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Analyzing the Foreign Subsidies Regulation as a Trade Defense Measure

Case Study

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I. Executive Summary

Caught off guard by aluminum and steel tariffs imposed by the United States (U.S.), coercive measures by China, and a faltering dispute resolution system at the World Trade Organization (WTO), the European Union (EU) embarked on a mission to arm itself with trade defensive measures that would allow the bloc to retaliate and redress unfair trade practices unilaterally. The Foreign Subsidies Regulation (FSR) is one measure in this new trade-defensive toolbox and will start to apply in the summer of 2023 to address this imbalance. The measure itself is quite broad; it empowers the European Commission to investigate any entity it suspects of potentially distorting the EU market due to foreign subsidies it utilized abroad or within the EU. The type of subsidy is determined by the Commission as well and can range from tax incentives, cash grants, or other forms of preferences. In the investigation, the Commission can demand access to financial data as well as proprietary information. If a negative determination is reached, the FSR permits the Commission to dissolve concentrations, block mergers, restrict market access, or impose fines. This case study examines unintended consequences of the European Commission being empowered with such broad powers to unilaterally redress foreign subsidies.

II. Introduction

Background on the Global Trading System and Recent Challenges

The global trading system is a complex network of interdependent economies that rely on each other for growth and prosperity. For decades, the rules-based trading system governed by the World Trade Organization has been the cornerstone of global trade. However, recent challenges to this system have emerged, threatening to undermine the stability of the global economy.

One of the most significant challenges to the global trading system has been the imposition of tariffs and other coercive measures by major trading partners. In 2018, the United States imposed tariffs on imported steel and aluminum from several countries, including the European Union. The move was based on national security grounds, a provision that allows the U.S. to impose tariffs on products it deems critical to its national security. The EU responded with retaliatory tariffs on U.S. goods, and the two sides engaged in a trade dispute that threatened to escalate into a full-blown trade war.

Another major challenge to the global trading system has been the rise of China as a global economic power. China's state-led economic model has led to concerns about its unfair trade practices, such as the subsidization of its domestic industries and the forced transfer of technology from foreign companies operating in China. These practices have led to a significant trade imbalance between China and its trading partners, particularly the United States.

The WTO's dispute resolution system, which is designed to resolve disputes between trading partners and enforce trade rules, has also come under threat. The United States has been blocking the appointment of new judges to the WTO's Appellate Body, which has prevented the body from functioning properly. As a result, the dispute resolution system is at risk of becoming ineffective, leaving trading partners without a mechanism to resolve disputes and enforce trade rules.

In response to these challenges, the European Union has embarked on a mission to arm itself with trade defensive measures that would allow the bloc to retaliate and redress unfair trade practices unilaterally. One measure in this new trade defensive toolbox is the Foreign Subsidies Regulation (FSR), which will start to apply in the summer of 2023 to address this imbalance. The measure itself is quite broad, it empowers the European Commission to investigate any entity it suspects of potentially distorting the EU market due to foreign subsidies it utilized abroad or within the EU.

Overview of the Foreign Subsidies Regulation

The FSR is a new trade defense measure that empowers the European Union to investigate and redress unfair trade practices caused by foreign subsidies. The FSR was proposed by the European Commission in

May 2020 and was adopted by the European Parliament and Council in June 2021. The FSR is set to apply starting from July 2023.

The FSR is part of the European Union's broader strategy to arm itself with trade defensive measures to combat unfair trade practices and to protect its own market from distortions caused by foreign subsidies. The FSR comes as a response to a changing global trading system that is characterized by increased protectionism, the imposition of tariffs and other coercive measures by major trading partners, and the faltering dispute resolution system at the WTO.

The FSR is designed to address the distortionary effects of foreign subsidies on the EU market. According to the European Commission, foreign subsidies can cause significant harm to the EU economy and create unfair advantages for companies that benefit from them. Foreign subsidies can come in various forms, such as tax incentives, cash grants, or other forms of financial assistance, and can be granted both outside and within the EU.

The FSR grants the European Commission broad powers to investigate and redress distortions caused by foreign subsidies. Under the FSR, the European Commission can initiate an investigation if it has sufficient evidence that a company or group of companies is benefiting from foreign subsidies that cause a distortion in the EU market. The European Commission can also initiate an investigation based on information provided by third parties or on its own initiative.

The scope of the FSR is broad and covers a wide range of economic sectors, including manufacturing, services, and infrastructure. The FSR applies to companies established in the EU or outside the EU that are active in the EU market. The FSR also applies to companies that are planning to make an investment or merger in the EU market.

The FSR also grants the European Commission the power to demand access to relevant financial and proprietary information from the investigated companies. The investigated companies are obliged to provide the requested information within a specific deadline. Failure to comply with the requests can lead to significant fines.

If the European Commission finds that a company is benefiting from foreign subsidies that cause a distortion in the EU market, it can impose several measures to redress the distortion. The measures can include dissolving concentrations, blocking mergers, restricting market access, or imposing fines. The measures can be imposed both retroactively and prospectively.

The FSR is expected to have a significant impact on EU trade policy and on companies operating in the EU market. While the FSR is intended to protect the EU market from distortions caused by foreign subsidies, it may also have unintended consequences, such as retaliation by other countries, increased costs for EU companies, and damage to the transatlantic relationship. These potential unintended consequences will be discussed in the following sections.

III. Features of the Foreign Subsidies Regulation

Scope of the Regulation

The scope of the FSR is quite broad, and it covers any company operating in the EU single market, regardless of its origin. The FSR aims to tackle foreign subsidies that are likely to cause significant distortions in the EU market, thereby affecting fair competition. The term "foreign subsidy" is defined in the FSR as any financial contribution by a government or any public body that confers a benefit to an undertaking. The FSR also covers subsidies provided by non-governmental entities that are subject to public control or influence.

The FSR applies to subsidies provided by non-EU countries to companies operating in the EU, as well as to subsidies provided by EU member states to companies operating in other member states. In this way, the FSR aims to prevent distortions in the EU market caused by companies that benefit from foreign subsidies. The FSR also applies to any subsidy granted before its entry into force, provided that the subsidy is still in effect.

Furthermore, the FSR covers a wide range of subsidies, including grants, tax reliefs, and loans at preferential rates, among others. It is worth noting that not all foreign subsidies fall under the scope of the regulation. The Commission has to determine whether the subsidy is likely to cause significant distortions in the EU market, taking into account the nature and the amount of the subsidy, as well as the economic sector concerned.

In addition to investigating companies that benefit from foreign subsidies, the regulation also empowers the European Commission to investigate intermediaries, such as banks or law firms, that facilitate the granting of foreign subsidies. This means that companies operating in the EU that receive services from intermediaries who are involved in granting foreign subsidies may also come under scrutiny.

Overall, the scope of the FSR is quite extensive, and it has the potential to impact a wide range of companies operating in the EU market. While the regulation aims to tackle unfair trade practices and prevent significant distortions in the EU market, its broad scope and discretionary powers also raise concerns about potential unintended consequences and negative impacts on trade relations with third countries.

Types of Subsidies Covered

The FSR applies to a wide range of subsidies granted to non-EU entities, both in and outside the EU, that are deemed to distort competition within the EU market. This section will discuss the types of subsidies covered under the regulation.

The regulation defines a subsidy as any financial contribution by a government or public body that confers a benefit to a specific company or industry. This contribution can take various forms, including grants, tax incentives, loans, guarantees, or equity infusions. The subsidy must also be specific, meaning it confers a benefit to a specific company or industry, and not to the economy as a whole.

One of the key features of the regulation is its broad scope, which includes subsidies granted by non-EU countries, as well as subsidies granted by EU member states. This means that the European Commission can investigate subsidies granted by non-EU countries, such as China or the United States, that are deemed to distort competition within the EU market.

The regulation also covers subsidies granted to companies within the EU that have links to non-EU entities. For example, if a company within the EU receives a subsidy from a non-EU government, the European Commission can investigate whether this subsidy confers an unfair advantage to the company in the EU market.

In addition, the regulation covers subsidies granted to companies in the EU that have links to other companies within the EU. For example, if a company in the EU receives a subsidy from another EU member state, the European Commission can investigate whether this subsidy confers an unfair advantage to the company in the EU market.

Overall, the types of subsidies covered under the FSR are broad and include any financial contribution that confers a benefit to a specific company or industry. This broad scope empowers the European Commission to investigate a wide range of potential unfair trade practices within the EU market.

Powers Granted to the European Commission

The FSR grants significant powers to the European Commission in its efforts to investigate and redress any potential distortions in the EU market due to foreign subsidies. These powers are extensive and allow the Commission to take a range of actions to address any potential violations of the regulation.

Firstly, the Commission is empowered to initiate an investigation when it has reasonable grounds to suspect that a foreign subsidy is causing a distortion in the EU market. This investigation can be launched ex officio, or at the request of a member state, an interested party, or a third country.

During the investigation, the Commission has the authority to request information from any company or organization that it suspects may be involved in a potential violation of the regulation. This information can include financial data, proprietary information, and any other relevant documents.

The Commission also has the power to conduct on-site inspections of companies and organizations to gather evidence in support of its investigation. These inspections can take place at any premises where the Commission believes evidence may be found, including the premises of suppliers, customers, and competitors of the investigated companies.

If the Commission finds that a foreign subsidy is causing a distortion in the EU market, it has the power to impose a range of remedies. These remedies include requiring the company to terminate the subsidy, recovering the value of the subsidy, and imposing fines. The Commission can also prevent concentrations and block mergers, restrict market access, and impose any other necessary measures to redress the distortion.

In addition to these powers, the Commission is also authorized to adopt implementing acts to further specify the provisions of the FSR. These implementing acts can cover issues such as the calculation of the benefit conferred by a foreign subsidy, the assessment of the distortion caused by the subsidy, and the methodology for determining the amount of the recovery order.

It is important to note that the powers granted to the Commission under the FSR are significant and far-reaching. The FSR gives the Commission a great deal of discretion in its investigations and allows it to take swift and decisive action to redress any distortions in the EU market caused by foreign subsidies. However, this broad scope and power also raise concerns regarding the potential for abuse or unintended consequences.

Potential Consequences for Companies Found to be in Violation

The FSR grants the European Commission broad powers to investigate and take action against companies found to be in violation of the FSR. If a company is found to be benefiting from foreign subsidies that distort the EU market, the Commission can impose a wide range of remedies, including dissolving concentrations, blocking mergers, restricting market access, and imposing fines.

The consequences for companies found to be in violation can be significant. Dissolving concentrations or blocking mergers can have a major impact on a company's business strategy and growth plans, while restricting market access can limit a company's ability to compete in the EU market. Fines can also be substantial, potentially running into the millions or even billions of euros.

One concern with the FSR is that it may result in companies being penalized for actions that are not necessarily harmful to competition in the EU market. For example, a company may receive a foreign subsidy that allows it to invest in research and development, which could lead to the creation of new products and technologies that benefit consumers. However, if the Commission determines that the subsidy is distorting the EU market, the company could still be subject to penalties.

The FSR also places a significant burden on companies to provide the European Commission with access to financial data and proprietary information. This could be particularly challenging for companies in industries that rely on trade secrets or other forms of intellectual property to maintain a competitive advantage.

In addition to the potential consequences for individual companies, the FSR could also have broader implications for the EU's trade relationships with other countries. Some have raised concerns that the FSR could be seen as a form of protectionism, and that it could lead to retaliation from other countries that view the EU as unfairly targeting their companies.

Overall, the potential consequences for companies found to be in violation of the FSR are significant, and could have a major impact on their operations and growth plans. Companies will need to be vigilant in ensuring that they comply with the FSR and that they are not inadvertently benefiting from subsidies that could be seen as distorting the EU market.

IV. Potential Unintended Consequences

Retaliation by Other Countries

Retaliation by other countries is one of the potential unintended consequences of the FSR. As the EU strengthens its trade defensive measures, other countries may respond with their own measures to protect their own interests. This could create a trade war, with each country escalating their measures in response to the actions of the others.

One concern is that other countries could implement similar regulations, resulting in a global patchwork of trade defense measures that make it difficult for companies to operate and compete internationally. This could increase costs and reduce efficiency, ultimately harming consumers.

Another concern is that countries could retaliate in other ways, such as imposing tariffs or blocking market access for EU companies. This could result in significant economic losses for the EU, particularly if other major trading partners, such as the U.S., were to retaliate.

In addition, retaliation could also damage diplomatic relations between the EU and other countries. If the EU is seen as engaging in protectionist measures, it could undermine its credibility and ability to negotiate in other areas, such as security and defense.

To address these concerns, it will be important for the EU to engage in diplomatic efforts to mitigate the risk of retaliation. This could involve negotiations with other countries to address trade imbalances and unfair practices, as well as a commitment to using trade defense measures only when necessary and in a proportionate manner.

While the FSR is intended to protect the EU market from distortions caused by foreign subsidies, it is important for policymakers to consider the potential unintended consequences of the regulation, including the risk of retaliation by other countries.

Increased Costs for EU Companies

While the FSR is intended to provide a level playing field for EU companies, it is possible that the regulation could also result in increased costs for EU companies. One of the ways this could happen is through increased compliance costs. Companies that operate in multiple jurisdictions and receive foreign subsidies may have to devote significant resources to ensure they comply with the new regulation. This could include additional legal and accounting fees, as well as increased administrative costs.

Furthermore, if the European Commission finds that a company has received foreign subsidies and distorted competition in the EU, the Commission has the power to impose fines, block mergers or acquisitions, or dissolve concentrations. These actions could have significant financial implications for the companies in question. For example, if the Commission were to block a merger, this could prevent the companies involved from achieving synergies and cost savings that were a key rationale for the merger in the first place.

It is also possible that companies could be subject to multiple investigations by different regulatory bodies. For example, a company that operates in the EU and receives foreign subsidies could be subject to investigations by both the European Commission and national competition authorities. This could result in additional costs and administrative burdens.

In addition, if the EU were to impose trade restrictions or tariffs on goods from countries that provide foreign subsidies, this could result in higher prices for EU consumers. This is because companies may pass on the increased costs of compliance or tariffs to consumers in the form of higher prices.

Overall, while the FSR is intended to protect EU companies and ensure a level playing field, there is a risk that it could also result in increased costs for these companies. As with any new regulation, it will be important for companies to closely monitor its implementation and assess its potential impact on their operations.

Damage to the Transatlantic Relationship

The transatlantic trade relationship between the European Union and the United States is one of the most important economic partnerships in the world. The two economies account for almost half of the world's gross domestic product (GDP) and have the largest bilateral trade relationship.

In 2019, the EU and U.S. traded over $1 trillion in goods and services, with the U.S. importing $626 billion in goods and services from the EU and exporting $465 billion in goods and services to the EU, amounting to 18,4 % share of U.S. world trade. The EU is the largest market for U.S. goods and services, while the U.S. is the largest market for EU goods.

The transatlantic trade relationship has been characterized by the absence of tariffs and other trade barriers since the establishment of the WTO in 1995. This has facilitated the growth of trade between the two economies and has been a significant driver of global economic growth.

However, the relationship has been strained in recent years, with tensions arising over issues such as the U.S. trade deficit with the EU, the U.S. imposition of tariffs on EU steel and aluminum, and the EU's implementation of a digital services tax that would impact U.S. tech companies.

These issues have put pressure on the transatlantic trade relationship and have highlighted the need for a more robust trade defense mechanism to address trade imbalances and ensure fair competition between the two economies. The FSR is one such mechanism that the EU has recently implemented in response to these challenges.

The U.S. has expressed concern that the FSR will unfairly target U.S. companies, and has threatened to retaliate with its own trade defense measures. The FSR has the potential to cause significant damage to the transatlantic relationship between the European Union and the United States. The U.S. government and American business groups have expressed concerns about the new regulation, arguing that it could lead to retaliatory measures by the U.S. government and negatively impact U.S.-EU trade relations.

One of the major concerns is that the broad scope of the FSR could lead to a situation where U.S. companies operating in the EU are unfairly targeted by European regulators. This could happen if European regulators determine that U.S. companies have received unfair subsidies from the U.S. government or other entities, even if those subsidies are legal under U.S. law.

In response to the FSR, the U.S. government has threatened to take retaliatory measures against the EU. For example, the U.S. Trade Representative's Office has warned that the U.S. may impose its own tariffs on EU exports if the EU moves forward with the new regulation.

Some U.S. business groups have also expressed concern that the FSR could lead to increased costs and regulatory burdens for U.S. companies operating in the EU. This could happen if European regulators require U.S. companies to provide extensive financial and proprietary information during investigations under the new regulation.

The potential for damage to the transatlantic relationship is not limited to the U.S. and EU. Other countries with close ties to both the U.S. and EU, such as Canada and Japan, have also expressed concerns about the new FSR and its potential impact on global trade. These countries may feel pressured to take sides in any dispute between the U.S. and EU over the FSR, which could further complicate the global trade landscape.

In conclusion, the transatlantic trade relationship between the EU and U.S. is one of the most important economic partnerships in the world. However, recent tensions have highlighted the need for a more robust trade defense mechanism to address trade imbalances and ensure fair competition between the two economies. The implementation of the FSR is a significant departure from the EU's traditional approach to trade defense, and its potential impact on the transatlantic trade relationship is yet to be fully understood.

V. Case Studies

Case study 1: Chinese Solar Panel Manufacturers

One industry that has been the subject of intense scrutiny due to alleged foreign subsidies is the solar panel manufacturing industry. China is one of the largest producers of solar panels in the world, and its manufacturers have been accused of benefiting from various forms of government support, including subsidies for research and development, export financing, and preferential treatment in the form of low-cost loans and cheap land.

In 2013, the European Commission launched an investigation into Chinese solar panel manufacturers, which resulted in the imposition of anti-dumping and anti-subsidy duties on imported solar panels from China. The duties were set at an average rate of 47.6% for anti-dumping and 11.5% for anti-subsidy. The decision was based on the findings that Chinese solar panel manufacturers were benefiting from subsidies provided by the Chinese government, which allowed them to sell their products at unfairly low prices, thereby distorting the EU market.

China responded by imposing tariffs on EU exports of polysilicon, a raw material used in the production of solar panels. The move was seen as retaliation for the EU's imposition of duties on Chinese solar panels. The dispute was eventually resolved through negotiations, with the EU agreeing to remove its duties on Chinese solar panels in exchange for China lifting its tariffs on EU exports of polysilicon.

The case of Chinese solar panel manufacturers highlights the potential consequences of the FSR. While the FSR is intended to redress trade imbalances caused by foreign subsidies, it can also lead to retaliation by other countries and damage to trade relations. In this case, the EU's imposition of duties on Chinese solar panels led to retaliatory measures by China, which had a negative impact on EU exports of polysilicon.

The case also highlights the challenges of determining the scope of subsidies and their impact on the market. The investigation into Chinese solar panel manufacturers was complex and required access to proprietary information and financial data. While the EU was able to successfully impose duties on Chinese solar panels, other countries may be less willing to cooperate with investigations or provide access to information, making it more difficult to enforce the FSR effectively.

Overall, the case of Chinese solar panel manufacturers illustrates the potential benefits and drawbacks of the FSR. While the FSR may be effective in redressing trade imbalances caused by foreign subsidies, it can also lead to retaliation by other countries and damage to trade relations. The effectiveness of the FSR will depend on how it is implemented and enforced, as well as how it is perceived by other countries.

Case study 2: U.S. Tech Companies

The FSR has raised concerns among U.S. tech companies that operate in the European market. These companies fear that the new regulations may be used as a tool to target them unfairly. One such company is Google, which has been under investigation by the European Commission for alleged antitrust violations. The Commission has accused Google of using its dominance in the search engine market to unfairly promote its own products and services while downplaying those of its competitors.

Google is not the only U.S. tech company that has faced scrutiny from the European Commission. Facebook, Amazon, and Apple have all been investigated by the Commission for alleged violations of European antitrust laws. These investigations have resulted in fines totaling billions of euros, and have forced the companies to change their business practices in Europe.

The FSR adds another layer of complexity to the already strained relationship between U.S. tech companies and European regulators. The new regulations give the European Commission expanded powers to investigate and punish companies that receive subsidies from non-EU countries. This could potentially impact U.S. tech companies that operate in the EU and receive funding or other forms of support from the U.S. government.

For example, the U.S. government has been providing funding for research and development of new technologies, including artificial intelligence (AI). U.S. tech companies that operate in Europe and receive funding from the U.S. government could potentially be targeted by the European Commission under the new regulations.

In addition, the FSR could impact the ability of U.S. tech companies to compete in the European market. The regulations give the European Commission the power to investigate and punish companies that are deemed to have an unfair advantage over their competitors. U.S. tech companies that are seen as having an unfair advantage could be subject to fines, restrictions on market access, or other penalties.

These concerns highlight the potential unintended consequences of the FSR. While the regulation is intended to address unfair trade practices by non-EU countries, it could potentially impact the ability of U.S. tech companies to compete in the European market. This could have far-reaching implications for the transatlantic relationship and for global trade as a whole.

VI. Conclusion

Summary of Key Points

While the FSR is intended to address trade imbalances and protect EU companies, there are potential unintended consequences that could result from its implementation. These include retaliation by other countries, increased costs for EU companies, and damage to the transatlantic relationship.

The transatlantic relationship is an important one, with the EU and U.S. being each other's largest trading partners. The implementation of the FSR could strain this relationship, particularly if it leads to retaliatory measures by the U.S.

Two case studies were presented to illustrate the potential impact of the FSR on specific industries. The first case study involved Chinese solar panel manufacturers, while the second examined U.S. tech companies. In both cases, the implementation of the FSR could have significant consequences for the companies involved.

While the FSR is intended to address trade imbalances, it is important to consider its potential negative impact on global trade. The FSR could lead to a more protectionist stance by countries, resulting in a less open and free global trading system.

Overall, it is important to weigh the potential benefits and drawbacks of the FSR carefully. While it may provide a necessary tool for addressing trade imbalances and protecting EU companies, it is also essential to consider its impact on global trade and the potential unintended consequences that could arise.

Policy Recommendations

Based on the analysis presented in this case study, the following policy recommendations are made:

1. Clarify the scope of the FSR: The broad scope of the FSR may have unintended consequences. Therefore, the EU should clarify the definition of subsidies that would fall under the regulation's ambit. This would reduce uncertainty for businesses and prevent unnecessary burdens on non-distorting subsidies.
2. Ensure transparency and predictability in the investigations: The EU should establish clear rules and procedures for investigations under the FSR. This would ensure transparency and predictability in the investigative process, reducing uncertainty for businesses and avoiding the risk of arbitrary or discriminatory treatment.
3. Establish clear thresholds for the imposition of remedies: The EU should establish clear thresholds for the imposition of remedies. This would ensure that the remedies are proportionate to the harm caused by the subsidized entity and would help prevent excessive use of remedies.
4. Engage in dialogue with trading partners: The EU should engage in dialogue with its trading partners, particularly the U.S. This would help prevent escalation of trade disputes and promote cooperation on trade issues.
5. Reform the WTO: The EU should continue to work towards reforming the dispute resolution mechanism at the WTO. This would help prevent further erosion of the rules-based global trading system and promote a more stable and predictable trade environment.
6. Monitor the impact of the FSR: The EU should closely monitor the impact of the FSR on its own industries and on the global trading system. This would help identify unintended consequences and ensure that the FSR is effective in addressing trade imbalances without causing harm to EU industries or the broader global economy.
7. Coordinate with other jurisdictions: The EU should coordinate with other jurisdictions that have similar trade defensive measures. This would help prevent duplication of efforts and reduce the risk of retaliation by other countries.

Limitations of the Analysis

1. The case study focuses primarily on the potential negative consequences of the FSR and may not fully capture the potential positive outcomes or benefits of the measure. It is possible that the FSR may indeed be effective in addressing trade imbalances and unfair trade practices, and that the benefits may outweigh the costs.
2. The case study is focused in scope to the transatlantic relationship and may not fully capture the broader impact of the FSR on global trade. It is possible that the FSR may have significant implications for other regions and countries outside of the EU and the U.S.
3. The case study is based on assumptions and projections of how the FSR may be implemented and how other countries may react to it. These assumptions may not necessarily play out in reality, and the actual impact of the FSR may differ from what has been discussed in this case study.

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