.

Subsidization of exports, a typical mechanism for fostering domestic production, causes negative externalities to trade partners. Export subsidies are however, only one part of the problem, as subsidization of products intended for the domestic market might also cause cross-border spillovers.

The problem of the impact of domestic subsidies on international trade has been subjected to imposition of regulatory parameters on various fronts. The OECD was probably the central place for regulation of industrial trade in the 1970s. As noted in the article referred to above, the hands of the German government were rather tied by OECD rules on export subsidies:

Now, if the federal government participate through Hermes guarantees, these should comply with OECD consensus on export credit rules. The consensus is from 1978, from a time when most Asian countries were aid recipients, not competitors. The rules determine in detail how small interest on government loans can be, how big government guarantees should be, and at what level of debt a country is expelled. The agreement, to which officials of member countries should comply, aims at “substantially eliminating” the state export support.<sup>13</sup>

<sup>12</sup> Editorial, *Bedingt bereit zum Export* (2016) p. 26. In German: “Die Grundstzfragen lauten: Wie strategisch will Deutschland die Außenwirtschaftspolitik betreiben? Soll der Bund wie der französische Staat direkt für Unternehmen bürgen, damit sie im Ausland Risiken eingehen? Soll Berlin die Unternehmen über günstige Kredite staatlicher Banken (KfW) ins Rennen um große Projekte schicken, wie es Peking tut?” Translated by the author.

<sup>13</sup> Editorial, *Bedingt bereit zum Export* (2016) p. 26. In German: “Nun, falls sich der Bund über Hermes-Bürgschaften beteilige, geschehe das nach dem OECD-Konsens über Exportkreditbestimmungen. Der Konsens stammt aus dem Jahr 1978, aus einer Zeit, als

With a further 50 years of global economic development, however, and the rise of several economically powerful nations that are not bound by the OECD, has come a need for broader rules, both in terms of substance and reach. The regime and form of oversight chosen by states for the regulation of subsidies is a series of treaties under the World Trade Organization.

In law and economics theory, an international treaty is a legal instrument used by a group of states to (re)allocate authority among themselves in order to overcome problems preventing cooperation and to regulate excessive unilateralism.<sup>14</sup> Like a contract, a treaty is used to generate mutual benefits to those who are party to it, through the regulation of future behavior.<sup>15</sup> In a trade agreement, for instance, parties exchange market access concessions through tariff cuts, in order to improve the welfare of certain economic sectors by fostering exports and reducing the prices of imports.

The parties to a trade agreement are expected to reach a mutual increase in welfare<sup>16</sup> through the process of negotiation of tariff reductions. The aim is to balance the positive and negative effects of tariff

die meisten Länder Asiens noch Empfänger von Entwicklungshilfe waren, keine Wettbewerber. Darin ist bis ins Detail geregelt, wie klein Zinsen für staatliche Kredite, wie groß Staatsgarantien sein dürften und ab welcher Schuldenhöhe ein Land ausgeschlossen wird. Der Vertrag, den Beamte der Mitgliedsländer regelmäßig anpassen, soll den 'Konditionenwettlauf' bei staatlicher Exportunterstützung 'weitgehend eliminieren.'" Translated by the author.

<sup>14</sup> States are the subject of international law *per excellence*, but other subjects also have competence to enter into treaties, such as international organizations, certain territories, etc.

<sup>15</sup> Under the contractual theory of law and economics, parties thus trade a portion of their sovereignty in order to obtain an expected benefit in the future. The economic study of contracts has long been object of law and economic theory. See, for instance, Robert Cooter and Thomas Ulen, *Law and Economics* (International Edition, New York: Pearson Addison Wesley 2008). For a discussion about the analogy about contracts and treaties, see Joel P Trachtman, *The Economic Structure of International Law* (Cambridge University Press 2008) p. 120–22.

<sup>16</sup> As it will be discussed in the appropriate section, the concept of welfare increase supports different views. Part of the literature focuses on net global welfare, other scholars argue that policymakers prioritize domestic net welfare, and a third school of thought defends that policymakers strive to increase the welfare of domestic politically organized groups as a means to gain political support. The decision to adopt one or the other view has impacts on how commitments are designed. For instance, if we assume that governments are benevolent at a global level, we would expect a treaty to lower tariffs to zero. However, if we assume that governments respond to political economy incentives, it seems more plausible that trade agreements reduce certain tariffs while keeping certain markets protected.

reductions—increases in the welfare of exporters and consumers and decreases in welfare of domestic producers—across all parties in order to achieve a set of tariff cuts that ensures mutually beneficial results to negotiators.

An international agreement regulating subsidies, such as the Agreement on Subsidies and Countervailing Measures (SCM Agreement) may be similarly understood as an instrument to guarantee mutual benefits to participants by overcoming unjustified unilateralism. In relation to subsidies, this can be achieved, for instance, by tackling protectionist policy substitution, or in other words the opportunistic use of subsidies as a means of bypassing tariff reductions. A subsidies agreement might also prevent states from engaging in strategic actions, such as profit shifting, that lead to externalities for trade partners. It could also create monitoring mechanisms to better inform parties about the behavior of others, facilitating the identification and prevention of opportunistic uses of subsidies.

By regulating the unilateral use of subsidies, WTO Members thus ideally promise to make use of subsidies in such a way that they (i) preserve the balance of concessions negotiated under the GATT, and (ii) avoid strategic behaviors that result in imposition of negative externalities on trade partners. The SCM Agreement ensures that WTO Members realize the gains expected from tariff reductions and, at the same time, benefit from less distorted competition in the world trading system.<sup>17</sup>

Commitments that restrict the discretion of governments to act unilaterally are the cornerstone of any international agreement. In the GATT, such commitments comprise explicit rules governing market access, as in Article II (restrictions on unilateral increase in tariffs), qualified by rules requiring homogeneity in the competitive conditions afforded all parties to the agreement (non-discrimination and most favored nation clauses). In the SCM, commitments entail the agreement of Member States to prohibitions and restrictions on the use of certain subsidies, as determined by Articles 3 and 4.

Such commitments are, however, only one aspect of an international agreement. Treaty negotiators must also strike an appropriate balance between commitments, which generally restrict unilateral action, and flexibility, which is necessary to adjust the limitations

<sup>17</sup> Through the SCM Agreement, WTO Members trade market access guarantees (and expected increased trade flows in certain economic areas) for sovereignty by committing to restrict their regulatory discretion.



reflected in such commitments to exceptional and unforeseen circumstances.

Flexibility is a concept drawn from contract theory to designate the possibility, in a narrow sense, of acting within a range of legality without breaching the treaty.<sup>18</sup> In a broader sense, flexibility also includes the option of breaching the commitment and paying compensation, usually at a level at which the other party remains indifferent toward performance or compensation.<sup>19</sup> The various legal and economic arguments for the introduction of flexibility into a treaty all aim for similar results: to allow for *ex post* adjustment of commitments in order to, in good faith, customize the application of the treaty to unforeseen or ambiguously regulated situations, while controlling for opportunistic behaviors.<sup>20</sup>

The question that arises is therefore how strict or flexible rules should be. How are commitments and flexibilities to be combined in order to achieve the purposes of an agreement? How, for example, should activities be regulated to overcome externality problems and promote joint welfare, while appropriately separating good faith measures from opportunistic behavior?<sup>21</sup>

<sup>18</sup> The concept has been recently applied to subfields of international economic law, such as WTO and investment law. See, respectively, Simon Schropp, *Trade Policy Flexibility and Enforcement in the WTO: A Law and Economic Analysis* (Cambridge International Trade and Economic Law, Cambridge University Press 2009) p. 101–23; and Anne van Aaken, “Opportunities and the Limits of an Economic Analysis in International Law” (2011) 3 *Transnational Corporations Review* p. 27–46. This perception of flexibilities as a permitted action within a legal range is found in Anne van Aaken, “Smart Flexibility Clauses in International Investment Treaties and Sustainable Development” (2014) 15 *The Journal of World Investment & Trade* p. 827–61.

<sup>19</sup> This is commonly termed “efficient breach” and is understood as a flexibility mechanism because it allows parties to make *ex post* adjustments. If attached to an appropriate level of compensation, these mechanisms may lead to efficient outcomes. See, for instance, Cooter and Ulen, *Law and Economics* p. 307–41. For an application and criticisms on its use in international law, see Trachtman, *The Economic Structure of International Law* p. 142–44; and also Joost Pauwelyn, *Optimal Protection of International Law* (Cambridge University Press 2008) p. 66–74.

<sup>20</sup> From a legal theory viewpoint, flexibilities are necessary because treaties are incomplete, meaning that negotiators cannot fully predict all future states of the world and have issues in translating their will into the contract. Economically, they are necessary because subsidies, as well as other instruments of state intervention in the economy, can be used for legitimate purposes such as overcoming market failures and protecting health, environmental and social values.

<sup>21</sup> Opportunistic behavior in a subsidies agreement works twofold. At the commitment level, subsidies agreements are designed to avoid that subsidies be opportunistically used



## INTRODUCTION

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In recent years, scholars of international trade law have examined, through economically informed analysis, how the rules of the world trading system have dealt with issues related to treaty design and the balancing of commitments and flexibility: how treaties might control for opportunistic behavior while granting states enough space to implement legitimate policy objectives. While much attention has been placed on the GATT, however, only recently has the scholarship approached other substantive areas of WTO law such as technical barriers to trade or intellectual property. The SCM Agreement, a treaty that contains rules regulating industrial subsidies, has also been overlooked.

The outstanding issue of flexibility in the SCM regulation of subsidies is important, because the use of subsidies is on the rise in several economic sectors,<sup>22</sup> as are WTO disputes over this issue.<sup>23</sup> According to the World Bank, there has been a steady increase in governmental spending classified as subsidies in virtually all G20 Members between 2006 and 2010. This is especially true for emerging economies such as Brazil, India, South Africa, Korea, and Russia, but is also valid for major economies such as France, Germany, Japan, Canada, the UK, and the USA. Of the developed countries, only Italy showed a slight decrease in levels of subsidization between 2010 and 2012.<sup>24</sup>

to circumvent tariff commitments and to strategically shift profits from foreign to domestic firms. On the enforcement level, once the contract is already in place, parties might opportunistically use poorly or ambiguously drafted commitments to prevent a WTO Member from making use of good faith subsidies. Treaties should, therefore, strive to identify and strictly regulate opportunistic behavior (both at the commitment and enforcement level) while allowing for good faith subsidies either because they respond to a legitimate economic need, such as a subsidy used to tackle a market failure, or because they are a good faith response to unforeseen contingencies.

<sup>22</sup> There are different datasets suggesting this, such as “Global Trade Alert.”

<sup>23</sup> This is particularly true after 2008, as governments made use of several measures to mitigate the impacts of the crises in their territories. Moreover, with international rules already restricting the use of several subsidies, states have made use of more elaborated measures to implement public policies in several areas, such as environment, posing a challenge on those responsible for judging their consistency.

<sup>24</sup> Data on subsidies and other transfers (current LCU) retrieved on 25.11.2015 <<http://data.worldbank.org/indicator>>. There was no data for Argentina, China, Mexico, and Saudi Arabia. As will be discussed, subsidies are an object of difficult definition and this fact poses a problem on measuring the amount of subsidies given by governments. For instance, the World Bank dataset includes social expenses that would, normally, not fall under the SCM Agreement.

Table 1: *Subsidies given by G20 members between 2006 and 2012.*

	2006	2010	2012
Australia	173,315,000,000	240,944,000,000	263,998,000,000
Brazil	324,537,752,576	509,729,304,777	597,340,933,432
Canada	160,574,000,000	209,175,000,000	219,689,000,000 <sup>25</sup>
France	416,440,670,000	492,316,000,000	521,706,000,000
Germany	560,970,000,000	622,440,000,000	625,200,000,000
India	3,485,140,000,000	7,905,000,000,000	9,938,860,000,000
Indonesia	334,028,993,820,455	472,684,961,057,015 <sup>26</sup>	n.a. <sup>27</sup>
Italy	359,123,000,000	429,055,000,000	425,176,000,000
Japan	52,090,600,000,000	58,567,800,000,000	62,241,000,000,000
Korea	98,284,800,000,000	135,399,621,000,000	147,577,560,000,000 <sup>28</sup>
Russia	2,886,900,000,000	7,671,200,000,000	9,701,300,000,000
South Africa	317,630,000,000	543,234,467,528	675,103,005,616
Turkey	139,462,495,225 <sup>29</sup>	186,659,799,807	239,315,752,212
UK	277,048,000,000	352,755,000,000	373,058,000,000
US	1,678,200,000,000	2,409,400,000,000	2,473,300,000,000 <sup>30</sup>

Source: The World Bank

The data suggests that subsidies are still a commonly used instrument for the implementation of public policy. Along with the level of “general” subsidies, the number of subsidizing measures that have a potentially harmful and discriminatory impact on international trade has also increased.<sup>31</sup> The number of bailout and domestic subsidization programs has been particularly high. The Global Trade Alert dataset registered over 1200 of such measures between 2009 and 2015.<sup>32</sup>

<sup>25</sup> Data for the year 2013.  
<sup>26</sup> Data for the year 2009.  
<sup>27</sup> Not available.  
<sup>28</sup> Data for the year 2011.  
<sup>29</sup> Data for the year 2008.  
<sup>30</sup> Data for the year 2013.  
<sup>31</sup> It would require studies beyond this research to test for a clear connection between the rise of such more “general” subsidies, as provided by the World Bank, and the increase in protectionist subsidies, as captured by the Global Trade Alert data. The fact, however, is that according to the data available, both general subsidies and protectionist measures have increased in the period.  
<sup>32</sup> In the present research it was used to establish the data of the measure the publishing date indicated at the Global Trade Alert. Since the website shows both “publishing date” and