

Global Trade Tensions: Analyzing the WTO Legality of the U.S. Inflation Reduction Act and Strategic Responses

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Abstract. With the profound changes in the global economic landscape and the increasing proximity of the United States and China in terms of power contrasts, the hegemonic anxiety of the U.S. has been increasing, leading to the adoption of a series of protection measures in the field of trade. Among them, the Inflation Reduction Act, as an important part of the U.S. trade protectionist policy, its implementation has not only aggravated the tension in international trade, but also violated the relevant rules of the World Trade Organization (WTO). This paper elaborates the specific content of the Act and its impact on international trade, especially its large-scale subsidy policy in the field of green energy and its potential impact on the global supply chain. Subsequently, this paper analyzes in depth the illegality of the Act under the WTO framework from the perspective of prohibited subsidies and non-discriminatory principles, and argues with specific cases. Finally, this paper puts forward China's response strategy, aiming to provide theoretical support and practical guidance for China in dealing with U.S. trade protectionist policies. The purpose of this paper is to reveal the nature and impact of the U.S. trade protectionism policy, to provide theoretical support for China to safeguard its legitimate rights and interests in global trade, and to provide useful reflections and insights for China to promote trade liberalization and facilitation, strengthen international cooperation, and jointly respond to challenges in the context of global economic integration.

Keywords: Enter key words or phrases in alphabetical order, separated by commas.

1. Introduction

In today's era of globalization and ongoing scientific and technological revolution, the arena of international trade has become more diversified and complex. As the world's two largest economies, the proximity of China and the U.S. in terms of comprehensive strength has not only exacerbated the tension in the international competitive landscape, but also touched off the hegemonic anxiety of the U.S. In order to safeguard its global hegemony, the U.S. has adopted a series of trade protection measures, of which the strengthened export control policy is the most notable. These measures are aimed at controlling the export of key technologies and products, curbing the development of competitors and ensuring the strategic advantages and security interests of the U.S.

Against this backdrop, the U.S. enacted the Inflation Reduction Act (IRA, the "Act"), which not only covers a wide range of areas such as taxation and health care, but also implements a large-scale subsidy policy, particularly in the area of green energy. The introduction of this policy is undoubtedly a major adjustment to the global trade pattern. By giving huge subsidies to its own green industry and clean energy enterprises, the U.S. aims to promote the development of its own high-tech industry, while excluding competitors such as China in the global supply chain. This initiative has not only triggered widespread concern in the international community, but also poses a challenge to global trade liberalization and fair competition.

In the face of the implementation of the Act, China, as the world's second-largest economy, should analyze in depth the contents, impacts and illegality of the Act in order to formulate an effective response strategy. The research in this paper aims to comprehensively analyze the specific provisions of the Act, assess its impact on international trade, especially on the green energy sector, and explore its legitimacy under the framework of the World Trade Organization (WTO). Through in-depth analysis, this paper hopes to reveal the nature and impact of U.S. trade protectionist policies, and provide theoretical support and practical guidance for China to safeguard its legitimate rights and interests in global trade.

Specifically, this paper will conduct an in-depth study of the Act from multiple perspectives. First of all, this paper will explore the background of the development of U.S. export control policy and its strategic intent behind, and analyze the impact of these measures on the international trade pattern. Next, this paper will elaborate on the specific contents of the Act, especially its massive subsidy policies in the field of green energy, and assess the impact of these policies on the global supply chain and the international trade order. Then, this paper will deeply analyze the illegality of the Act under the WTO framework from the perspective of prohibited subsidies and non-discrimination principle, and argue with specific cases. Finally, this paper will put forward China's response strategies, including uniting other countries with damaged interests to jointly prosecute, accurately understanding the WTO determination criteria and enhancing litigation capacity, and actively carrying out multi-bilateral environmental cooperation, etc., aiming to provide theoretical support and practical guidance for China in responding to the U.S. protectionist trade policies.

2. Specifics of the Inflation Reduction Act and its Implications

2.1. Key Elements of the Inflation Reduction Act

The Inflation Reduction Act was enacted into law by the U.S. Congress on August 7, 2022. Spearheaded by the Biden Administration, the Act is nominally designed to reduce inflation. However, in reality, it has limited impact on the pressing inflation concerns within American society. Instead, the Act serves as a comprehensive legislative package that melds substantial green subsidies with healthcare savings and new revenue measures, thereby bolstering domestic green industries and clean energy initiatives.

The bill proposes the following measures:

The first measure is increasing corporate taxes. The bill would impose a 15 percent corporate minimum tax on large corporations. It would also spend \$80 billion on improving the IRS's tax enforcement and compliance capabilities, as well as adding a tax on stock buybacks. The Congressional Budget Office estimates that the bill would reduce the deficit by \$305 billion through 2031, including a reduction of more than \$20 billion in the 2022 year.

The second measure is reforming prescription drug pricing. For the first time, the bill requires the Centers for Medicare and Medicaid Services (CMS) to negotiate the prices of prescription drugs in Medicare beginning in 2026 in an effort to reduce drug costs. The bill plans to spend about \$64 billion in health care. A portion of these funds will be used to provide health insurance subsidies to reduce the cost of health insurance for individuals and make health insurance more affordable.

The third measure is tax credits and subsidies for some eligible new energy vehicles. The bill plans to invest a total of \$369 billion in energy security and climate change programs. Demand-side policies include refundable tax credits for new energy vehicles and previously owned electric vehicles. The supply-side policies include a 10-year extension of the investment tax credit, which will be raised from 26 percent to 30 percent, and will be prorated out in three years after the 10-year period. And, the Bill also adds a number of new tax credits for new energy projects. The new energy policies in the bill are characterized by large-scale subsidies, diversified subsidies, comprehensive subsidies, and an emphasis on supply chain security. The bill in the field of climate and clean energy investment amounted to about \$790 billion, accounting for about 3% of the U.S. GDP in 2022, much higher than the total amount of clean energy subsidies in the "2016-2022 federal energy financial interventions and subsidies" statistics. The subsidies adopted are a combination of tax credits, financial grants, and state loans (or loan guarantees) to build reliable clean energy supply chains.

Overall, the Act focuses on all segments of the clean energy supply chain, especially manufacturing, and shifts the focus of subsidy allocation from the front-end of clean energy technology research and development to upgrading domestic production capacity for clean energy technologies and products. The Act significantly reflects its industrial policy and trade protectionist tendencies, with severely restrictive subsidies aimed at reducing the clean energy supply chain's high dependence on China and competing with other countries for technological and industrial dominance

in the green energy transition. This series of policy measures reflects the U.S. government's firm stance in seeking green energy independence and global technological leadership [1]. The specific provisions of the clean energy subsidy measures will be analyzed in depth below.

2.2. Subsidy Provisions in New Energy Policies Limiting Foreign Entities

The Act imposes stringent conditions on new energy vehicles to qualify for subsidies, with a distinct focus on localizing critical aspects of their production in North America.

First, the Act mandates that a certain percentage of the battery's critical minerals—such as lithium, cobalt, graphite, nickel—must be extracted or processed within the U.S. or a country with which the U.S. has a free trade agreement in force (currently 20 countries have free trade agreements with the U.S., excluding China), or obtained by recycling the battery in North America. The above percentage requirement increases incrementally, with the percentage requirement being 40% in 2023 and increasing by 10% annually thereafter. For those put into use after December 31, 2026, the minimum requirement for the percentage of critical minerals is 80%.

Additionally, the Act specifies that the value of components used in the batteries, including essential elements like electrode materials, electrolyte salts, and other battery parts, must be predominantly manufactured or assembled in North America. The percentage is required to be 50% in 2023, increasing annually thereafter, and rising to 100% for vehicles placed in service after December 31, 2028.

Another key stipulation is that the final assembly of the vehicles must occur in North America, which compels relevant automotive companies to invest locally by setting up manufacturing facilities in the region. This provision effectively restricts the ability of companies operating predominantly outside of North America from accessing subsidy benefits.

The Act also introduces stringent restrictions against vehicles associated with foreign sensitive entities (FEOC), as defined in section 40207 (a) (5) of the U.S. Infrastructure Investment and Jobs Act. From December 31, 2023, any electric vehicle with battery components manufactured or assembled by FEOCs is ineligible for tax credits. The restrictions tighten further after December 31, 2024, when electric vehicles containing any critical minerals that are extracted, processed, or recycled by FEOCs also become ineligible for tax credits. FEOCs include a range of entities such as foreign terrorist organizations, entities listed on the Office of Foreign Assets Control's (OFAC) Specially Designated Nationals (SDN) list, and those controlled or influenced by governments of specific countries deemed adversarial, including North Korea, China, Russia, Iran. Additionally, entities engaged in espionage or unauthorized activities harmful to U.S. national security or foreign policy are also classified as FEOCs [2]. Consequently, all new energy vehicles owned by companies from these designated countries are barred from receiving the substantial subsidies offered under the Act [3].

2.3. Possible Impacts of New U.S. Clean Energy Subsidy Policies

The Act introduces new clean energy subsidy policies with significant implications for major global players in the clean energy market, including the European Union (EU), Japan, South Korea, and China.

2.3.1. Impact of the bill on the EU

Europe's production of clean energy technologies and raw materials has always ranked among the world's top producers. The EU is both an important demander and supplier of clean energy technologies and products globally, with demand accounting for about 23 per cent of the global total and supply accounting for 15 per cent of the global total. It is expected that 100% of EU lithium-ion battery demand and two-thirds of cathode active material demand (the most valuable part of the battery) will be met by 2027. The Act's provision that only electric vehicles assembled or sourced within the U.S. or in countries with which the U.S. has free trade agreements (Canada and Mexico) can be subsidized puts EU producers at a competitive disadvantage and could force investors in

related industries out of Europe and into North America. This would result in a loss of European leadership in the clean energy sector. For example, the German power producer Rheinland Group (RWE) has decided to spend \$6.8 billion to acquire the clean energy business of Consolidated Edison and deepen its operations in the U.S. The Spanish green energy giant Iberdrola and the French multinational Safran, which specializes in the aerospace, defense, and space markets, have already shifted some of their operations to the U.S. [4]. In addition, the Act's subsidization of the green energy industry has effectively lowered the cost of green hydrogen and renewable energy production in the U.S., giving it a comparative advantage in the European market as well.

2.3.2. Impact of the bill on the Japan and South Korea

The requirements of the Act on vehicle assembly sites and batteries will have the greatest impact on the new energy vehicle industry in Japan and South Korea. Of the 32 EV models currently sold in the U.S., 26 are assembled domestically, with only the Nissan LEAF and a few European models manufactured in the U.S. [5]. All electric vehicles sold by Kia and Hyundai are currently manufactured overseas, and are therefore not eligible for tax credits. In the short term, the discriminatory policy of clean energy subsidies will inevitably harm the interests of Japan and South Korea in the U.S. market for new energy vehicles, and prompt the flow of investment into the U.S. in Japan and South Korea's related industries, which may result in the outflow of Japanese and South Korean technology and hollowing out of the industry. This will have an immediate impact on the Japanese and Korean electric vehicle industry.

2.3.3. Impact of the bill on the China

After nearly two decades of sustained investment and construction, China has become a global leader in technology and production capacity in the clean energy sector. China produces three-quarters of lithium-ion batteries, with 70% of cathode and 85% of anode production capacity (both are key components of battery production). more than two-thirds of the world's electric vehicle battery production capacity by 2023 will be supplied by Chinese manufacturers, in addition, China has basically got rid of import dependence on the four major raw materials (cathode, anode, electrolyte, diaphragm) in electric vehicle batteries, and the rate of localization of lithium equipment has also reached more than 90%. The localization rate of lithium equipment has also reached more than 90%. In fact, it is because of China's huge advantage in the field of clean energy, which triggered the U.S. of America's anxiety as well as the production of the Act, it can also be said that China is the U.S. of America to introduce the "Act" of the most important target.

The biggest advantage of the U.S. in the clean energy industry chain is that it is the world's largest market and one of the buyers. But because the U.S. has been on China's related products, especially photovoltaic trade remedy measures, automobile exports, the same high additional tariffs, China's clean energy products on the U.S. market dependence is very low. But from another point of view, because the Act provides a large number of demand-side subsidies to stimulate the consumption of clean energy products, while China is excluded from this market is expected to grow rapidly, undoubtedly also a loss of expected returns. For China, the biggest challenge posed by the Act is that the U.S., through its subsidy policy, will significantly reduce the production costs of U.S. clean energy producers, improve their international competitiveness, and, combined with the highly protective trade policies already implemented by the U.S., may cultivate a technologically advanced clean energy industry chain with a certain degree of price advantage, thus posing a threat to China's current leading position.

3. Analysis of the Illegality of the Act under the WTO Framework

3.1. Violation of Prohibited Subsidies

The Act's policy of making the use of domestic raw materials a prerequisite for receiving subsidies not only fails to achieve the desired low-carbon environmental benefits, but also encourages firms to

switch to higher-cost domestic materials and components rather than lower-cost imports. Such domestic content subsidies are in fact import substitution subsidies, which are prohibited under the Subsidies and Countervailing Measures (SCM) Agreement and can be highly trade-distorting. Import substitution subsidies, i.e. subsidies conditional on the use of domestic products instead of imported products. If the eligibility of the subsidy is affected by the local content of the product, then such subsidies should be considered to be de facto dependent on export performance.

In addition, the Article provides that Members shall not impose on their export's internal taxes, charges, levies, fees and fees in excess of those levied on domestic consumption products of the same kind. Thus, under Article 3 of the SCM Agreement, a subsidy is prohibited and cannot be supported if it is "conditioned solely on the use of domestic rather than imported goods, or as one of several conditions".

Prohibited subsidies are not permitted in the WTO, and are designed to maintain a fair international trade environment and prevent members from obtaining unfair competitive advantages through the use of subsidies. The WTO Dispute Settlement Body (DSB) will take appropriate measures to adjudicate and enforce against a member party that violates the provisions. One of the most typical examples is the dispute case of EU v. U.S. Aircraft Subsidies. The U.S. Boeing Company and the EU's Airbus are the world's only two manufacturers of large commercial airliners, and both have been engaged in fierce competition for market share and technological innovation. To support their respective aerospace industries, both U.S. and European governments have long provided subsidies of varying degrees, and in 2013, in an effort to entice Boeing to continue building a new model of the 777X civilian jumbo jet in the state of Washington, the state of Washington enacted ESSB 5952. ESSB 5952 substantially extends and modifies Washington's aviation tax incentives, requiring nearly \$9 billion in subsidies for Boeing as a result. In contrast to the previous bill, the bill contains two siting provisions, the first of which states that the bill does not take effect until "a major commercial airplane manufacturing project is located in Washington State. The second siting provision provides that the tax credit applies only to the manufacture or sale of commercial aircraft that have been located in Washington State under the first siting provision.

On December 19, 2014, the EU requested consultations with the U.S. on a tax incentive granted by the State of Washington for the development, manufacture, and sale of large civil aircraft under certain conditions (DS487). The EU believes that the measure, as applied by the State of Washington, is not a significant tax incentive. The EU argued that the measure imposed by the State of Washington is a prohibited subsidy under Article 3.1(b) of the SCM Agreement. The DSB, through the Appellate Body and Panel Reports, concluded that the siting provisions under ESSB 5952, and in particular the future form of operation of the discretion established by the Revenue Service pursuant to the second siting provision, make the business and opening of business for the manufacture or sale of commercial airplanes under the 777X Project Licensing Aviation Tax Rate, constitute de facto subsidies under Article 3.1(b) of the SCM Agreement depending on the use of domestically produced goods rather than imported products, in violation of WTO regulations, and require the U.S. to rescind the relevant Act and authorize the EU to impose tariffs on up to \$3.99 billion of U.S.-origin goods and services annually in retaliation for the U.S. government's violation of the prohibition on subsidies to The Boeing Company [6]. Such findings are instrumental for any country involved in similar disputes, as they provide a strong basis for challenging unfair subsidy practices at the WTO level.

3.2. Violation of the Principle of Non-discrimination

In addition to being illegal under the SCM Agreement, the Act also violates the WTO principle of non-discrimination, which encompasses the principles of national treatment and most-favored-nation (MFN) treatment. The Act conditions certain tax incentives on vehicle assembly within North America, exclusively favoring Mexico and Canada. This requirement creates a significant disparity in how automobile assembly operations from other countries are treated in the U.S. market compared to those from Mexico and Canada, undermining the MFN principle which is a foundational element of global trade relations.

The principle of national treatment requires that imports from a member country enjoy treatment in that country's market that is no less favorable than that enjoyed by similar products in its own country. This principle, codified in GATT 1994, aims to ensure that foreign products do not suffer discrimination. However, the local content requirements in the Act clearly disadvantage and discriminate against foreign equipment and raw materials, which contravenes this principle.

The principle of non-discrimination has an important position in the WTO, and it is the basis for trade liberalization and fair competition. Violation of the non-discrimination principle may lead to trade disputes and WTO sanctions. Trade subsidies related to tax policies are highly susceptible to causing serious damage to fair competition in the market due to the direct transmission of their benefits. Tax-related subsidy cases have been brought many times in the dispute settlement mechanism under the WTO, such as the famous EU v. Foreign Sales Corporation (FSC) of the U.S. The FSC Act provides that U.S. investors who set up a company in a foreign country that is primarily engaged in the trading of exported U.S. products are exempted from federal income tax on the income derived from the exports and sets the use of imported inputs as a condition of obtaining the exemption to a maximum of 50 percent. The EU argued that this section of the U.S. provision ostensibly provided a disguised export subsidy for the domestic tax system.

The Appellate Body in this case held that neither the SCM Agreement nor the WTO had the authority to interfere with a country's tax system, but that certain WTO provisions did relate to taxation. A tax measure imposed by a member may raise issues with respect to subsidies, and a subsidy is a prohibited subsidy if it depends on export performance. The U.S. is not entitled to adopt a system of global taxation while designing exemptions specifically for exports, and then claiming that it provides export subsidies to eliminate the adverse effects of the U.S. tax system on exporters. Ultimately the panel ruled that the US FSC Act violated WTO rules and the EU retaliated against the US by imposing additional tariffs [7]. Therefore, WTO members should strictly observe the principle of non-discrimination when conducting trade activities to ensure the fairness and impartiality of trade activities.

Throughout the subsidy cases heard by the WTO DSB, the definition of government subsidies is mainly based on the GATT 1994 and the Anti-Dumping Agreement (ADA), rather than the SCM Agreement. Looking back at the subsidy's cases in the past ten years, the DSB has accepted a total of 37 requests for consultations and dispute settlement cases, of which 13 applied the ADA, 12 involved the GATT principles of national treatment and MFN treatment, and only four applied the SCM Agreement, including two disputes over prohibited subsidies, and the other two were disputes over trade in services and public institutions. The other two cases were disputes concerning trade in services and public institutions. Therefore, proving that the Act violated the prohibition of subsidies and the principle of non-discrimination was the key to China's success [8].

4. China's Response Strategies

4.1. Solidarity with Other States or Regions Whose Interests are Impaired to Prosecute

China can enhance its position at the WTO by forming alliances with other nations that are similarly disadvantaged by the Act, such as Japan, South Korea and the EU. By uniting with these countries, China can pool resources and strengthen its collective bargaining power, thereby increasing the likelihood of a favorable ruling. Collaborative efforts can help in consolidating common appeals, strategizing effectively, and providing robust evidence that supports the case. This collective approach will make it easier for the DSB to recognize the violations of the respondent party, and thus make a ruling in favor of the prosecuting party. Through successful litigation and ruling enforcement, trade barriers and discriminatory measures can be reduced, promoting the liberalization and prosperity of international trade. At the same time, uniting other countries helps to strengthen international cooperation and communication. By facing trade disputes together, countries can increase understanding, reduce misunderstanding and lay a solid foundation for future trade cooperation. If the U.S. does not fulfill its obligations after implementation, countries should actively

seek effective countermeasures from the WTO, such as increasing tariffs and limiting the number of imports.

4.2. Understand the WTO Determination Standards and Improve Litigation Capacities

China should emphasize the training of foreign-related legal talents, improve the comprehensive ability of case handlers in law and foreign languages, and continuously improve the litigators' knowledge of the criteria for determining WTO rules. Many WTO cases involve specialized economic and technical issues, which require litigators to have relevant economic and technical knowledge. At the same time, due to the complex and time-consuming WTO dispute settlement procedures, litigators in dispute settlement, not only have to state the specific facts of the measures involved, but also have to analyze the legal matters involved in the case in conjunction with the WTO rules, but also in the negotiation with the other party around the focus of the measure dispute to actively defend; not only have to realize the external efficient communication with each other, but also have to realize the internal high-quality teamwork; not only have to solve the substantive disputes, but also have to solve the procedural disputes, these issues are the most important issues. To resolve procedural disputes, the resolution of these issues require litigators to have superior wisdom and skillful litigation skills, so the need for litigators to pay attention to the accumulation of litigation strategy, and constantly improve the litigation ability to comprehensively strengthen the WTO dispute settlement participation and ability to manage [9]. China should set up a special training program for foreign-related legal talents, including comprehensive training in law, foreign language, economy and technical knowledge, and strengthen the teaching of WTO rules and international law in law schools of colleges and universities, and set up special courses, so as to cultivate more foreign-related legal talents with an international perspective, a good understanding of international rules, a good command of foreign languages and professional knowledge. In addition, China can encourage relevant legal practitioners to organize regular seminars to discuss the application of law and litigation strategies in WTO dispute settlement, to enhance the legal practitioners' understanding and mastery of WTO rules, and to enhance their competitiveness in the field of international law.

4.3. Proactive Bilateral and Multilateral Environmental Cooperation

Climate change is a global issue, so the response program is not unilateral, isolated, and cannot be separated from the basis of global collaboration. It is undeniable that the green energy compliance subsidies in the Act are conducive to addressing climate change. China still needs to uphold the important concept of the community of life between human beings and nature, maintain multilateral consensus, engage in dialog with the U.S., strive to remove obstacles to cooperation, and actively participate in and promote the construction of a fair and reasonable global climate governance system with win-win cooperation. At the same time, they should also adhere to a high level of opening up to the outside world, cooperate with other countries in the field of clean energy, and optimize the regional collaboration of the clean energy technology industry chain. In addition, countries should formulate binding environmental agreements through international organizations and multilateral mechanisms, such as the United Nations Framework Convention on Climate Change (UNFCCC), to clarify the responsibilities and obligations of countries in reducing greenhouse gas emissions and promoting sustainable development. Countries should organize international conferences, seminars and other activities to strengthen exchanges and cooperation among governments, enterprises and civil society organizations, so as to form a synergy in addressing climate change [10].

5. Conclusion

The implementation of the U.S. Inflation Reduction Act has undoubtedly exacerbated tensions in international trade, especially the subsidy policy for new energy vehicles and other areas, which not only violates the WTO's principle of prohibited subsidies and non-discrimination, but also causes serious disruption to the global supply chain. Although this unilateralism and protectionism policy

may help the development of the U.S. domestic industry in the short term, in the long term, its damage to global economic integration and challenge to international trade rules will surely trigger more trade frictions and disputes.

In the face of this challenge, China should adopt corresponding response strategies, reflecting China's respect for and maintenance of international trade rules, and demonstrating China's sense of responsibility and commitment in global economic governance. China should continue to adhere to the development concept of openness and cooperation, promote global trade liberalization and facilitation, and at the same time strengthen its own innovation capacity and core competitiveness in order to better cope with the challenges of global trade protectionism and unilateralism. At the same time, China will also actively participate in global climate governance, promote the development and application of global clean energy technologies, and contribute Chinese wisdom and Chinese programs to building a community of human destiny.

Against the backdrop of global economic integration, countries can only achieve win-win and sustainable development by strengthening cooperation and jointly addressing challenges. The implementation of the U.S. Inflation Reduction Act, while bringing new challenges to international trade, also provides an opportunity for global countries to reflect and act. By strengthening cooperation, improving rules and promoting fair competition, we are expected to jointly build a more stable, prosperous and sustainable global trading system.

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