Focus Note 1: Addressing current trade tensions: Market-distorting government support

The causes of current trade tensions are complex, but have their roots in widespread frustration that the international rulebook has not kept pace with economic and technological changes, and not everyone is playing by the existing rules. While there is no shortage of concerns – from border restrictions, and behind-the-border regulations that can impose unnecessary costs on traders, to new restrictions on the cross-border data flows that underpin trade in the digital era – particular attention has focused on government support that distorts international markets. This support is both long-standing – in the case of agriculture – and more recent - in the case of industrial products – but in both cases appears to be sizeable.

A first step in addressing market distorting government support is understanding its nature and scale. What do we know about government support?

Agriculture

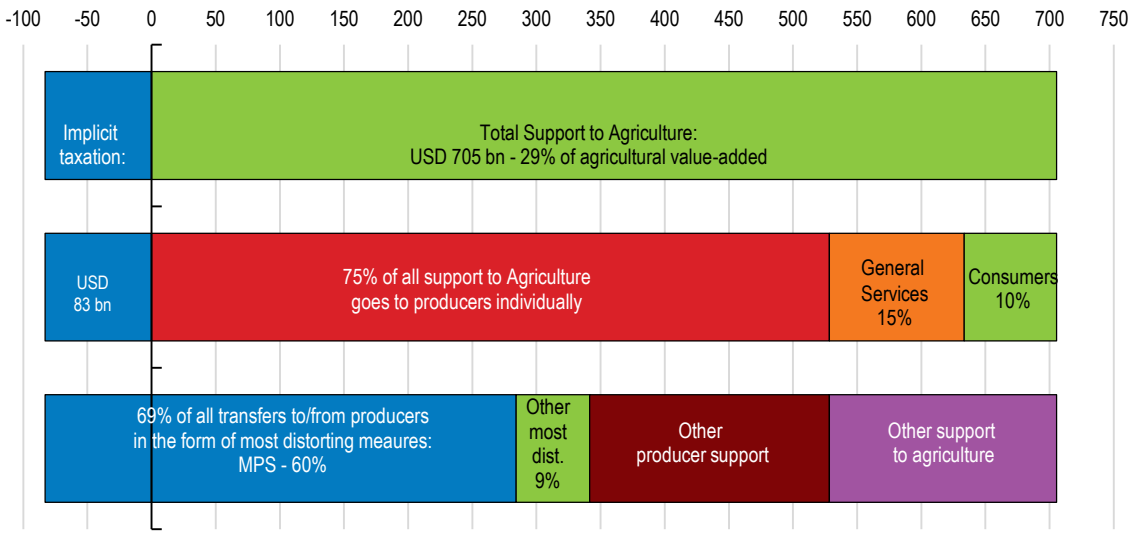
In the late-1980s, the OECD introduced a methodology to identify and estimate government support in agriculture, providing governments with the necessary information to begin to remove the most egregious forms of trade distorting support - including by integrating agriculture, for the first time, into the international trade rule-book. This has led to reduced government support, notably in some OECD countries to which all multilateral disciplines applied, and reduced trade distortions. However, reform in this area has now largely stalled across the OECD and much remains to be done. Moreover, some key emerging-market economies have increased their support to farmers, albeit from a low base, and have tended to rely relatively more on measures that are particularly market distorting (OECD, 2019a).

In agriculture, government support currently stands at over USD 700 billion per year for the 53 countries,[1] covering 74% of global value added in the sector, covered by OECD monitoring (Figure 2.1). Only a quarter of this provides general services to the sector (such as research and development) or support to consumers (e.g. food stamps); three-quarters (USD 530 billion) goes directly to individual producers. And of this USD 530 billion, over two-thirds takes the form of the most distorting support – including in the form of agricultural policies that raise domestic prices above world market levels (market price support), sustained by market access barriers that prevent cheaper competitive imports from entering. At the same time, a few emerging-market economies apply policies that lower producer prices relative to international markets, thereby implicitly taxing their producers to the tune of USD 83 billion a year.

[1] The countries covered in those estimates are the OECD members, non-OECD EU member states and 12 emerging-market economies (Argentina, Brazil, China, Colombia, Costa Rica, India, Kazakhstan, the Philippines, Russian Federation, South Africa, Ukraine and Viet Nam).

Figure 2.1. Support to agriculture, 2016-18

USD billion per year, 2016-18



Source: OECD (2019a), *Agricultural Policy Monitoring and Evaluation 2019,* OECD Publishing, Paris; OECD Agriculture statistics (database).

Industrial sectors

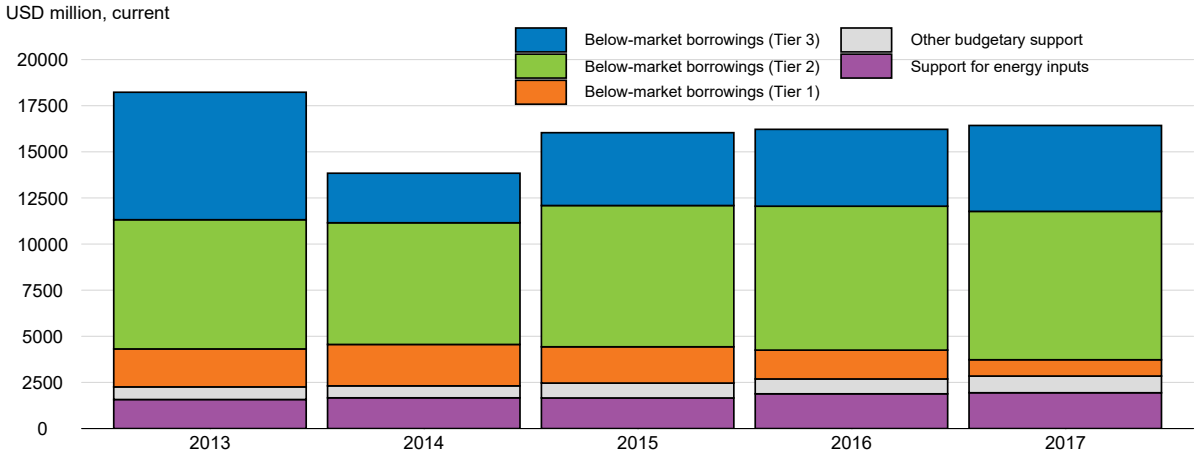
While support to agriculture is relatively well understood, attention is only now turning to support benefitting industrial sectors. Much less is known about the nature and scale of this support. The limited evidence available suggests it is common and sizeable in manufacturing, and that it is highly distorting to international markets. This support also takes a variety of forms, from relatively well understood input subsidies to less transparent and harder to measure support conferred through the financial system - as shown, for example, in recent OECD work on the aluminium value chain (Figure 2.2; OECD, 2019b).

The aluminium study and new work on semiconductors (OECD, forthcoming) both highlight the important role of support provided by central and local governments through their state enterprises. This support is complex and includes below-market loans from state banks; equity that state investment funds inject in companies on below-market terms (and which in turn creates channels for other forms of support, such as implicit state guarantees, and financial assistance with acquisitions or capacity addition); and a range of inputs (e.g. electricity) sold to manufacturers at below-market prices by state utilities and suppliers. These forms of support, and more generally a porous relationship between firms and the state, can make it difficult to identify individual support measures.

The effects of support in industrial sectors propagate through entire value chains that span multiple industries and countries. Measures that lower the cost of capital, and encourage the construction of more plants than market conditions would warrant, distort global markets and may also end up benefitting suppliers of equipment to those plants. Likewise, subsidised inputs for aluminium smelters can translate into cheaper products downstream that are then used to produce cars, aircraft and high-voltage transmission lines. Government support in a world of global value chains needs to take account of the way that support can accumulate along the supply chain. Support thus matters not just for particular industries, but also for the entire global trading system, which points to the need for policy solutions that address the issue in a holistic fashion.

Figure 2.2. Government support for 17 of the largest firms in the aluminium value chain

By type of support



Note: Below-market borrowings under Tier 1 are estimated by comparing actual interest rates paid by firms with a market benchmark that comprises a risk-free base rate and spreads reflecting the risk profile of USD-denominated debts, taking into account individual company credit ratings. Tier 2 further considers the risk profile of debts denominated in the local currency (e.g. the Chinese yuan or the Indian rupee). Tier 3 considers the additional interest that would have been charged absent the implicit government guarantee enjoyed by some firms. Data for two firms in the sample (SPIC and QPIG) are for the period 2012-16.
Source: OECD (2019b), "Measuring Distortions in International Markets: The Aluminium Value Chain", *OECD Trade Policy Papers*, No. 218, OECD Publishing, Paris.

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Not all producer support is equally harmful; there can be good public policy reasons for applying targeted support to address market failures (for example, support for basic research). Determining which support policies meet this test, and which are wasteful and market-distorting requires information. Transparency is thus a fundamental first step: only with adequate information can analysis help distinguish benign forms of support from more harmful policies, and in turn enable more informed policy discussions on how best to tackle government support, including in a trade context. Yet, industrial subsidies in particular are marked by a lack of transparency, especially for complex forms of support, stemming not just from insufficient disclosure by governments, but also from the difficulty of measuring such support in the absence of a market benchmark.

What can be done about government support?

Effectively addressing market-distorting government support requires disciplines across four fronts:

- Transparency (understanding the "what, how, when and where" of support): The essential starting point for levelling the playing field. Rules require objective, comparable information on the nature and scale of government support. While OECD monitoring helps to clarify the means of agricultural support and to measure them consistently across countries and time, there is a need for similar transparency exercises for government support in industrial sectors.
- Predictability (knowing that support will not increase further): An understanding of the nature and scale of existing support enables the development of rules to bind that support at existing levels. This can be critical in preventing harmful subsidy competition.
- Reduction (remove the most egregious and discipline others): Support measures differ in their impacts on markets and trade. The priority is to identify and reduce those measures that have

particularly harmful impacts on international markets. This is not an easy task in view of the variety of ways that support is provided to industrial sectors.

- Prevention (for tomorrow's sectors and tomorrow's subsidisers): While binding and reducing existing support would create a more level playing field today, effective rules need to prevent the use of new trade distorting measures, by new actors, in new sectors.

While some of these elements may be achieved bilaterally, only multilateral rules can deliver all four for all sectors. The critical first step is transparency – and not just for the development of rules. In the absence of transparency about the nature and scale of government support, businesses are reluctant to make new investments. And just as trade policy uncertainty is hampering global growth, failure to address some of the underlying causes of the current trade tensions is bringing its own costs in terms of heightened uncertainty about the future environment, leading to reduced business investment and, ultimately, lower growth.

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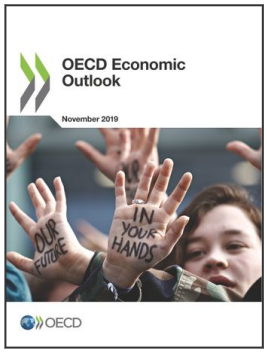

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