does it make sense?

INTERNATIONAL TRADE

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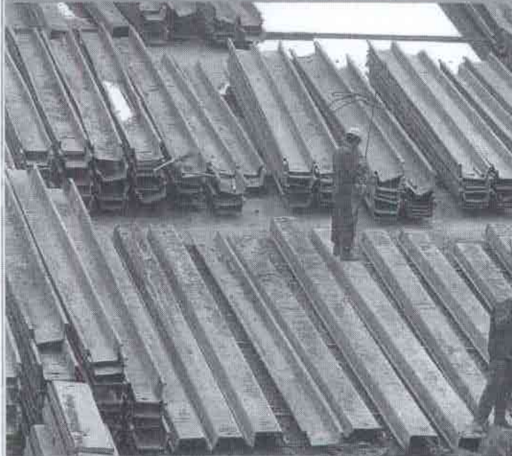

Growing Gains

Georgetown Steel and Subsidy Exemptions

The past few years have seen an explosion in privately and publicly expressed concern over the surging US imports from, and trade deficit with, China. The resulting political pressure, fueled by the US manufacturing sector's well-documented troubles, is so intense that earnest discussions have begun both inside and outside the government over whether the current arsenal of trade remedy tools is adequate, and in particular over whether there should be a readily usable import remedy against Chinese goods that benefit from subsidies. Senior officials in the administration of US President George W. Bush have hinted at a review taking place within the US Department of Commerce (DoC), which administers the principal US trade remedy laws. The review addresses whether the countervailing duty (CVD) remedy (a border tax imposed on injurious, subsidized imports) should be made applicable to goods imported from non-market economies (NMEs) like China.

This review of the CVD law's reach is welcome—indeed overdue. The existing "NME exemption" makes little policy sense and rests on shaky ground. However, the DoC's actual output in the CVD field indicates that, far from narrowing or revoking the NME exemption, the agency is actually bolstering and expanding that exemption. In particular, the decision in *Sulfanilic Acid from Hungary*, issued by the DoC in 2002, carved a significant additional hole into the CVD law's protection by ruling that large subsidies bestowed in a foreign country prior to its "graduation" from NME status can not be offset even after graduation. This article reviews the decision, its rationale, and potential consequences for future CVD cases involving imports from China as well as Russia and other transitional economies.

The Sulfanilic Acid Decision

Hungary was considered, for the purposes of trade remedy law, to be an NME until its "graduation date" of January 1, 1998, after which the country's lengthy transition from central planning to market-orientation had progressed sufficiently to enable home market prices to be used in determining "normal value" in antidumping cases. In antidumping analysis, normal value is compared with the price at which goods are exported. Under US court precedents, that January 1998 graduation date also marked the beginning of the period in which US industries could obtain CVD relief with respect to subsidized imports from Hungary.

The US producer Nation Ford Chemical filed a CVD petition in September 2001 alleging that subsidized sulfanilic acid products imported from Hungary were causing material injury to the competing US industry. The CVD investigation focused on the 2000 calendar period of investigation and on subsidies to the Hungarian producer Nitrokemia. The DoC straightforwardly handled the subsidy allegations except in regard to two large subsidies bestowed in the latter half of 1997—a July 1997 assumption of environmental liabilities and a November 1997

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cash grant. While there was no question that Hungary was a market economy subject to CVD law during the period of investigation examined by the DoC in the 2000 calendar year, these particular subsidy transactions occurred just before Hungary's graduation date. Subsidies are ordinarily allocated and offset through countervailing duties over a period corresponding to the average useful life of renewable assets in the industry involved, in this case 11 years. Therefore, if these 1997 bestowals were indeed subsidies, they would have definitely yielded a benefit in 2000.

The case was a minor one economically, and since neither the US industry nor the Hungarian respondents participated through counsel, the important and novel question posed by the 1997 bestowals was not briefed by any party. The question at hand was whether the DoC in such a case must investigate and remedy all subsidies bestowed in the relevant allocation period, including those bestowed prior to graduation?

The DoC determined that it was under no obligation to include pre-graduation subsidies in the investigation and, in fact, was precluded by law from doing so. The DoC relied on a 1986 Court of Appeals for the Federal Circuit decision, *Georgetown Steel Corp. v. United States*, to support this conclusion.

Unanswered Questions in Sulfanilic Acid

The DoC's reliance on *Georgetown Steel* was misplaced. The issue addressed in *Georgetown Steel* was whether the DoC in 1983-4 had acted lawfully in terminating a pair of CVD investigations involving steel wire rod imported from Poland and Czechoslovakia and in refusing to conduct CVD investigations involving potash imported from the German Democratic Republic and the Soviet Union. The cases arose many years before any of these countries gained market economy status. In rejecting the CVD petitions, the DoC reasoned that while the CVD law contained no express exclusion for NME countries, it could not be applied to NME products because concepts like subsidization and resource misallocation were meaningless in the context of a centrally planned economy. The question raised by the petitioners' appeal was whether the DoC's interpretation of the CVD statute was a permissible one. The Court of International Trade disagreed with the DoC in its 1985 *Continental Steel Corp. v. United States* decision holding that the CVD law did apply to NME products, and called for further agency proceedings. But the Federal Circuit reversed *Continental* in its *Georgetown Steel* decision and found the DoC's action to be neither contrary to law nor an abuse of discretion.

Perhaps regrettably, the Federal Circuit did not curtail its ruling there, but instead added some extensive *dicta* expressing its opinion that the DoC could not have found the CVD law applicable to NME products. In establishing this *dicta*, the US Federal Circuit answered an entirely hypothetical question; this is an important, but often overlooked, element of the decision. Nonetheless, in any event, *Georgetown Steel* addressed the situation in which the country targeted by a CVD petition was, on the date the petition was filed, still an NME. The issue was whether a CVD proceeding even needed to be conducted under the applicable CVD law. *Georgetown Steel* did not address or lay out detailed rules for what would happen if an NME country graduated to market economy status and a later CVD case included allegations dating from the pre-graduation period. The US Federal Circuit said nothing —even in *dicta* —about this situation.

A closer examination shows that the *Georgetown Steel* outcome, both at the agency level and in court, was driven

Opposite: Two loading workers stand on a shipment of steel in a Shanghai factory in June 2003. The biggest Chinese and Japanese steelmakers were in talks in 2003 to form a joint venture company. *Above*: Hundreds of US steelworkers gather in front of the US Capitol in Washington, DC, in 1999 to protest US steel import laws.

Photos Courtesy AFP Photo/Getty Images

largely by the practical difficulties impeding CVD analysis in an NME environment. The US Federal Circuit reasoned that CVD remedies had to be inapplicable in such a situation—that the US Congress must have intended to exclude NMEs from the law's coverage—because of the practical difficulty involved in determining the amount of the unfair advantage given to an investigated firm by its government. The primary issue, for the US Federal Circuit and for the DoC, was the inability to identify benchmarks in the distorted environment of a NME. In the underlying 1984 agency decision *Carbon Steel Wire Rod from Czechoslovakia* the DoC stated, "subsidies in market economy systems are exceptional events. They can be discerned from the background provided by the market system. No such background exists in an NME. ... In such a situation, we could not disaggregate government actions in such a way as to identify the exceptional action that is a subsidy." The benchmarks regularly needed in CVD analysis include, for example, market-determined prices against which the DoC can compare the price charged to the recipient of a government-provided input, and market-determined interest rates which the DoC can use to capture the "time value of money" element of large non-recurring subsidies whose benefits must be spread out over a period of years.

In a thoroughly distorted NME environment—before the transition to market economy status has begun, or even early in that transition—these market-determined comparison points may indeed be difficult to find. While some subsidies (for example, a per-unit export bounty whose calculation requires no benchmark) could arguably be identified and measured in even the most distorted NME environment, an overall assessment of a given enterprise's level of subsidization probably cannot be made with sufficient confidence in such an environment. *Georgetown Steel* can be read as holding that such practical difficulties can be substantial enough to override what is otherwise a clear statutory mandate to countervail bounties and grants.

But in an economy that has for many years been in transition, as Hungary had been by 1997, valid benchmarks may well be available, especially for certain types of subsidies. In *Sulfanilic Acid*, the only benchmark the DoC needed to identify in order to countervail the November 1997 grant was a "discount rate" reflective of Nitrokemia's alternative (commercially determined) cost of borrowing during 1997. Certainly, the DoC could have done this with tolerable accuracy. Among other things the IMF's annual *International Financial Statistics* compendium—one of the standard sources the DOC relies upon to find commercial lending rates for use in CVD cases—published information on commercial interest rates prevailing in Hungary during 1997. Moreover, the DoC had no troubling finding a discount rate to use in valuing infusions bestowed on Nitrokemia just a few months later, in May 1998. However the DoC made no attempt to locate a decent discount rate. Nor did it even use the "no benchmark" approach of countervailing just an allocated share of the principal amount of the grant—applying the favorable assumption (to Nitrokemia) that the company could have borrowed at zero interest funds equal to the amount granted. Instead, the DoC took a theological approach, insisting that a cash grant bestowed before graduation was not a subsidy at all. Yet, such a grant certainly meets the statutory definition of a subsidy—a government financial contribution conferring a benefit.

Whether or not *Georgetown Steel* was, as suggested above, fundamentally a practical rather than a theological decision, it does not compel the DoC's new rule regarding pre-graduation subsidies. Even in the part of the decision that contained broad *dicta*, the Federal Circuit's rationale

was that subsidization within a NME does not "create the kind of unfair competitive advantage over American firms against which the countervailing duty act was directed." The US Federal Circuit reasoned that the subsidization of goods exported from an NME could not harm competing US producers. But in *Sulfanilic Acid*, the exports at issue were not NME exports. Hungary had graduated before 2000, and there is no room to argue that the subsidization of the goods exported during 2000 was incapable of injuring competing US producers. The only question—not even broached by *Georgetown Steel*—was what universe of subsidies could properly be considered in a CVD investigation focusing on the 2000 POI.

"EVEN WITHOUT THE CURRENT FIRESTORM OVER IMPORTS FROM CHINA, IT WOULD MAKE SENSE FOR THE DOC TO RECONSIDER ITS RULE ON PRE-GRADUATION SUBSIDIES..."

A more provocative question, particularly given the current China-related political pressures noted above, is whether, even on the topic it did directly address, *Georgetown Steel* is still good law. In view of subsequent statutory changes, could a CVD case be filed directly against NME exports today? The CVD law interpreted in *Georgetown Steel* was repealed in 1994 through the Uruguay Round Agreements Act, and the surviving CVD law (which had paralleled section 303 apart from the inclusion of an injury test) was substantially amended—most notably through the long-awaited insertion of a definition of the term "subsidy." Prior to 1994, a rather imprecise working definition had emerged through agency and judicial case law. The new statutory definition copies almost verbatim Article 1 of the WTO *Agreement on Subsidies and Countervailing Measures* (ASCM), and its basic elements are a "financial contribution" and the conferral of a "benefit." This definition is certainly not confined to activities engaged in by governments holding power in market-oriented economies. On the contrary, WTO members, including the United States, have made it clear that an NME government can bestow a "subsidy" according to the ASCM definition, including, for example, in the detailed negotiation with China during its WTO accession process about its right, after accession, to benefit from the various special "developing country" rules in ASCM Article 27. None of those negotiations would have been necessary had China been considered incapable of carrying out the actions described in ASCM Article 1. In addition, the post-Uruguay Round CVD laws of other major jurisdictions, such as Canada and the European Union, apply in principle (although they have not yet been applied in an actual case) to NME products.

The 1994 statutory changes would therefore present a court with an interesting question were an US industry to file a CVD petition against imports from an NME country today. To be sure, the DoC has already indicated its likely (negative) response to such a petition. But would the courts agree? The US Congress, while legislating in 1994 against the backdrop of existing case law, certainly did not enact an explicit exemption from the CVD law for transitional economies or NMEs. The current US Congress has seen several bills that would expressly remove NME exemption, legislatively overruling *Georgetown Steel*. In view of history noted above, however, such US Congressional action is probably unnecessary. A well-explained determination by the DoC, applying the existing CVD law to NME exports, might survive judicial review.

DoC Practice and Graduation from NME Status

NME status is determined today by several statutory factors including currency convertibility, government ownership and control of input resources and output allocation, treatment of foreign direct investment, and the bargaining of wages and work conditions between employers and employees. At the time of the *Georgetown Steel* decision, this test was not part of the statute, and the DoC had simply defined a NME as an economy that "operates on principles of non-market cost or pricing structures so that sales or offers for sale of the merchandise in that country or to other countries do not reflect the market value of the merchandise." Under the current, expanded test, the DoC graduated Hungary—even though its economy was not yet operating on pure market principles—because a substantial portion of the Hungarian economy had already transitioned. It is difficult to fathom the DoC's failure to take account of this evolutionary process in analyzing subsidies bestowed during the transition period.

Similarly, the DoC's recent decision terminating Russia's NME status stated that the country had been in transition for several years and decided that, although Russia is still undergoing transition, it had made sufficient progress to

graduate. This analysis is incompatible with the notion that conditions that permit market benchmarks to be identified in such a country, usable in CVD analysis, tend to emerge abruptly.

Finally, in the DoC's antidumping practice, producers in pre-graduation NME countries can show that their industry operates on market principles, and thereby become eligible to have their home market costs used instead of surrogate country costs in determining normal value. Consequently, the DoC itself has recognized that the industrial environment prevailing in a pre-graduation economy may not always be as completely distorted as the *Sulfanilic Acid* decision suggests.

Construction workers for China's largest steelmaker, Baoshan Iron and Steel, walk on steel rods framing a new highrise in Beijing in 2003.

Implications of the Decision

The DoC's decision on pre-graduation subsidies was not altogether without precedent. In the *Preamble* to its 1998 CVD Rules, 63 Red. Reg. at 65,360, the DoC declared that:

"[I]t is important to note here our practice of not applying the CVD law to non-market economies. The Federal Circuit upheld this practice in *Georgetown Steel Corp. v. United States* ... . We intend to continue to follow this practice. Where the Department determines that a change in status from non-market to market is warranted, subsidies bestowed by that country after the change in status would become subject to the CVD law."

This statement of intention was not codified in a regulation, and even if it were, it would be valid only to the extent that it was not found to conflict with the underlying CVD statute. The decision is not insulated from reconsideration at the agency level and certainly not from judicial review, even if the DoC may have expected to reach this result and believed that it rested on a permissible interpretation of the statute in 1998. The DoC has never applied its rule on pre-graduation subsidies in a case other than *Sulfanilic Acid*.

Even without the current firestorm over imports from China, it would make sense for the DoC to reconsider its ruling on pre-graduation subsidies, which was issued without the benefit of interested party comment, and encourages the provision of large capital subsidies in transitional economies. The WTO Appellate Body recently delivered a severe blow to CVD-using industries by decreeing a new exemption for pre-privatization subsidies. An exemption for pre-graduation subsidies will only aggravate the harm to industries , forced, through no fault of their own, to compete with subsidized imports. The most extreme fact pattern is the one actually presented in *Sulfanilic Acid*: large subsidies which are bestowed immediately prior to a country's graduation, and which should be subject to CVD offset for the next 10 to 15 years, will continue to have trade-distorting effects but will be unreachable by CVD law.

Russia and Kazakhstan recently graduated to market economy status, and the DoC is currently examining the economic status of neighboring countries such as Ukraine, Moldova, Romania, Lithuania, and Estonia. Controversy concerning these countries will reflect the extent to which they are observed to have bestowed large "non-recurring" (amortizable) subsidies during their respective transition periods. Nevertheless, with the CVD law's direct applicability to NME, specifically Chinese, goods now apparently in play, the theological approach reflected in the *Sulfanilic Acid* decision will almost certainly get a well-deserved second look.

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