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Committee on Subsidies and Countervailing Measures

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ROLE OF SUBSIDIES IN CREATING OVERCAPACITY AND OPTIONS FOR ADDRESSING THIS ISSUE IN THE AGREEMENT ON SUBSIDIES AND COUNTERVAILING MEASURES

The following communication, dated 12 April 2017, is being circulated at the request of the Delegations of Canada, the European Union, and the United States.

Document G/SCM/W/569 (**The contribution of the WTO to the G20 call for action to address certain measures contributing to overcapacity**), submitted by the European Union, Japan, Mexico and the United States, suggested that industrial overcapacity has become a major problem for the global economy as it distorts international trade and creates multiple negative externalities. The document also noted the recent statement by G20 leaders acknowledging that collective action is needed to address the issue of overcapacity. Against that backdrop, the document identified a set of three initial questions around which Members could launch a useful discussion in the Subsidies Committee.

Given the complexity of the issue of subsidies and overcapacity, and the general nature of the three questions raised in the previous document, the purpose of this paper is to present some initial thoughts and ideas aimed at fostering a more detailed debate among Members on how to tackle subsidies contributing to overcapacity. Addressing the issue of overcapacity should not be seen as the sole prerogative of one forum. Rather, different fora, including the Global Forum on Steel Excess Capacity facilitated by the OECD, can usefully look at various aspects of the issue. The relevant and appropriate aspect for the Subsidies Committee is how certain types of subsidies contribute to overcapacity, and how best to address this aspect of the issue.

The question of how and to what extent subsidies act as a contributor to overcapacity is complex. The answer depends on the circumstances prevailing in the specific sector of the economy in which excess capacity exists. It is clear that market forces such as a decrease in demand may also play an important role in contributing to overcapacity, at least initially. However, the experience gathered in sectors currently experiencing high excess capacities, such as steel, aluminium, and solar panels, shows that governments often identify national strategic industries and systematically support them to boost their production, grow GDP, and expand or preserve employment, uncoupling these privileged sectors from supply and demand signals, and from other market indicators. In particular, the relevance of market forces diminishes when the state – functioning as the leading economic actor – owns, controls, or influences large numbers of important industrial enterprises and banking entities, and generally retains a significant role in resource allocation. In these circumstances, subsidization becomes a dominant contributor to excess capacity, which is further exacerbated as governments, both at the central and sub-central levels, often provide financial and other support throughout the entire lifetime of the preferred industries.

Indeed, in pursuit of strategic industry objectives, governments can create overcapacity by providing concessional loans or equity to newly-established companies without due consideration of market conditions, such as projected future demand and profitability. Similarly, when perceived strategically important companies begin to fail, governments may seek to maintain employment, production and capacity – especially in the absence of an exit mechanism. For example, governments may forgive debt, roll-over loans from state-owned or controlled financial institutions, convert debt-to-equity or provide new equity, without restructuring the failing companies such that they can operate profitably and their capacity is in line with market demand.

Governments also may provide, directly or through other public bodies implementing public policy objectives such as state-owned or state-controlled financial institutions, relatively cheap financing to beneficiaries in strategic sectors that otherwise would have been forced to seek more expensive market-based financing. Some of these beneficiaries are unprofitable and highly leveraged, and have low interest coverage ratios and an uncertain outlook for the future. Relatively cheap financing may be provided not only at the initial stage to facilitate the development of nascent domestic industries, but also subsequently through their medium-term development, leading to the build-up of additional capacity over time. Last but not least, in order to boost capacity and production in such preferred sectors of the economy, governments may also provide various key inputs, such as raw materials, water, electricity, gas or land, at below market prices.

The use of subsidies to create and maintain excess capacity, without sufficient attention to the forces of supply and demand, often leads to increased exports in times of domestic economic downturns. While some of the subsidies employed may be prohibited under Article 3 of the Agreement on Subsidies and Countervailing Measures (SCM Agreement), many are not. Given the highly distortive nature of these subsidies and the often-resulting spill-over of excess production onto export markets, the effects on trade of these subsidies often can be the same as – if not worse than – export subsidies. Therefore, these types of subsidies rightly should be considered for more stringent disciplines. This conclusion is all the more true in the current situation of the world economy in which several sectors suffer from severe excess capacity. Market forces normally would ensure that the least efficient producers in these sectors exit the market, thereby rebalancing demand and supply and eliminating overcapacity. Government financial and other support, however, keep ailing and non-economically viable companies afloat and prevent market forces from achieving the appropriate outcome.

In any event, if Members are to address effectively those subsidies that contribute to the excess capacity currently plaguing a number of industrial sectors, we need as an indispensable first step to know more about them. While the SCM Agreement requires WTO Members to notify subsidy programs, the continuously rising number of WTO Members that have failed to make the required notifications is deeply worrying. An alarming 65% of the Members having failed to submit their legally required notification for the 2015 cycle. Equally worrying is the fact that, while notifications are required for subsidy programs implemented at both the central and sub-central levels of government, some Members do not notify sub-central subsidy programs. This is particularly troubling where a government's industrial policy objectives are crafted at a central level and subsequently implemented by sub-central governments, and where sub-central governments implement their own beggar-thy-neighbour policies in competition with other regions. The quality of actual notifications, including the attempts by some Members to notify subsidy programs that clearly fall outside the scope of the SCM Agreement to create the appearance of transparency without subjecting actual industrial subsidies to global scrutiny, also deserve attention.

The European Union, the United States, and Canada call upon Members to heed the call of world leaders in the G20 for transparency and collective action. Members must strive to find ways to tackle more effectively harmful subsidies and other types of support from governments or government-sponsored institutions that contribute to severe overcapacity as we are experiencing in several sectors today.
