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Confronting China's Threat to Open Trade

A Smarter Strategy for Securing America's Innovation Edge

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INTRODUCTION

In early April, reportedly after "zero substantive internal debate," President Trump ordered the U.S. Trade Representative (USTR) to consider imposing additional tariffs on $100 billion in Chinese products.[1] Trump's order claimed that new tariffs were needed to retaliate against China's threatened retaliation for tariffs that Trump had announced earlier.[2]

Trump's impulsive escalation[3] was denounced by farmers[4], retailers[5], tech organizations, and others, and by bipartisan political leaders[6]. Sen. Ben Sasse (R-NE) put things bluntly: "[T]his is nuts. China is guilty of many things, but the President has no actual plan to win right now."[7]

China, meanwhile, has a plan – a highly detailed one – to seize the global economic future.

China's leaders are relentlessly implementing a comprehensive set of state-driven industrial and mercantilist policies specifically designed to assure China's future economic leadership. China's ultimate goal is to dominate in the production of advanced-technology products, like aircraft, integrated circuits, and computers. To achieve that end, China is employing an array of tactics – including illegal and unfair measures – to "assimilate" American technology and innovation, shield Chinese competitors, and restrict foreign access to its markets, all while continuing to benefit from China's assured access to global markets.[8]

China's technology mercantilism poses a serious threat to America's economic future – one that's potentially far more harmful than the damage the "China Shock" caused to lower-skilled manufacturing sectors in the early 2000s.[9] Developing a tough and effective American strategy to counter China's threat is absolutely vital – but will not be easy.

China's unfair practices and shameless manipulation of its WTO privileges[10] have eroded support for open trade among a significant portion of the American public – and have led to calls to respond to China's mercantilism with "America First" protectionism.[11] That would be a huge mistake.

Open global markets are manifestly in America's interest. Given a level playing field, America's innovative businesses can compete and win anywhere.[12] Instead of trade wars, responding to China's technology mercantilism requires a tough, targeted, long-term U.S. response that enlists allies, enforces rules and writes new ones, focuses negotiations, and ratchets up pressure on China—all while advocating aggressively to keep global markets open.

We outline such a strategy below. But we first describe China's growing challenge to the rules and norms of free trade and its mounting threat to U.S. technology leadership, and highlight key shortcomings in the Trump Administration's response.

CHINA, THE WTO, AND GLOBAL NORMS

When China joined the World Trade Organization (WTO) in 2001, America and its allies anticipated that WTO membership would significantly open up China to foreign trade and investment. They were right. Today, despite an array of serious trade barriers,[13] China is the third-largest export market for U.S. manufactured goods[14] and the second-largest export destination for American services[15] and farm products.[16] These exports support hundreds of thousands of good jobs throughout the United States.[17]

But America and its allies also made a bigger bet on China. They hoped that WTO membership would transform China by encouraging it to adopt the broader norms of an open market economy.[18] Unfortunately, that bigger bet wasn't a winning one.

In 2000, President Clinton expressed the hope that WTO membership would significantly diminish the state's role in China's economy and move China away from "state-owned dinosaurs that are least likely to survive in the global economy."[19] Today, however, an arm of China's State Council controls, manages, and funds over half of the China's Fortune 500 companies – roughly equivalent to the U.S. Commerce Department controlling General Electric, General Motors, Ford, Boeing, US Steel, DuPont, Verizon, Honeywell, and United Technologies.[20] More broadly, China's government employs an intricate array of rules, plans, subsidies, and "informal guidance" to influence key decisions of domestic and foreign businesses – including compelling foreign firms to set up Communist Party branches and appoint Party members to influential positions.[21] According to the USTR, the state's role in China's economy has increased significantly over the past five years.[22]

In the first decade of China's WTO membership, China's U.S.-bound exports of lower-tech goods like furniture and textiles – aided by unfair practices like dumping and currency manipulation – caused serious and concentrated economic dislocations, especially for lower-skilled U.S. workers and their communities. Although there's robust debate about the causes and extent of this "China Shock," its impact was undeniably significant, costing (by some estimates) up to 2.4 million U.S. jobs, and undermining support for open trade.[23]

Today, China's high-tech mercantilism poses an even more serious threat to open trade and an American economy in which intellectual property (IP) IP-intensive industries alone support more than 45 million jobs and represent 39 percent of U.S. GDP.

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China is increasingly using unfair means to boost exports and limit imports of more advanced products – with the eventual goal of becoming self sufficient in key technologies.[24] China seeks to dominate innovative sectors through a supercharged, state-directed combination of industrial policies, trade and investment restrictions, and formal and informal requirements to transfer, acquire and "assimilate" valuable foreign know-how. Many of these measures violate the letter or spirit of the WTO. China has reneged on repeated promises to end them.[25]

STEALING AMERICA'S FUTURE

The linchpin of China's future-oriented mercantilism is an extensive and coordinated array of plans, policies, rules, and practices to enable the transfer and "assimilation" of foreign technology and intellectual property for China's benefit. These measures are unprecedented in design and scope. They present a new and serious challenge to open trade, market access and, in particular, America's economic future.[26]

China's "Made in China 2025" plan, for example, seeks to build up Chinese competitors in 10 strategic industries of the future, including aviation, advanced information technology, robotics, and new energy vehicles. The plan has three goals: (1) to ensure Chinese firms develop, extract, or acquire their own technology and intellectual property, (2) to substitute "domestic" technologies and products for foreign ones in order to achieve domestic market dominance, and (3) to boost China's market shares in world markets in the targeted industries.[27] The plan, for instance, calls for 70 percent "self sufficiency" in key sectors by 2025, including capturing 80 percent of China's domestic market for new energy vehicles, and a 90 percent domestic share for energy equipment.[28]

To achieve these goals, China is employing a wide range of policy tools – including many unfair or illegal measures. The USTR's ongoing Section 301 investigation of China's technology transfer, intellectual property, and innovation practices highlights four areas of particular concern.

First, China uses foreign ownership restrictions – including joint venture requirements – and administrative licensing and approvals to require or pressure American companies to transfer their technology. In an effort to evade WTO scrutiny, demands to transfer technology are increasingly made orally or through informal "administrative guidance." To many American technology businesses, China's demands are effectively "an offer they can't refuse." especially given the non-transparent and discretionary nature of China's regulatory system.[29]

Technology transfer pressures are particularly intense in sectors targeted by China's development plans. For example, China uses joint venture and other requirements to pressure foreign automakers and aviation suppliers to transfer their core innovative technologies to Chinese partners. It also employs restrictive and ambiguous regulations to effectively force U.S. cloud computing suppliers to turn over their technology, know-how, and brands. And China often requires foreign companies in key sectors – like information and communications technology (ICT), pharmaceuticals, chemicals, and advanced agriculture – to disclose unreasonable amounts of sensitive technical information in order to obtain required licenses and approvals – often to "expert panels" that include Chinese competitors.[30]

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Second, in addition to these pressures, China's mandatory rules prevent U.S. firms from freely negotiating market-rate licenses for their technologies. Among other things, China requires that foreign tech licensors assume all indemnity risks, mandates that the Chinese licensee own all improvements, and generally authorizes Chinese joint ventures to freely use the technology in perpetuity after 10 years.[31]

Third, China's government is directing and funding a highly coordinated effort by Chinese SOEs and private firms to acquire foreign tech firms and to assimilate and commercialize their know-how. China is particularly interested in scooping up American businesses in targeted and sensitive sectors like artificial intelligence, aviation, biotechnology, semiconductors, and renewable energy.[32]

Finally – despite a specific commitment by President Xi in September 2015 to stop the practice – there's extensive evidence that China is continuing to direct state-backed cyber espionage (including spying by units of the People's Liberation Army) against U.S. companies and to share the results with their Chinese competitors.[33]

THE TRUMP ADMINISTRATION'S RESPONSE

The Trump Administration has aggressively embraced challenging China's mercantilism, and it seems willing to risk a major trade conflict to change China's conduct. But does Trump have a winning strategy?

In its Section 301 investigation, the Administration seeks to counter China's unfair innovation practices through a combination of retaliatory duties, a new WTO case against China's discriminatory technology licensing, and tighter restrictions on China's U.S. investment.[34] Importantly, however, the Administration is also undertaking these initiatives in a broader strategic context – a protectionist "America First" trade policy that's radically altered the U.S. approach to trade and trade partners.[35]

Highlighting China's Challenge

The Administration should be commended for bringing greater urgency to the serious threat of China's state-driven industrial and trade policies to America's economic future. The USTR's detailed Section 301 investigation, in particular, underscores how China's comprehensive plans to build its economic future are based, often in significant part, on stealing America's.[36] This has contributed to a growing bipartisan consensus that China – and particularly China's supercharged, future-oriented mercantilism – must become a singular focus of American trade and economic policy.[37]

The President has been far less successful, however, in pursuing clear and consistent goals

– and effective tactics – to counteract this threat from China.

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Conflicting Goals

The Administration – and others – have repeatedly stressed that America's ultimate goal in dealing with China's technology mercantilism must be to eliminate China's discriminatory and predatory trade and industrial policies. Promises or half-measures by China or small-scale tactical wins can no longer be enough.[38] Achieving this difficult goal will require comprehensive, coordinated, long-term planning, and a disciplined focus.

Unfortunately, the Trump Administration is pursuing other goals with respect to China that distract from – and, indeed, undercut – the more vital effort to thwart China's unfair, state-driven innovation practices.[39]

Reducing the China Trade Deficit

The President – unlike virtually all mainstream economists – believes that bilateral trade balances are the ultimate scoreboard of America's trade success. To that end, the Administration has been pressing China for a $200 billion reduction in America's trade deficit with China.

Reducing the bilateral deficit is no easy matter, since the deficit is driven by the daily economic decisions of millions of American consumers – and will almost certainly be increased by recent tax cuts.[40] But, more importantly, achieving the blunt goal of reducing the deficit with China would do nothing meaningful to address the threat of China's high-tech mercantilism. China recently sought to provide Trump with a trade deficit "win" by making broad promises to buy more low-tech farm and energy commodities.[41] This won't stop China, however, from continuing and even expanding efforts to "assimilate" American high-tech know-how.[42]

The Administration appears to have squandered its negotiating capital on a highly questionable deficit-reduction goal – and America's economic future is no more secure.

Winning the Past

Similarly, Trump's laser-like focus on trade in "old economy" products like steel and aluminum is a distraction from the vital goal of addressing China's challenges to America's economic future.

To be sure, reducing China's subsidy-driven overcapacity in these products is important for American companies and workers. But the economic harm and uncertainty caused by the Administration's chaotic roll-out of ill-considered steel and aluminum tariffs has served only to antagonize foreign countries and business allies that America critically needs to address China's assimilation of global innovation. And, by basing steel and aluminum tariffs on a thinly-supported "national security" exception to WTO rules, the Administration has undercut America's global standing to oppose China's use of dubious national security rationales to justify its ongoing appropriation of American and foreign innovation.[43]

Despite the President's claims to the contrary, trade wars are neither good nor easy to win.[44] If the President is dead set on starting a major trade conflict with China, the objective should at least be about securing America's economic future – not the industries of its past.

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Damaging and Counterproductive Tactics

A number of the Administration's tactics in confronting China's technology mercantilism are similarly concerning and potentially counterproductive in confronting China's technology mercantilism.

Damaging Duties

The centerpiece of the Administration's Section 301 investigation is the proposed imposition of 25 percent duties on $50 billion – later potentially increased by the President to $150 billion – in Chinese-origin products. The list of proposed tariffs covers 1,300 tariff lines and includes aerospace, machinery, metals, and ICT products.[45]

While these duties may have gotten China's attention, they're unlikely to change China's conduct – and will cause significant collateral damage in the process.

It's important to remember that, while the proposed 25 percent duties would be imposed on Chinese-origin products, they would be *paid* by Americans and impose serious costs on the U.S. economy. Proposed tariffs on TV and camera parts, for example, would increase consumer prices,[46] while new tariffs on ICT products would reduce ICT investments, which are a key source of U.S. economic growth.[47] And time-consuming and expensive lobbying by companies and industry groups to secure special exemptions from the proposed duties would waste American business and government resources that might be better spent in pursuing joint efforts against Chinese abuses.[48]

There are also serious doubts that proposed unilateral tariffs will cause China to change its unfair innovation practices. Because many of the listed items are complex products that incorporate significant levels of third-country parts and/or are made by foreign-invested companies in China, the Administration's unilateral tariffs will harm – and likely alienate – important allies in the fight against Chinese mercantilism.[49] China's quick announcement of proposed retaliatory tariffs – including tariffs on all-American and politically sensitive exports like soybeans, cotton, meats, and whiskey, as well as aircraft and vehicles – demonstrates Beijing's willingness to escalate a trade conflict with targeted tariffs rather than abandon its mercantilist policies.[50] And, no country is more adept than China in pressuring trade partners by using "informal" measures as guerrilla tactics to impede trade.[51]

A tit-for-tat tariff war would seriously damage the American economy. U.S. tariffs on $150 million in Chinese-origin goods – combined with Chinese retaliation on $150 million in U.S. goods – would cost an estimated 455,000 American jobs, most in less-skilled sectors. The farm economy would be especially hard hit – farm incomes would decline by 15 percent and the sector would lose some 181,000 jobs.[52]

"Go-It-Alone-ism"

While America is a particular target of China's unfair innovation practices, it's far from the only one. Innovative companies in Europe, Japan, Korea, and elsewhere also face serious threats to their intellectual property in China and should be natural allies in opposing China's practices.[53]

Unfortunately, "America First" often means that America acts alone. In its trade actions on steel and aluminum, for example, the Administration ignored joint approaches to common problems in favor of unilateral tariffs that target key allies – and continues to alienate allies by demanding concessions as the price of tariff exemptions.[54] Trump's ill-advised withdrawal from the Trans-Pacific Partnership (TPP) removed American support from an alliance that's advancing new rules to help curb digital protectionism and unfair competition by State-Owned Enterprises (SOEs) – key pillars of China's innovation mercantilism.[55] Moreover, as Trump has alienated foreign businesses with ill-targeted tariffs and trade actions, he's made them less likely to make common cause – and more likely to take American business – in any trade conflict with China.[56]

Transactional Wins/Impossible Requests

There's significant concern that President Trump may undercut the long-term, strategic effort required to address Chinese technology mercantilism by, instead, focusing on smaller, short-term "wins."[57]

After President Xi pledged to reduce China's tariffs on U.S. autos, for example, Trump was effusive in his praise on Twitter, even though industry sources noted that Xi's promises were largely inconsequential, and old pledges that China has yet to fulfill.[58] China is similarly seeking to deflect the Administration's attention away from its high-tech mercantilism by promising to buy more low-tech farm and energy commodities. And Trump's apparent willingness to bargain away sanctions on China's ZTE – for illegally transferring American technology – for deficit reduction is especially troubling.[59]

To succeed in the difficult task of reining in China's abusive technology policies, Trump will need to resist his tendency to declare victory and go home.

Chinese leaders are adept at telling negotiating partners what they want to hear. To succeed in the difficult task of reining in China's abusive technology policies, Trump will need to resist his tendency to declare victory and go home.[60]

At the same time, the Administration's hardline demands that China essentially upend its economic system won't work either.[61] For instance, requiring that China cease support for Made in China 2025 and tolerate U.S. import restrictions on related products – which U.S. negotiators recently proposed in Beijing talks[62] – is a waste of American negotiating capital and undercuts the critical task of eliminating the many discriminatory and predatory measures that China uses to advance its industries to America's detriment.

A SMARTER STRATEGY

Developing a tough and effective response to China's growing technology mercantilism is not easy, and has posed a vexing challenge for previous U.S. administrations of both parties. While the Trump Administration deserves credit for bringing much-needed attention to China's threat, its impulsive strategy – based on duties that damage America's economy and "America First" policies that alienate allies – is flawed. America should keep all options on the table in opposing China's abusive innovation practices, including, potentially, targeted and intensifying trade sanctions.[63] But these tactics must be part of a smarter, focused, long-term U.S. strategy for confronting China and securing America's economic future – while keeping global markets open for trade. We outline some key elements of such a strategy below.

International Cooperation

Enlisting Allies

To confront China's mercantilism, America needs to work more closely with its trade partners. China's unfair policies and practices seriously threaten innovative businesses in many countries, and they – and their governments – can be key allies in pushing back. But it's hard to build a "trade coalition of the willing" against China when the Administration needlessly antagonizes allies, as it has, for example, with ham-handed threats and 11th-hour deadlines in the steel and aluminum cases.[64] America will always have disagreements with its friends, but it needs their support in countering the fundamental challenge posed by China's abusive innovation practices.

Using the WTO

Despite the President's suggestions to the contrary, America has a good record of "winning" at the WTO when challenging trade violations by China and others.[65] The Administration's launch of a WTO case against China's abusive technology licensing rules is an important step in confronting China's illegal practices. The United States needs to use the WTO much more aggressively – ideally, working closely with allies in Europe, Japan and elsewhere – to launch a bold series of WTO challenges to China's other rules violations, such as China's repeated failures to disclose subsidies and abide by transparency obligations, its standards practices, and its abusive restrictions on cloud computing.[66]

And, instead of denigrating the WTO and lecturing trading partners on the virtues of "America First" trade protection, the United States should take every opportunity to use global forums to advocate for open markets, while forcefully calling out the hypocrisy of mercantilist China's professed love for free trade.[67]

Writing New Rules

Unfortunately, many of China's unfair innovation practices aren't covered by existing global trade rules. America needs to again take the lead in establishing new rules and norms, including rules to limit digital protectionism, the abuse of regulatory requirements, and unfair competition by SOEs. This will require actively reengaging with allies in North America, the TPP, Europe, and elsewhere in a variety of forums – including forums outside the WTO. The long-term goal of this effort should be an ever-widening network of countries that explicitly rejects key pillars of China's state-interventionist model and supports modern trade rules that help assure a fair and level playing field for global innovation.

Focused, Results-Oriented Negotiations

The United States also needs to speak with a single voice, have focused goals, and expect specific results in negotiating with China about its abusive mercantilism.

The Administration should designate a single, high-level official to negotiate with China about core trade issues related to China's unfair innovation practices. This official should also actively seek cooperation from allies on those issues. Trump's "Team of Trade Rivals" have widely divergent – and often conflicting – views. Sending them all to recent negotiations in China sent an especially confusing message to Chinese leaders on what America actually wants.[68]

The Administration should make it clear to China that America's overriding negotiating objective should be ending China's use of abusive practices to harm American competitors in innovative industry sectors.

It should be equally clear that the United States is not asking China to abandon "Made in China 2025" or similar industrial plans; rather, it demands that China stop using discriminatory and mercantilist means to advance those plans.

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The Administration should also pare down bloated economic talks with China to focus on core issues and should seek specific and verifiable commitments from China.[69] For example, it should press China to stop abusive technology transfer practices – and seek to verify any progress by asking for legal authority to require that American companies report licensing activity in China to the U.S. Government on a confidential basis.[70]

Congressional Engagement

Congress should play a more active role in setting U.S. strategy and providing necessary tools to confront China's innovation mercantilism.

Congress should establish a clear set of negotiating objectives for China – on intellectual property, SOEs, digital protectionism, cyber espionage, etc. – that underscore the primacy of confronting China's abusive technology practices. It should also work with its legislative counterparts in other countries to internationalize those objectives and to catalogue China's abuses. Additionally, Congress should provide additional resources to the USTR and other agencies to support ramped-up investigation, consultation, and enforcement related to China's unfair trade and technology practices, including its cyber espionage.[71]

Congress should amend current law to broaden Executive Branch authority to use national security investment reviews by the Committee on Foreign Investment in the United States (CFIUS), export controls, and other tools to address national security and industrial base threats posed by China's acquisitions and technology demands. At the same time, Congress should assure that these measures are workable[72] and – unlike many measures in China – that they are not disguised barriers against legitimate trade.

Finally, Congress should establish an escalating series of sanctions that would kick in if China fails to make rapid and verifiable progress in eliminating abusive innovation practices.

These might include reciprocal rules restricting Chinese technology licensing, the withdrawal of U.S. scientific and technical cooperation, and/or targeted sanctions on Chinese products that are based on stolen or unfairly obtained American know-how.

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BUILDING THE FUTURE

America's innovation ecosystem is an

extraordinary driver of U.S. jobs and growth. But other countries are working hard to catch up. In addition to its unfair practices, China is spending massively to upgrade its own innovative capacity. China's gross domestic spending on research and development is growing by some 18 percent annually and is poised to surpass the United States in the next few years.[73]

Meanwhile, the United States risks losing its innovative edge. Federal funding for basic research has effectively declined since 2008 – and that's before taking into account the Trump Administration's efforts to slash funding for the National Science Foundation and the National Institutes of Health. America's universities conduct half of federally funded basic research. But vital research capacity at many public universities, particularly in the Midwest, is being hollowed out by deep cuts in state budgets.[74] The Trump Administration has also sought to de-fund manufacturing innovation programs like the Manufacturing Extension Partnership, which helps small and mid-sized American companies compete by becoming more innovative and efficient.[75]

Working to secure industries of the future from China's mercantilist threats is critical. But it's equally vital that America continue to aggressively build that future. This requires smart investments – in education, infrastructure, basic research, and commercialization – to support American innovators as they create and grow the industries and jobs of tomorrow.

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