

Foreign Trade | Foreign Markets and Export

The WTO - Crisis and Reform

vbw

Position
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Bavarian Industry Association



Foreword

A common will to reform is the order of the day

The World Trade Organization (WTO) became a success story: It brought about the gradual removal of trade barriers and led to the expansion of world trade and the reduction of uncertainties in global trade policy. The continuous increase in its membership to 166 shows that the WTO is seen worldwide as the central negotiating and decision-making forum for multilateral trade issues.

However, as the number and diversification of its members increased, so did the difficulties. The Doha Round, which was supposed to lead to further trade liberalization, has not produced any results for years due to far-reaching differences and has come to a standstill. As a result, many members are increasingly relying on bilateral or regional free trade and cooperation agreements. The WTO's dispute settlement system has also been unable to function since the Appellate Body was blocked and China's membership is the subject of controversial debate due to Chinese state capitalism.

The current debate is not about the continued existence of the WTO. Its purpose and benefits are beyond question. It is about how the number of divergent interests can be overcome and how the World Trade Organization can be further developed to the satisfaction of all members in order to meet current and future challenges. To achieve this, we need a willingness to compromise.

Our position addresses the need for reform that is most urgent for our economy.

Bertram Brossardt
16 January 2025

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Position at a Glance

Dispute resolution must be ensured and industrial subsidies must be curbed.

In an increasingly globalized world, the importance of the World Trade Organization is growing. It is the central multilateral negotiating and decision-making forum for global trade issues. However, the WTO rules are outdated, incomplete and in need of reform. With 166 members, it is not easy to reach a consensus. The vbw - Bavarian Industry Association appeals to all WTO members to show willingness to reform and to implement these reforms. Two points are particularly urgent for our economy:

1. The dispute settlement mechanism must be designed in such a way that it aims at a solution accepted by both parties to the dispute, as provided for in the WTO Dispute Settlement Understanding. If legal uncertainty arises on certain issues during the appeal process, these issues must be referred to the WTO committees for further discussion between WTO members. "Authoritative interpretation" should be used in cases where no consensus can be found.
2. Competitive neutrality in global trade must be strengthened and trade-distorting effects of industrial subsidies must be prevented. In order to prevent unauthorized subsidies, stricter control regulations must be enshrined in the WTO Subsidies Agreement. The USA, Japan and the EU have submitted joint proposals to this effect (extension of the list of prohibited subsidies, reversal of the burden of proof, incentive for notification of subsidies, restrictions on financial aid from state-owned enterprises). These proposals are appropriate. In addition, the rules on subsidies must apply not only to goods but also to services.

1 The WTO - A Success Story

The World Trade Organization is the central forum for global trade issues.

The emergence of the rules-based multilateral world trade system was the answer to the economic crises of the 1930s. With the General Agreement on Tariffs and Trade (GATT), trade liberalization was set in motion after the Second World War, finally breaking with the high-tariff policy that had prevailed since 1929 and exacerbated the global economic crisis. The conclusion of the GATT in 1947 and the Agreement establishing the World Trade Organization in 1994 (WTO Agreement) led to an expansion of global trade, which contributed significantly to job creation and prosperity. In 2023, for instance, goods and services worth over 30 trillion US dollars were traded across national borders. This is thanks to continuous trade liberalization based on tariff reductions, the removal of non-tariff trade barriers and the most-favored-nation principle, which generally prohibits discrimination against goods and services.

The WTO was not only instrumental in opening up and integrating the global economy. The WTO has also prevented its members from reacting to exogenous shocks such as the financial crisis of 2008 or the coronavirus-related economic crisis by increasing tariffs and other protectionist measures.

The WTO became a success. More and more countries recognized the advantages of a rules-based and open world trade system that limits discrimination against foreign goods and services. Today, the WTO has 166 members and includes all major economies such as Canada, the USA, Brazil, the United Kingdom, the European Union, South Africa, Russia, Saudi Arabia, India, China and Japan. Trade between WTO members covers 98 per cent of worldwide trade.

Most members of the WTO are countries of the global South. The WTO has made a significant contribution to poverty reduction by promoting the integration of developing countries into the global economy, even if the position and capacities of many developing countries within the WTO still need to be strengthened.

The WTO has been increasingly weakened for around 15 years. Every effort must be made to give the institution new strength. In an increasingly globalized and multipolar world economy, the need for global governance is growing and with it the importance of the WTO.

2 Ensuring Dispute Resolution

WTO members must agree on a reform of the WTO dispute settlement procedure.

2.1 The USA's criticism of the WTO Appellate Body

Since December 2019, the WTO's Appellate Body has no longer been able to function. The Trump administration had refused to make any payments to fund it since 2017 and blocked the appointment of members to the Appellate Body. With only one remaining member, the body is no longer able to conduct appeal proceedings.

The WTO dispute settlement system consists of two instances. Firstly, a so-called panel decides on a trade dispute and presents its decision in a report. The parties to the dispute can appeal against this report. The Appellate Body is the second instance of the dispute resolution system. If an appeal is lodged against a panel report, but the Appellate Body has fewer than three members, the dispute cannot be finally settled.

The USA's dissatisfaction with the WTO Appellate Body did not only grow during the Trump administration, but also during Barack Obama's time in office. In addition to procedural complaints, the USA accuses the body of two things:

1. Judicial activism: The Appellate Body does not fulfil the institutional role assigned to it in the WTO Agreement of 1994. It does not safeguard the rights and obligations of the members, but rather extends them in part and restricts them in part. The Appellate Body creates its own rules and thus oversteps its mandate.
2. Expansion of the subject matter in dispute: The Appellate Body often deals with issues that were not raised by the parties to the dispute. These obiter dicta hindered the goal of resolving disputes quickly and influenced future disputes as possible precedents.

The USA cites the Appellate Body's decisions on zeroing as a prime example of the curtailment of WTO members' rights. Zeroing is a method of calculating dumping margins for imports, which is used as the basis for anti-dumping duties. The USA considers zeroing to be permissible under Article 17.6 of the WTO Anti-Dumping Agreement. The Appellate Body declared the method inadmissible. However, panels have ruled differently in various dispute settlement proceedings. The "jurisprudence" of the WTO with regard to zeroing is therefore inconsistent.

2.2 WTO members must demonstrate political will

The crisis of the Appellate Body not only affects the WTO's dispute settlement, but also jeopardizes its institutional credibility. The demand to restore the functioning of the Appellate Body alone is not helpful. What is needed is a dispute settlement mechanism that

is geared towards a solution acceptable to both sides and leads to reconciliation between the parties to the dispute. This is provided for in the WTO Dispute Settlement Understanding.

The 13th Ministerial Conference pledged to do everything in its power to ensure a functioning dispute settlement mechanism by the end of 2024. This goal has not been achieved until today. It must not remain mere lip service. This pledge must now lead to concrete results. Otherwise, the WTO will further lose its credibility. We need constructive discussions and negotiations. The WTO members must take the criticism of the USA seriously. At the same time, the USA must signalize its willingness to compromise. Any solution that does not involve the United States or even induces it to withdraw from the World Trade Organization would only exacerbate the WTO crisis and encourage the major trading nations to ignore or circumvent WTO obligations. The USA would also lose out if it left the WTO, as other trading partners could use unfair trade practices against the USA without any legal restrictions. Self-help with unilateral measures would become the operating principle of the world trade system.

Above all, the WTO members must agree on a new procedure for the Appellate Body. This is intended to submit questions of legal uncertainty arising in appeal proceedings to the respective WTO committees for further discussion among WTO members. If no consensus is reached in these negotiations, the WTO members could use the instrument of "authoritative interpretation" to clarify disputed issues, which requires a three-quarters majority of the members. Authoritative interpretation allows WTO members to respond to interpretations by WTO judicial bodies that contradict the will of the WTO membership. Such a procedure would create a link between the dispute settlement function and the WTO's role as a negotiating forum.¹

¹ For a detailed elaboration of this proposal, see T. Payasova, G. H. Hufbauer and J. J. Schott (2018): *The Dispute Settlement Crisis in the World Trade Organization: Causes and Cures*. Peterson Institute for International Economics.

3 Strengthening Competitive Neutrality

Industrial subsidies must be better recognized and monitored by the WTO rules.

3.1 Welfare effects of industrial subsidies

In recent years, industrial subsidies and their distorting effects on global trade have moved to the forefront of international debates. Subsidy programs can cause far-reaching negative international spillover effects and fuel trade conflicts. Production subsidies distort competition, export subsidies even more so. Production subsidies lead to a domestic production level that is above the optimum. Export subsidies lead to a level of domestic consumption that is below the optimum. The costs of this inefficiency are financed by the government of the subsidizing country or its taxpayers.

In both cases, the subsidized company can produce at artificially low marginal costs and thus increase its production and exports. In general, this even leads to a general increase in welfare in the importing country. The reason for this is that consumers in the importing country - at the expense of the foreign subsidizing government - gain access to cheaper goods. However, not everyone in the importing country benefits from the foreign subsidy. Domestic suppliers are disadvantaged in competition with their subsidized foreign competitors and lose market share and revenue.

One important characteristic of industrial subsidies is often neglected: they are generally discriminatory - not only between domestic and foreign companies, but also between domestic competitors on domestic markets. Many empirical studies indicate that industrial subsidies distort welfare and bring little lasting benefit to the domestic economy, as they lead to an inefficient allocation of resources also at national level. Researchers have found that governments usually favor inefficient and unprofitable domestic industries (so-called sunset industries).

In addition to industrial subsidies, state-owned enterprises (SOEs) deserve special attention. The reason for this is that state ownership or state control has similar effects on a company's supply and thus on prices and international competition as subsidies, since an SOE is able to produce larger quantities than the cost structure would otherwise allow.

3.2 Chinese industrial subsidies distort global trade

Since the beginning of the 21st century, China and other emerging countries have experienced enormous economic growth. Massive subsidies to their own industry have had a negative impact on international markets, which is seen as a problem. For comparison, in Germany and the USA, the share of government subsidies in 2019 - the last year before the coronavirus crisis and Russia's invasion of Ukraine - was 0.4 per cent of GDP, while in

China it was 1.7 per cent. The industries that have experienced overproduction in China in recent years included coal, aluminum, shipbuilding and steel in particular. It is believed that government subsidies in these sectors were a measure to compensate for company losses and artificially extend the life of companies with low profitability. The overcapacity in the Chinese steel sector went overseas. The increasing rise in Chinese steel exports led to a fall in prices on the international markets. Other sectors of the economy are now also suspected of benefiting from massive subsidies. These include, in particular, industries that have been identified as key sectors in the "Made in China 2025" strategy (e.g. semiconductors, machine tools, alternative fueled vehicles and nanomaterials). The reform of the WTO regulation on state subsidies is therefore of central importance. The breadth and diversity of competition-distorting subsidies must be covered by the WTO rules.

Multilateral regulations are often not sufficient to recognize and record trade-distorting industrial subsidies. The WTO Agreement on Subsidies and Countervailing Measures of 1994 (WTO Subsidies Agreement) defines a subsidy as a financial contribution by a government or public body that confers a benefit on the recipient company. There is no legal definition of "public body" in the agreement. As a result, Chinese state-owned enterprises do not fall under the term "public body".

Japan, the USA, the European Union and various other WTO members assume that China has violated the WTO Subsidies Agreement with its industrial subsidies and overproduction. The details of the Chinese subsidies, such as amount, origin, recipient and use, are difficult to determine. WTO members are obliged to report subsidies granted to the WTO. However, China has not yet submitted sufficient reports. The burden of proof in relation to violations of the Agreement lies with the complaining party, meaning that WTO members cannot prove violations without being able to determine the actual subsidy situation in China. Nevertheless, many WTO members are of the opinion that the subsidies granted to the Chinese steel industry largely comprise export subsidies prohibited under the WTO Subsidies Agreement.

3.3 Stricter disciplines needed in the WTO Subsidies Agreement

The United States, Japan and the European Union have presented several proposals in trilateral meetings on how the WTO Subsidies Agreement can be amended to better curb trade-distorting subsidies in the future (see Table 1). These reform proposals are to be welcomed. In addition, the agreement must be reformed so that it covers not only physical goods, but also services.

Table 1

Trilateral proposals for amendments to the WTO Subsidies Agreement

1. Extension of the list of prohibited subsidies

The following subsidies are to be added to the list of prohibited subsidies:

- Unlimited guarantees
- Subsidies to an insolvent or ailing company in the absence of a credible restructuring plan
- Subsidies for companies unable to obtain long-term financing or investment from independent commercial sources operating in sectors or industries with overcapacity
- Some direct debt cancellation

2. Reversal of the burden of proof

The following types of subsidies have such an injurious effect that a reversal of the burden of proof is justified, so that the subsidizing WTO member must prove that there are no serious negative trade or capacity effects and that there is effective transparency about the subsidy in question:

- "Too high subsidies"
- Subsidies to uncompetitive companies to help them stay in the market
- Subsidies that create overcapacity without commercial participation
- Subsidies that lower domestic input prices for exports

3. Ensuring the notification of subsidies

If required information is not provided by a subsidizing country and a financial contribution is counter-notified by another country, this is to be considered a subsidy that does not comply with WTO rules.

4. Restrictions on financial aid from SOEs

Many subsidies are granted by state-owned enterprises. It must be ensured that these subsidizing institutions fall under the term "public body" and in this way limits are placed on subsidies by SOEs.

The talks at the trilateral meetings must be extended to plurilateral platforms such as the G20 in order to secure broad support from other WTO members to create the necessary consensus at WTO level. As China's WTO reform proposals are diametrically opposed to the reform ideas of the trilateral meetings, it is advisable to define the negotiating topics broadly. This allows for maximum demands as well as concessions.

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All information in this publication refers to all genders without any intention to discriminate against any gender.

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