

## The Art of the China Deal

Trump's Section 301 China IPR-related Tariffs and Investment Measures

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Institute for China-America Studies

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## Executive Summary

United States-China trade, investment and intellectual property rights (IPR)-related relations remain in the balance. While it was feared that an action-reaction cycle of trade sanctions and investment restrictions could have broken out as early as June 2018, that threat has been placed on hold. During the third week of May, the U.S. and China arrived at a principles-based consensus to defuse their trade, investment and IPR-related quarrels. In exchange for markedly increased Chinese purchases of U.S. natural gas and agricultural products as well as near-term, pro-market liberalization of its restrictive foreign inward investment regime, the threat of tariff raises on \$50 billion worth of Chinese exports to the United States is to be suspended, going forward. While the U.S.-China trade war that Candidate and, thereafter, President Donald Trump had threatened now appears to be under control, episodic spikes in tension should not be discounted – particularly as the Trump administration jockeys for advantage to press home its market access demands during the implementation phase of their joint consensus. If that consensus falls through, though, during this implementation phase, the U.S. and China could well find themselves again on the cusp of one of the most significant trade conflicts witnessed in the international system in many decades.

The aggravated U.S.-China trade and investment frictions can be traced to the March 2018 release of an investigation report on China's technology transfer, intellectual property rights (IPR) and innovation practices, conducted under Section 301 of the Trade Act of 1974. In the report, the United States Trade Representative (USTR) determined that China had consistently engaged in the acquisition of foreign technologies through acts, policies and practices by the Chinese government that were unreasonable or discriminatory and which had burdened, restricted and penalized U.S. commerce. Subsequently, the Trump administration laid out an elaborate course of follow-on actions, including the proposed imposition of a 25 percent duty on 1,333 tariff lines of Chinese exports to the United States worth \$50 billion. Additional remedies were also proposed. In response, China threatened its own counter-retaliation. Dueling cases were also filed within the World Trade Organization's (WTO) dispute settlement system.

The United States is not wrong to argue that China uses foreign ownership restrictions, including joint venture requirements and administrative licensing procedures to induce and, in many cases, *de facto* pressure U.S. companies to transfer technologies to Chinese entities. Furthermore, a series of promises by China to liberalize its foreign inward investment regime to a more reciprocal basis, as well as cut down on its allegedly offending technology transfer policies and practices have not been translated into action. Equally, China is not wrong to argue that its foreign inward investment regime, including joint venture requirements, is *de jure* consistent (with minor exceptions) with its international treaty obligations, notably the World Trade Organization's (WTO) Trade-Related Investment Measures (TRIMs) Agreement and the Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement. China is not obliged to provide unreciprocated concessions to the United States in excess of international treaty rules – rules that it had no part in writing in the first place but ones it faithfully adheres to. The bilateral promises constitute no more than 'best endeavor' efforts; they are not legal commitments.

The United States is in the wrong to threaten the imposition (now placed on hold) of a 25 percent duty on 1,333 tariff lines that cover approximately \$50 billion worth of Chinese exports to the United States. The tariffs, if imposed, will violate fundamental principles of international trade law such as the non-

discrimination principle (most favored nation) and the predictability principle (related to tariff bindings). It will also procedurally violate the United States' legal obligation to submit its claims first to the WTO's dispute settlement body and, until that body rules, stay its hand on enforcement action. It is disturbing that the Trump administration would inflict the most regressive trade policy measures since the Smoot-Hawley tariff impositions of the early-1930s Great Depression era against a major trading partner on the basis of that partner having committed, at best, a marginal illegality. By its own account, USTR admits that China is broadly compliant with its international trade (TRIPs and TRIMs) commitments and that the United States' legal case is confined to relatively technical second-tier lapses within China's intellectual property rights (IPR) regime.

Going forward, if the United States wishes to penalize China for its allegedly abusive practices, it should restrict its actions to the area of investment flows. Investment rules in the multilateral system are shallow, so there is no bar to unilateral remedies, and President Trump enjoys broad domestic authority to impose a variety of tailored restrictions on Chinese inward investment flows and on China-bound U.S. technology transfer flows. The U.S.' CFIUS (Committee on Foreign Investment in the United States) mechanism as well as the export control process confer wide-ranging authority to the president to impose restrictions or bans on investments in sensitive sectors. From a competitive economic standpoint, President Trump could decree that the embedded intellectual property of key systems technologies in the strategic advanced manufacturing sectors enumerated in the *Made in China 2025* plan are barred from acquisition by Chinese entities in the U.S. Furthermore, if such core technologies are worked on in China by a U.S. enterprise, it must take place in the context of a fully or majority-owned investment structure. Be it batteries, drive or control systems in electric cars, advanced materials and flight control systems in the case of aircraft, or chips and power electronic applications in integrated circuits, President Trump could unilaterally proclaim that these technologies must be proprietarily retained in-house and cannot be sold to or shared with a Chinese entity. At this time, it appears that the U.S. executive and congressional branches are proceeding in unison with measures more or less along these lines.

It is worth pondering the effects of President Trump's pressure on China to liberalize its foreign inward investment regime. Should President Xi Jinping engineer a far-sighted liberalization of China's investment regime - much like Deng Xiaoping had engineered of its trade regime three decades ago - China will become the advanced manufacturing center, and *leader*, of the world by mid-century. And for having facilitated this dynamic shift of advanced industrial processes and technologies eastward, Donald Trump may well come to be remembered as one of the great offshoring presidents of the United States.

# Introduction

On November 8, 2016, Donald Trump defeated his Democratic Party challenger Hillary Clinton in a bruising race, despite having trailed in virtually every authoritative poll in the weeks and months leading into the election. Candidate Trump pulled off narrow but remarkable victories in the “swing” states of Ohio, Pennsylvania, Michigan and Wisconsin. In these states a disproportionate share of manufacturing workers, particularly low-wage manufacturing workers, were exposed to the forces of globalization. The job insecurity and deep resentment among predominantly white men and women in affected communities were important factors that tipped the election in Trump’s favor.

**DONALD J. TRUMP'S SEVEN POINT PLAN TO REBUILD THE AMERICAN ECONOMY BY FIGHTING FOR FREE TRADE**

-  Withdraw from the Trans-Pacific Partnership, which has not yet been ratified.
-  Tell NAFTA partners that we intend to immediately renegotiate the terms of that agreement to get a better deal for our workers. If they don't agree to a renegotiation, we will submit notice that the U.S. intends to withdraw from the deal. Eliminate Mexico's one-side backdoor tariff through the VAT and end sweatshops in Mexico that undercut U.S. workers.
-  Instruct the Treasury Secretary to label **China** a currency manipulator.
-  Direct the Secretary of Commerce to identify every violation of trade agreements a foreign country is currently using to harm our workers, and also direct all appropriate agencies to use every tool under American and international law to end these abuses.
-  Appoint tough and smart trade negotiators to fight on behalf of American workers.
-  Instruct the U.S. Trade Representative to bring trade cases against **China**, both in this country and at the WTO. **China's** unfair subsidy behavior is prohibited by the terms of its entrance to the WTO.
-  Use every lawful presidential power to remedy trade disputes if **China** does not stop its illegal activities, including its theft of American trade secrets - including the application of tariffs consistent with Section 201 and 301 of the Trade Act of 1974 and Section 232 of the Trade Expansion Act of 1962.

Source: *Trump for President* (2016)

Candidate Trump campaigned on an unabashedly anti-trade platform, with China listed as a key economic violator. Three of seven points of his centerpiece economic plan to rebuild the American economy and “Make America Great Again” were outright mercantilist or protectionist initiatives that related to China. In that **Seven Point Plan**, Trump promised to “use every lawful presidential power to remedy trade disputes if China [did] not stop its illegal activities, including its theft of American trade secrets” and presented an unusually detailed list of statutory and unconventional trade policy enforcement tools – Section 232 of the Trade Expansion Act of 1962; Section 201 and Section 301 of the Trade Act of 1974 – with which he would punitively sanction China (Donald Trump, 2016).

True to his promise, in January 2018, President Trump signed a safeguard proclamation under Section 201 of the Trade Act of 1974, imposing tariffs and tariff rate quotas on imports of Chinese (among others) solar cells and modules and manufactured washing machines. The safeguards action was the first in 16 years. On March 8, 2018, he continued by imposing a global tariff (with exceptions) of 25 percent on steel imports and 10 percent on aluminum imports, following a sweeping national security-related investigation conducted under Section 232 of the Trade Expansion Act of 1962 (White House, 2018 a). The probe was the first of its kind since a similar one launched on iron and steel in 2001. Finally, on August 18, 2017, Trump’s United States Trade Representative (USTR), Robert Lighthizer, ‘self-initiated’ an investigation of Chinese technology transfer, intellectual property rights (IPR) and innovation practices under Section 301 of the Trade Act of 1974. Although USTR Lighthizer had until August 18, 2018 to prepare the report, the findings were formally released on March 22, 2018.



## Trump's Presidential Memorandum on China's IPR Policies and Practices

The Section 301 investigation of China's technology transfer, intellectual property rights (IPR) and innovation policies produced a (predictably) damning report of Beijing's regulations and practices (US Trade Representative, 2018 a). The findings, which were categorized under four heads, were as follows:

- First, China uses foreign ownership restrictions, such as joint venture requirements and foreign equity limitations, and various administrative review and licensing processes, to force technology transfer from U.S. companies;
- Second, China's regime of technology regulations forces U.S. companies seeking to license technologies to Chinese entities to do so on non-market-based terms that favor Chinese recipients;
- Third, China directs and unfairly facilitates the systematic investment in, and acquisition of, U.S. companies and assets by Chinese companies to obtain cutting-edge technologies and intellectual property and generate the transfer of technology to Chinese companies;
- Fourth, China conducts and supports unauthorized intrusions into, and theft from, the computer networks of U.S. companies to access their sensitive commercial information and trade secrets.

The essence of USTR's Section 301 Investigation Report findings is that China, in its rush to become a strategically advanced manufacturing superpower, engages in the acquisition of foreign technologies through acts, policies, and practices by the Chinese government that are unreasonable or discriminatory and burden or restrict U.S. commerce. These acts, policies and practices, which work collectively as part of a multi-faceted strategy to advance China's industrial policy objectives and are implemented through a diverse set of state and state-backed actors, are unfair and harmful to U.S. commercial interests and undermine the fairness and balance of the international trading and investment system.

The essence of USTR's Section 301 Investigation Report findings is that China engages in the acquisition of foreign technologies through acts that are discriminatory and unfair.

### **China's Technology-led Industrial Policy Drive**

China has long aspired to be an economic and technological superpower and its industrial policies since the early-to-mid 2000s have been geared towards achieving this goal of becoming a global leader in a wide range of technologies, especially advanced technologies.

The beginnings of this quest for technological superpower-dom can be traced to a pivotal document in the mid-2000s articulating China's long-term technology development strategy – the *National Medium and Long-Term Science and Technology Development Plan Outline (MLP)* of 2005. The *MLP* identified 11 key sectors, and 68 priority areas within these sectors, for technology development. It designated eight fields of “frontier technology,” within which 27 “breakthrough technologies” were to be pursued.

The *MLP* also established the cross-cutting goal of reducing the rate of dependence on foreign technologies in the identified sectors to below 30 percent by the year 2020.

In 2010, the Chinese government announced another seminal technology development strategy, which called for the accelerated development of seven so-called “strategic emerging industries” (SEIs): (1) energy efficient and environmental technologies, (2) next generation information technology, (3) biotechnology, (4) high-end equipment manufacturing, (5) new energy, (6) new materials, and (7) new energy vehicles. The *12th Five-year National Strategic Emerging Industries Development Plan (12th Five-year SEI Plan)* subsequently recommended specific fiscal and taxation policy support and set a target for SEIs to account for 8 percent of China’s economy by 2015 and 15 percent by 2020.

In a similar vein, the State Council released the *Made in China 2025 Notice* five years later. *Made in China 2025* is Beijing’s ten-year plan for targeting ten strategically advanced technology manufacturing industries for promotion and development: (1) advanced information technology; (2) robotics and automated machine tools; (3) aircraft and aircraft components; (4) maritime vessels and marine engineering equipment; (5) advanced rail equipment; (6) new energy vehicles; (7) electrical generation and transmission equipment; (8) agricultural machinery and equipment; (9) new materials; and (10) pharmaceuticals and advanced medical devices (Xinhuanet 2015). The *Made in China 2025 Notice* expressly calls for China to achieve 40 percent “self-sufficiency” by 2020, and 70 percent “self-sufficiency” by 2025, in core components and critical materials in a wide range of industries, including aerospace equipment and telecommunications equipment.

Importantly, China’s industrial policies reflect a top-down, state-directed approach to technology development. Introducing, digesting, absorbing and re-innovating (IDAR) foreign intellectual property and technology is a key aspect of this technology development approach.

On March 22, 2018, pursuant to these findings, President Trump issued a **Presidential Memorandum** which laid out a three-part course of follow-on action (White House, 2018 b).

- First, to address China’s allegedly discriminatory IPR practices, Trump directed USTR Lighthizer to publish within 15 days (of March 22, 2018) a proposed list of Chinese products that were to be subjected to **tariff increases**. Following a public notice, comment and consultation period, a final list of proposed tariff increases is to be published by June 15, 2018;
- Second, Trump directed USTR Lighthizer to pursue **dispute settlement in the World Trade Organization (WTO)** against China’s IPR practices and report back to him on the status of action within 60 days;
- Third, Trump directed his Treasury Secretary, Steven Mnuchin, to provide a strategy to erect **investment restrictions** against Chinese inward and China-destined outward investment, thereby addressing concerns in the U.S. about investment directed or facilitated by China in industries or technologies deemed important. Mnuchin, too, was tasked to report back to the White House within 60 days. A specific list of investment restrictions and enhanced export controls related to the acquisition of industrially significant technologies by Chinese entities is slated to be announced on June 30, 2018.

## Developments Since the Issuance of Trump’s Presidential Memorandum

**TARIFFS-RELATED:** Following President Trump’s memo, **on April 3, 2018, USTR Lighthizer recommended that a 25 percent duty covering 1,333 tariff lines be applied to about \$50 billion worth of Chinese exports to the United States.** The proposed tariffs cover a range of items including semiconductors, engines, agricultural and textile machinery, batteries, tires, industrial robots, medical products and instruments used in aeronautical and space navigation. Importantly, Lighthizer’s Public Notice specifically noted that the identified products include those that are slated to benefit from the “Made in China 2025” industrial policy plan (US Trade Representative, 2018 b). The 1,333 products on the U.S. retaliation list represent about 9.4 percent of total U.S. imports from China. The highest dollar-value items on the list are flat-panel TVs (\$3.89 billion), followed by mid-size cars (\$1.42 billion), printer parts (\$1.35 billion), aluminum alloy plates (\$1.08 billion) and computer disc drives (\$882 million). Following a public comment period, a final list of covered imports, which are proposed to be subject to tariff increases, is expected to be announced by June 15, 2018. The tariffs are not expected to go into effect immediately and may in fact be shelved indefinitely.

**The next day, April 4, 2018, China’s Ministry of Commerce (MOFCOM) issued its own retaliatory list of 106 U.S. products on which an equivalent \$50 billion amount of tariff increases are to take effect** – if the United States carries through with its proposed tariff increases. Just three products account for 71 percent of the total coverage (US Department of Agriculture, 2018). They include aircraft (\$14.05 billion), soybeans (\$13.96 billion) and mid-size engine cars (\$10.32 billion). On April 5, 2018, Donald Trump – in response to China’s tariff retaliation threat – upped the ante and threatened to impose an additional \$100 billion of tariffs on Chinese exports to the United States. However, no specific list of products or tariff lines has been identified so far.

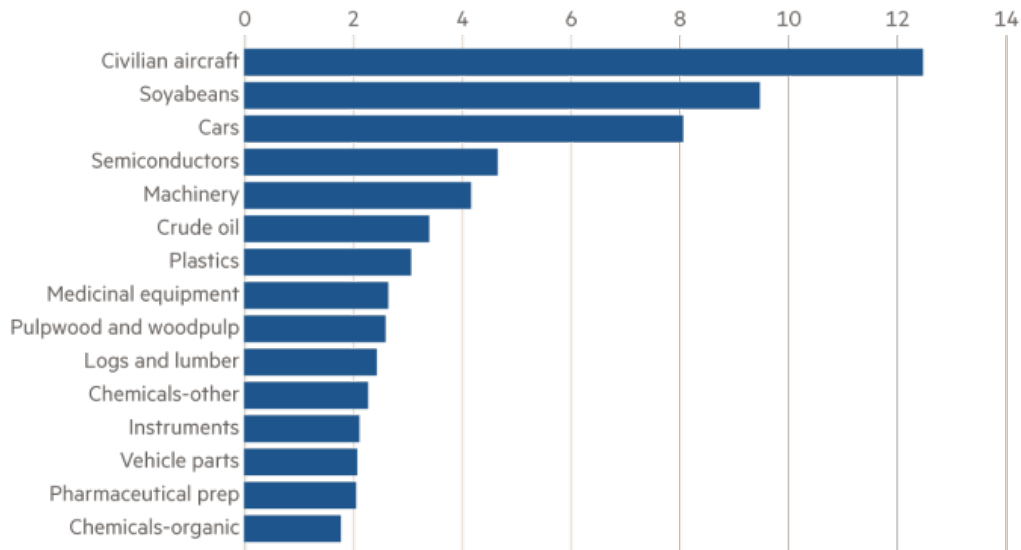
The Section 301 tariffs, *if implemented*, will constitute the single most damaging and regressive trade policy action since the Great Depression-era Smoot-Hawley tariff increases of the early-1930s (Irwin, 1996). It is disturbing that the Trump administration would inflict such an indiscriminate measure against a major trading partner on the basis of that partner having committed, at best, a marginal illegality. At a World Trade Organization (WTO) Dispute Settlement Body (DSB) meeting on March 27, 2018, the U.S. representative implicitly admitted that China was broadly compliant with its international trade commitments and that the United States’ legal case was confined to relatively technical second-tier lapses within China’s intellectual property rights (IPR) regime. **On “three [of four] categories of measures covered in the U.S. [Section 301] investigation,” including the key charge of forced technology transfers, the U.S. representative acknowledged that China’s**

The Section 301 tariffs, *if implemented*, will constitute the single most damaging and regressive trade policy action since the Great Depression-era Smoot-Hawley tariff increases.

policies and practices did “not appear to implicate (any) specific WTO obligation” (World Trade Organization, 2018 a).

### What the US exports most to China

In 2017 (% of total)



Source: US Census Bureau

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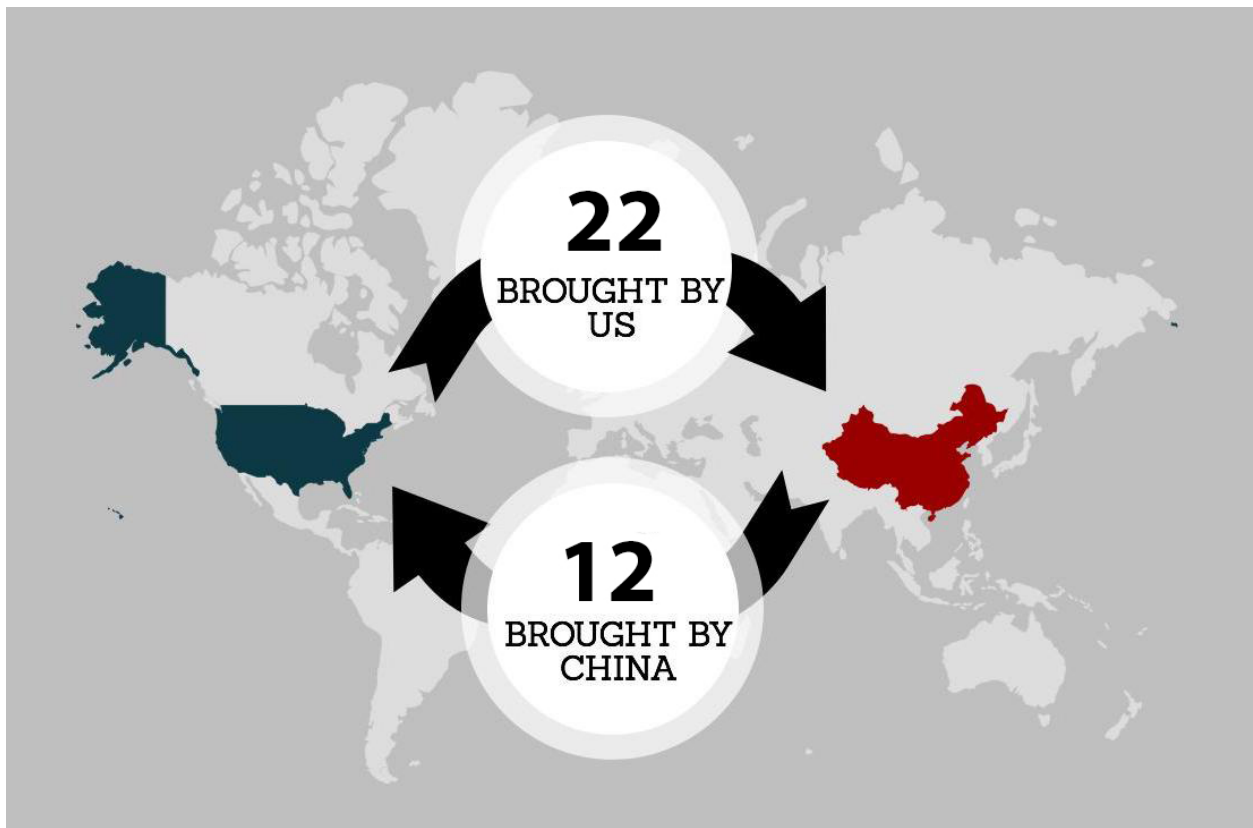
**WTO DISPUTE SETTLEMENT-RELATED:** On March 23, 2018, a day after the Presidential Memorandum, USTR Lighthizer issued a **Request for Consultation** to the Chinese Government’s representative at the World Trade Organization in Geneva, **which alleged that China was in violation of certain technical aspects of its WTO TRIPs (Trade-Related Aspects of Intellectual Property Rights) Agreement-related commitments** (US Trade Representative, 2018 c). A Request for Consultation is the first step towards launching a dispute against another member over an alleged WTO violation. Under Article 4.3 of the Dispute Settlement Understanding (DSU), China had 10 days to reply to the U.S.’ consultation request and must enter into consultations within 30 days. If the consultations do not resolve the matter, the United States could request the establishment of an arbitral panel 60 days after filing for consultations. The first request for a panel can be rejected, but a second request cannot be blocked. Although the 60-day clock ran out on May 22, 2018, the U.S. has yet to request the establishment of a panel.

The U.S.’ **Request for Consultation** alleged **two specific violations** (World Trade Organization, 2018 b):

- First, China denies foreign patent holders the ability to enforce their patent rights against a Chinese joint-venture party after a technology transfer contract ends. Because domestic patent holders continue to enjoy this right after a technology transfer contract ends, China’s policies and practices amount to a violation of the WTO’s “national treatment” rules;
- Second, China imposes mandatory adverse contract terms that discriminate against and are less favorable towards imported foreign technology. These relate to clauses that require foreign licensors to indemnify Chinese licensees for potential liabilities for infringement resulting from

use of the transferred technology, as well as clauses that provide that any improvements in imported technology belong to the joint venture party making the improvement, irrespective of agreements among the parties. Because China’s policies and practices do not place a similar indemnification and improvements-related burden on domestic licensors, these policies and practices, as such, amount to a violation of the WTO’s “national treatment” rules.

In its Request for Consultation, USTR listed out a number of technical provisions in Chinese laws and regulations, notably within the *Law of P.R. China on Chinese-Foreign Equity Joint Ventures*; *Contract Law of P.R. China*; *Regulations for the Implementation of the Law of P.R. China on Chinese-Foreign Equity Joint Ventures*; and *Regulations of P.R. China on the Administration of the Import and Export of Technologies*, which it alleges violate TRIPs Article 3 (related to national treatment) and Article 28 (related to patent rights). **In essence, the Trump administration argues that Beijing deprives U.S. intellectual property rights holders of the ability to protect their intellectual property rights in China, as well as freely negotiate market-based terms in licensing and other technology-related contracts.** Japan and the European Union have joined the case as third parties, as WTO rules allow, and Tokyo, in particular, has made a similar “national treatment”-related argument going back to a Transitional Review Meeting (TRM) of the TRIPs Council in October 2011 (Japan Ministry of Economy, Trade and Industry, 2017). It is likely that a WTO panel will rule that China needs to tweak its relevant laws and administrative regulations to bring them into compliance with its TRIPs obligations.



Source: World Trade Organization (2018a)

On April 4, 2018, in response to the proposed imposition of \$50 billion of tariffs, **China initiated its own Request for Consultation at the WTO challenging the American measure** (World Trade

Organization, 2018 b). **The Request for Consultation states that the U.S.’ proposed tariffs violate Articles I.1 and II.1(a) and (b) of the General Agreement on Tariffs and Trade (GATT) as well as Article 23 of the WTO’s Dispute Settlement Understanding (DSU).** GATT Article I.1 establishes the WTO's most-favored nation principle. GATT Article II.1(a) and (b) commits WTO members to not exceed bound tariff rates. DSU Article 23, titled “Strengthening of the Multilateral System,” says members will use the WTO's dispute settlement mechanism to seek redress of WTO violations. The U.S. issued a subsequent rejoinder declaring that because no tariff measures had actually been adopted, China was in no position to bring forth a case - at least at this time.

**INVESTMENT RESTRICTIONS-RELATED:** The proposed investment restrictions are the least developed aspect of the Trump administration’s Section 301 response, to date. It is understood that, until recently, the U.S. Treasury Department was studying two key China-related investment restriction-related measures: **First, the Trump administration was exploring whether it should trigger the International Emergency Economic Powers Act (IEEPA), which gives the president broad authority to regulate commerce “to deal with an unusual and extraordinary threat with respect to a national emergency.”** Following the declaration of a “national emergency,” which could pertain simply to a threat to the economy or foreign policy of the United States (and does not have to extend to a national security emergency), IEEPA empowers the president to:

*investigate, block during the pendency of an investigation, regulate, direct and compel, nullify, void, prevent or prohibit, any acquisition, holding, withholding, use, transfer, withdrawal, transportation, importation or exportation of, or dealing in, or exercising any right, power, or privilege with respect to, or transactions involving, any property in which any foreign country or a national thereof has any interest by any person, or with respect to any property, subject to the jurisdiction of the United States.*

With IEEPA powers under his belt, Trump could have imposed – if he so chose - virtually any investment or acquisition-related restriction on Chinese entities (Jeydel and Egan, 2018). These restrictions would be policed by the Treasury Department’s Office of Foreign Asset Control (OFAC), which enjoys strong civil enforcement power.

Alongside the consideration of IEEPA, **the Trump administration was also reviewing the scope of expanding the regulatory jurisdiction of CFIUS (Committee on Foreign Investment in the United States)** – the U.S. Treasury-led inter-agency committee tasked with reviewing foreign-origin inbound investments for national security concerns (US Department of Treasury, 2012). As per this option, the body’s jurisdiction would be expanded to include joint ventures in which intellectual property held by a U.S. firm is transferred abroad, as well as provisions that would strengthen oversight of certain non-controlling investments in U.S. firms by foreign entities. This would sweep in Chinese persons or entities-related deal structures, such as minority stakes in domestic joint ventures, seed-stage venture capital financing and IP licensing, as well as greenfield investments. A “China track” within the CFIUS process could also be created whereby CFIUS would enjoy specific authority to regulate and restrict China-specific inbound acquisitions and outbound U.S. technology transfers.

**Examples of Equity Restrictions and Local Partner Requirements in China’s 2017  
Foreign Investment Catalogue**

<b>Sector</b>	<b>Summary of Requirements</b>
Selection and cultivation of new varieties of crops and production of seeds	Chinese party must be the controlling shareholder.
Exploration and development of oil and natural gas	Limited to CJV or EJV
Manufacturing whole automobiles	Chinese party’s investment cannot be lower than 50 percent, and the same foreign investor may establish no more than two JVs in China for the same kind of automobiles, subject to certain exceptions.
Manufacturing commercial aircraft	Chinese party must be the controlling shareholder.
Construction and operation of nuclear power plants	Chinese party must be the controlling shareholder.
Value-added Telecommunications Services	Foreign investment cannot exceed 50 percent, excluding e-commerce, and is limited to WTO commitments. Note that China classifies a broad range of internet and technology-related services under this sector.
Basic telecommunications services	Chinese party must be the controlling shareholder and foreign investment is limited to WTO commitments.
Banks	Foreign financial institution investment cannot exceed 20 percent or 25 percent depending on how the investment is structured.
Medical institutions	Limited to CJV or EJV.
Surveying and mapping companies	Chinese party must be the controlling shareholder.

Source: China Foreign Investment Catalogue (2017 Amendment)

**At time of writing, it is understood that the Trump administration has dropped the IEEPA option and is leaning towards a slimmed-down version of the CFIUS option.** As per this option, CFIUS will *not* enjoy the authority to review outbound investments, including China-bound technology transfers. That will instead remain under the purview of a broadened export control system. Specifically, an inter-agency process, led by the president, is to be constituted that will identify emerging technologies that are to be subject to U.S. export controls. Following a determination within this inter-agency process, the Commerce Secretary will be authorized to establish and regulate controls on such technologies. For its part, **the authority of CFIUS is to be expanded to cover four additional types of inbound investments and transactions:** (a) “non-passive” investment by a foreign person into critical technology or a critical infrastructure company; (b) any change in a foreign investor’s rights in relation to a U.S. business; (c) any action designed to evade or circumvent CFIUS; and (d) the purchase, lease or concession to, or by, a foreign person of real estate in close proximity to sensitive national security facility or military base.

It is expected that this expansion of CFIUS’ regulatory authority will sweep in Chinese transactions that have hitherto been viewed with suspicion. These include acquisitions that could result, initially or eventually, in the transfer of U.S. technology and intellectual property to Chinese entities *even absent a shift in ownership of the U.S. company to the Chinese entity*. The Trump administration is currently

working with Congress to write this expansion of CFIUS' writ as well as that of the U.S. export control system into law (Covington & Burling, 2018). **By June 30, 2018, the U.S. Treasury Department is expected to publicly release the specific investment restrictions and enhanced export controls against Chinese persons and entities related to the acquisition of industrially significant U.S. technology.**



## Recent U.S.-China Trade, Investment and IPR-related Consultations

During a short but intense three-week period of consultations in May 2018, the United States and China were able to arrive at a principles-based consensus to partially resolve their deep-seated trade, investment and intellectual property rights-related differences.

The consultations got off to a rocky start. The first round of meetings was held in Beijing during the first week of May. The visiting U.S. delegation was led by Treasury Secretary Steven Mnuchin and included U.S. Trade Representative Robert Lighthizer, White House economic adviser Larry Kudlow, U.S. Ambassador to China Terry Branstad, Commerce Secretary Wilbur Ross, White House trade

The U.S. side made eight far reaching demands, with the broader intent to make the bilateral trade and investment relationship less unbalanced.

adviser Peter Navarro and the deputy assistant to the President for international economic affairs, Everett Eissenstat. At the meeting, the U.S. side made eight far-reaching demands, with the broader intent to make the bilateral trade and investment relationship less unbalanced (Inside US Trade, 2018).

First, the U.S. side demanded that **China reduce its trade surplus** by \$100 billion in 12 months, beginning on June 1, and by an additional \$100 billion over the following 12 months, such that the U.S. trade deficit with China will have decreased compared to 2018 by at least \$200 billion by the end of 2020. China's additional purchase of U.S. goods was to account for 75 percent of the first \$100 billion reduction and 50 percent of the second reduction.

Second, on **intellectual property rights**, the U.S. side demanded that China end government support to industries highlighted in the *Made in China 2025* plan as well as eliminate particular policies and practices with respect to technology transfer by January 1, 2019. Beijing was also asked to ensure that all Chinese-government conducted and sponsored cyber intrusions into U.S. commercial networks and cyber-enabled theft targeting U.S. companies be terminated. In this context, the U.S. side further demanded that China withdraw its Request for Consultations at the WTO over the U.S.' proposed Section 301 tariffs, as well as commit to not taking further action on the matter within the WTO's dispute settlement system.

Next, **with regard to Chinese investment in the U.S.**, the U.S. side demanded that China cease challenging, opposing or taking any retaliatory action even if the U.S. went ahead and restricted Chinese investments in sensitive U.S. technology sectors or sectors critical to U.S. national security.

Fourth, **with regard to U.S. investment market access in China**, the U.S. demanded that China issue an improved nationwide negative list for foreign investment by July 1, 2018. Sectors on negative lists are closed to foreign investment. Within 90 days thereafter, the U.S. would identify existing Chinese investment restrictions that denied American investors fair, effective and non-discriminatory market access and treatment. Following receipt of the U.S. list of identified investment restrictions, China was to act expeditiously to start removing the specified restrictions.

Fifth, **with regard to tariffs**, the U.S. demanded that China, by July 1, 2020, reduce its tariffs on all products in non-critical sectors to levels that were no higher than the levels of the United States' corresponding tariffs. Specified non-tariff barriers were also to be removed – even as U.S. maintained the right to impose restrictions and tariffs on products in critical sectors identified in the *Made in China 2025* plan.

Sixth, the U.S. demanded that China improve **market access for U.S. services and service suppliers**.

Seventh, similarly China was to **improve market access for U.S. agricultural products**.

Finally, **from an implementation standpoint**, the U.S. demanded that the two sides meet on a quarterly basis and review the proposed targets and reform commitments. If China did not comply with its assigned targets in a time-bound manner, then the U.S. would be at liberty to impose additional restrictions and tariffs on Chinese exports. And if that was to be the case, the Chinese side was not to oppose, challenge or take any action against those tariffs or restrictions at the WTO or bilaterally. China was also required to withdraw its separate WTO challenges to U.S. and European Union decisions to treat China as a 'non-market economy' (NME) in anti-dumping cases. This NME case is currently being litigated at the WTO.

#### **The ZTE Enforcement Saga and Trade Policy Inter-linkage**

On April 16, 2018, the U.S. Commerce Department banned American chip companies from selling components to Chinese telecom equipment maker ZTE Corp for seven years, saying that the company had violated the terms of a 2017 settlement of criminal and civil charges for making illegal shipments to Iran and North Korea. As per the terms of the settlement, ZTE Corp had promised to dismiss four senior employees and discipline 35 others by either reducing their bonuses or reprimanding them. ZTE failed to follow through *fully* on its required actions. While it did fire the four senior employees, it did not discipline or reduce the bonuses to the 35 others involved. The Commerce Department's draconian enforcement action threatened the very existence of ZTE as a business entity.

Following a mid-May call from President Xi Jinping to President Trump, the punishment was set aside in exchange for a steep billion dollar-plus fine, a shake-up of ZTE's management and placement of U.S. compliance officers within the company. Further, as per the outlines of a deal that is in the works, the tariffs on U.S. agricultural products, notably on pork, that China had imposed in early-April as retaliation to U.S. tariffs on Chinese steel and aluminum imports, is to be withdrawn. Moreover, the roadblocks in China being faced by a U.S. semiconductor company, Qualcomm Inc., whose proposed acquisition of NXP Semiconductors NV of the Netherlands has been held up by regulators in Beijing, are expected to be eased.

**Some of China's demands in response were no less expansive.** The U.S. was to commit to eliminating the sanctions imposed on China after the 1989 Tiananmen Square crackdown, U.S. export restrictions on high technology products such as integrated circuits were to be relaxed, the U.S. was to drop its pending anti-dumping cases against China at the WTO, and the U.S. was to terminate its investigations into Chinese intellectual property theft and not impose any of the sanctions that had been announced by President Trump (Rogin, 2018).

By mid-May, however, both sides had pulled back from their extreme demands – such that by the third weekend of May, both parties were able to turn an important corner and firmly draw a line under their trade, investment and intellectual property rights-related quarrels. The visiting Chinese delegation to Washington, D.C. was led by Vice-Premier Liu He and included Yi Gang, People’s Bank of China governor, Ning Jizhe, National Development and Research Commission vice chairman, Liao Min, the new deputy director of the Office of the Central Commission for Financial and Economic Affairs, Zheng Zeguang, vice minister of foreign affairs, Luo Wen, vice minister of industry and information technology, Zhu Guangyao, vice minister of finance, Han Jun, vice minister of agriculture and rural affairs and Wang Shouwen, vice minister of Commerce. Following four days of intense consultations, the two sides reached a Joint Consensus on May 19, 2018. The key elements of the consensus are:

**First, China and the U.S. are to substantially reduce their bilateral trade imbalance – not by restricting trade through tariffs and other penalties but by means of expanding exports of U.S. goods and services to China.** There is no overall numerical figure of the increased amount of exports planned or size of deficit to be reduced. That said, natural gas imports to the tune of \$50 billion a year and agricultural product purchase increases in the range of 30 to 40 percent have been banded around. In exchange for qualitatively greater Chinese market access, the \$50 billion threat of tariff increases that Trump had brandished against China is to be placed on hold – most probably, open-endedly.

**Second, China is to make the necessary modifications to certain technology licensing measures in its joint venture laws and regulations that appear to discriminate against foreign intellectual property-rights holders.** These relate to indemnity risks that Chinese laws compel foreign technology transferors to bear as well as laws that hinder foreign technology transferors’ ability to enforce patent rights

against a Chinese joint-venture partner after a technology transfer contract has ended. Although intended to boost the relatively weaker position of Chinese parties in technology transfer negotiations and contracts, these licensing measures likely violate the multilateral trading system’s ‘national

## China, U.S. issue joint statement on economic, trade consultations

China and the United States issued a joint statement on Saturday on economic and trade consultations, vowing not to launch a trade war against each other.

Based on the directions of Chinese President Xi Jinping and U.S. President Donald Trump, the Chinese and U.S. delegations conducted constructive consultations on trade issues on Thursday and Friday, the statement said.

The two nations agreed to meaningfully increase the export of U.S. agriculture and energy products. The U.S. side will send a delegation to China for further consultations

The two sides talked about the expansion of trade on manufactured goods and service, and have reached consensus to create favorable conditions to increase trade in those areas

The two sides also agreed to encourage the two-way investment, and committed to creating a business environment for fair competition

The two sides agreed to take effective measures to substantially decrease the U.S. trade deficit in goods with China. China will significantly increase its purchase of U.S. goods and service to meet the consumption needs of the Chinese people and propel the high-quality economic development of China, which also helps support the U.S. economic development and employment

The two sides highly valued intellectual property protection and agreed to promote cooperation in this regard. China will promote revision of related laws and regulations including the Patent Law

The two nations agreed to maintain high-level contacts in this regard and actively seek to resolve their economic and trade concerns



Source: Xinhua

treatment' rule. Upon coming into full compliance with the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPs) Agreement, the U.S.' ongoing case at the WTO is to be closed.

**Finally, China is to liberalize its foreign inward investment regime in a number of industrial sectors, including advanced manufacturing sectors, by paring down its negative list and progressively relaxing its existing equity caps and allowing full or majority ownership of companies and joint ventures.** While China is within its rights to draw up its own industrial policies in advanced manufacturing sectors, including its *Made in China 2025* plan, the planning bias in its industrial policies that lead to overseas technology acquisition on either implicitly coerced or on subsidized non-market terms is to be progressively reduced.

All-in-all therefore, from the U.S.' perspective, it gets to enjoy ramped-up sales in the Chinese market, ensure that Beijing's patent laws are appropriately tweaked, obtain investment liberalization (at a graduated pace) in additional Chinese sectors, and subject Chinese investment in the U.S. to qualitatively more granular checks – all in exchange for setting aside its (almost-certainly WTO illegal) tariff threat. For Beijing as well, predictability and stability in this key bilateral economic relationship - a necessary condition for its domestic welfare and international rise - remain on track.

In all likelihood, this process will be a drawn-out affair, with the inevitable setbacks and Trumpian threats along the way.

The Joint Consensus is, as of yet, just a statement of principles. The details of its implementation, featuring sector-by-sector liberalization and product-by-product purchases (including finalization of long-term supply contracts), as well as the modifications to China's investment caps, remain to be fleshed out. In all likelihood, this process will be a drawn-out affair, with the inevitable setbacks and Trumpian threats along the way. The threat of tariffs, in particular, as a point of leverage during the course of these talks is likely to remain (White House, 2018 c). That said, the broad consensus arrived at by the two sides should hold – in turn, winding down the most aggravated aspects of the U.S.-China trade and investment frictions over the past few months. For its part, China has already announced an expedited tariff and investment liberalization plan of action for its auto and auto-parts sector and new follow-on, opening-up measures, including paring down of the national negative list, are expected in the near-term in the areas of finance, energy, resources, infrastructure, shipping and transportation, and professional services. Tariffs on a range of household consumption items including appliances, kitchen equipment, processed foods, clothing and cosmetics and select healthcare products are also slated to be halved in the near-term. Overall, 1,449 items are slated for tariff reductions that kick in on July 1, 2018.

US-Japan Trade Frictions then (1960s-1990s) ... and China today: *Will Past be Prologue?*

The US supported Japan's entry to the General Agreement on Tariffs and Trade (GATT) in 1955. However, starting with Japanese textiles exports, tensions soon arose in the bilateral trade relationship. The first US-Japan **orderly marketing arrangement** was signed as early as 1957, signifying a non-most favored nation (MFN) approach on the part of Washington to resolve its bilateral trade frictions. Over the following decades, this took the form of bilateral **voluntary export restraints (VER)** that were negotiated across a wider range of products. Typically, rapid export growth would result first in a US safeguard (Section 201) petition requesting relief from surging Japanese imports for an injured domestic industry, which would then be followed up by a negotiated VER. By the 1980s, US anti-dumping law became the primary import-restricting means to seek out new trade measures that would typically result in a bilaterally negotiated VERs limiting Japanese exports to the US. This reached a peak during the 1984-1988 period when Washington initiated more than 20 new anti-dumping investigations on Japanese exporting firms - the most notorious of these being a semiconductor VER negotiated after a pair of anti-dumping petitions filed in 1985. Japan alone accounted for more than 20% of all new anti-dumping measures the US imposed during this period. Interestingly, the US never used its countervailing duty law to restrain imports from Japan during this period of intense trade friction.

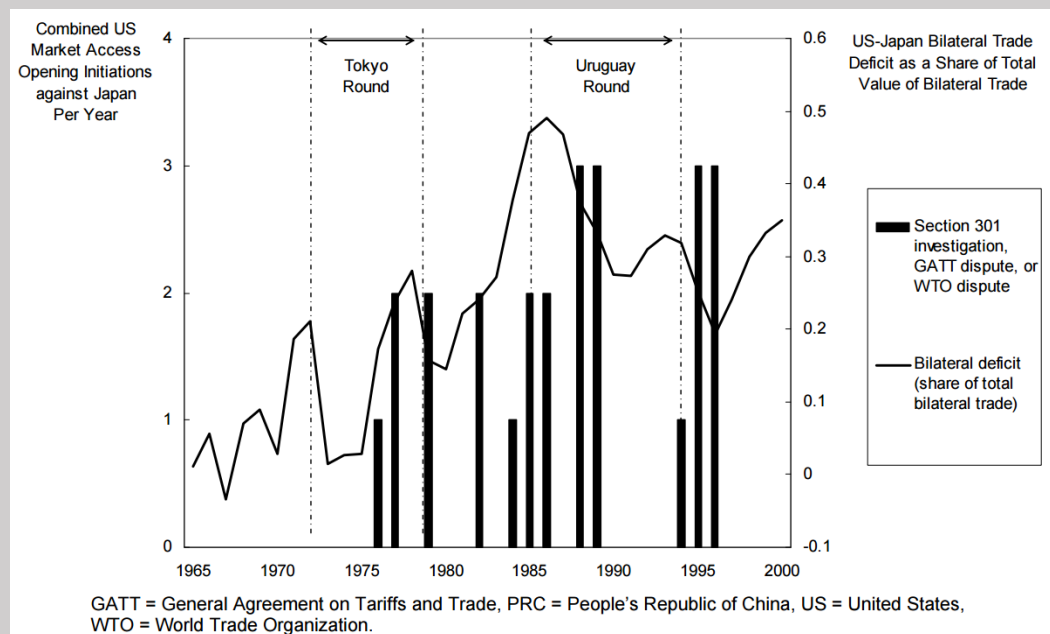
Table 1. Examples of US Safeguard and Antidumping Petitions Resulting in VERs with Japan, 1975–1997

	US Law	Product	Petition Year	USITC Case Number	Initial Year of VER
1	SG	Stainless steel and alloy tool steel	1975	201-TA-5	1976
2	SG	Footwear	1975	201-TA-7	1976
3	SG	Footwear	1976	201-TA-18	1977
4	SG	Television receivers	1976	201-TA-19	1977
5	SG	Certain motor vehicles and chassis/bodies thereof	1980	201-TA-44	1981
6	SG	Carbon and certain alloy steel products	1984	201-TA-51	1984
7	AD	Erasable programmable read-only memory-semiconductors (EPROMS)	1985	731-TA-288	1986
8	AD	256K and above Dynamic random access memory-semiconductors (DRAMS)	1985	731-TA-300	1986
9	AD	Photo paper and chemicals	1993	731-TA-661	1994
10	AD	Sodium azide	1996	731-TA-740	1997

AD = antidumping, SG = safeguard, US = United States, USITC = United States International Trade Commission, VER = voluntary export restraints. Notes: SG refers to a safeguard under the US Section 201 law; AD refers to antidumping under the US Section 731 law.

Parallel to the efforts to limit Japanese exports with the use of domestic trade remedies measures, particularly anti-dumping policy, Washington also adopted a legalistic and coercive approach to improving its exporters' access to the Japanese market through the combined use of GATT dispute settlement and **Section 301** policy actions. Over twenty years, starting in the mid-1970s, the US pursued at least two-dozen formal Section 301, GATT, and WTO trade disputes against Japan. Washington's use of GATT dispute settlement in an attempt to open up Japan's market to its firms was most frequent during the 1977–1988 period, when it filed a total of 11 formal disputes against Japan. Starting in the mid-to-late 1980s, the US shifted away from using GATT dispute settlement (partly out of frustration with its relatively toothless dispute settlement provisions) and instead relied solely on its unilateral Section 301 policy tool to pursue cases against Japan. Whereas all but one of the Section 301 investigations against Japan during 1977–1988 had resulted in the US bringing a formal GATT trade dispute, none of the next four Section 301 cases, initiated during 1989–1994, did so.

Figure 5. The US-Japan Bilateral Trade Deficit and US Section 301, GATT, and WTO Formal Trade Dispute Activity against Japan, 1965-2000



The range of sectors and issues subjected to additional US market access demands spanned a wide range. In the 1970s, desired market access was primarily in agriculture-based products (tobacco and leather) and lower value-added manufacturing (silk, cigars, cigarettes, footwear, and bats). By the mid-1980s, while there was continued pressure to obtain access in the Japanese market for US agricultural products and wood products, a wider set of exportable products, such as intellectual property-intensive products (semiconductors, supercomputers, satellites), also came to the fore. New issue-areas, such as in the trade in services sector (construction, architectural, engineering) and government procurement, also became a bone of contention.

Source: Bown and McCullough (2009)

## Essence of the Section 301 China IPR-related Dilemma: What is *Legitimate* v. What is *Legal*

The main thrust of USTR’s Section 301 Investigation Report findings is that China, in its rush to become a strategic advanced manufacturing superpower, engages in the acquisition of foreign technologies through acts, policies and practices by the Chinese government that are discriminatory and restrict U.S. commerce. These include implicit *de facto* pressure on U.S. companies to transfer technologies to Chinese entities. For its part, China argues that its foreign inward investment regime, including joint venture requirements, is *de jure* consistent with its international treaty commitments. China is not obliged to provide unreciprocated concessions to the United States in excess of such treaty rules. Its bilateral commitments relating to technology transfer over the past half-decade are ‘best endeavor’ efforts, at best.

The essence of the Section 301 China IPR investigation-related dilemma therefore boils down to the

The essence of the Section 301 China IPR investigation-related dilemma is that, while certain Chinese policies and practices are by and large legal, they are not necessarily legitimate in the eyes of the U.S.

fact that, while certain Chinese policies and practices are by and large legal, they are not necessarily legitimate in the eyes of the U.S. and other Western countries. In the context of this *legal v. legitimate* debate, there are two key points that are worth elaborating upon.

First, the investigation of Chinese IPR practices by USTR was brought under Section 301 of the

Trade Act of 1974. Section 301 does not require the trading partner to be in violation of the U.S.’ international legal rights. It can simply require that the trading partner’s “acts, policies or practices are unreasonable or discriminatory and that [they] burden or restrict U.S. commerce.” An “unreasonable” policy by a trading partner can simply be one which “while *not necessarily in violation of, or inconsistent with, the international legal rights of the U.S.*, is otherwise unfair and inequitable” (US Trade Representative, 2018). “Unfair and inequitable” is a vague and undefined standard. As such, the burden of proof to find that China’s IPR policies or practices have violated or restricted U.S. commercial interests is relatively lower, as per the Section 301 law. This also makes it easier for the USTR to formally determine that China’s IPR policies restrict U.S. commercial interests and, on that basis, deserve to be punished. **This (relatively shallower) burden of proof may appear to be a legitimate basis for remedial action in the United States’ eyes but not from China’s perspective.**

Second, in its Section 301 Investigation Report, USTR effectively admits that China is by-and-large not in violation of its international TRIPs and TRIMs treaty commitments (aside from some narrow technical provisions of the TRIPs agreement). China has broadly brought its intellectual property laws in compliance with its WTO commitments since its accession to the body in December 2001. Nevertheless, because Beijing’s technology transfer policies have gone from being explicitly mandated to becoming more implicit, often carried out through oral instructions and behind closed doors, U.S. companies with investments in China are impacted just as much in the post-2001 environment as they were before. And, in fact, because China has elevated the role of long-term indigenous technology development within its industrial policy goals since the mid-2000s, U.S. commercial interests have been discriminatorily burdened far more in the post-2001 era. **Essentially, therefore, while**



Washington has a legitimate grievance that is anecdotally laid out in exhaustive detail in the Section 301 Investigation Report, it does not enjoy a sufficiently robust basis on which to mount a strong legal challenge against China's IPR policies and practices in a neutral third-party arbitral setting.

**Table I.1 China's Bilateral Commitments Relating to Technology Transfer, 2010 - 2016**

<b>Year</b>	<b>Mechanism</b>	<b>Commitment</b>
2010	S&ED	China reaffirmed that the terms and conditions of technology transfer, production processes, and other proprietary information will be determined by individual enterprises.
2011	JCCT	China confirmed that it does not and will not maintain measures that mandate the transfer of technology in the New Energy Vehicles Sector. China further clarified that "mastery of core technology" does not require technology transfer for NEVs.
2012	S&ED	China reaffirmed its commitment that technology transfer is to be decided by firms independently and not to be used by the Chinese government as a pre-condition for market access.
2012	Xi Visit Commitment	China reiterated that technology transfer and technological cooperation shall be decided by businesses independently and will not be used by the Chinese government as a pre-condition for market access.
2012	JCCT	China reaffirmed that technology transfer and technology cooperation are the autonomous decisions of enterprises. China committed that it would not make technology transfer a precondition for market access.
2014	JCCT	China committed that enterprises are free to base technology transfer decisions on business and market considerations, and are free to independently negotiate and decide whether and under what circumstances to assign or license intellectual property rights to affiliated or unaffiliated enterprises.
2014	JCCT	China confirmed that trade secrets submitted to the government in administrative or regulatory proceedings are to be protected from improper disclosure to the public and only disclosed to government officials in connection with their official duties in accordance with law.
2015	Xi Visit Commitment	China committed not to advance generally applicable policies or practices that require the transfer of intellectual property rights or technology as a condition of doing business in the Chinese market.
2015	Xi Visit Commitment	China committed to refrain from conducting or knowingly supporting cyber-enabled theft of intellectual property, including trade secrets or other confidential business information, with the intent of providing competitive advantages to companies or commercial sectors.
2016	Xi Visit Commitment	China committed not to require the transfer of intellectual property rights or technology as a condition of doing business.

*Source:* USTR, CATALOGUE OF JCCT AND S&ED COMMITMENTS (2016); 2016 USTR REP. TO CONG. ON CHINA'S WTO COMPLIANCE 7.



And this, in turn, raises the \$50 billion question (and \$100 billion question if China's retaliatory threat is factored in): if the grounds for remedial action are legitimate but not legal, is it wise for Washington to threaten reprisals in an area of economic exchange – bilateral trade flows – that is covered by a dense body of international law? **Specifically, are the proposed unilateral 25 percent tariffs on 1,333 tariff lines representing \$50 billion of Chinese exports the appropriate – as in legally appropriate – measure to penalize Beijing for its IPR policies and practices? Is it not wiser to threaten reprisals in an area of economic exchange – bilateral investment flows – where international rules are vague and, hence, there is no bar to the imposition of unilateral remedies?** Washington would be better served by restricting its retaliatory actions to the area of investment restrictions using its domestic statutes, which do not violate international law or the U.S. treaty obligations.

### China's State-Guided Technology Financing Model

The National IC (Integrated Circuit) Fund is a useful prototype to understand China's state-aided technology financing model. The National IC Fund was established in September 2014 under the guidance of the Ministry of Industry and Information Technology (MIIT) and the Ministry of Finance (MOF) and lists several large SOEs and state-owned financial institutions as key capital contributors. These include:

- China Development Bank Capital, a subsidiary of the state-owned policy bank CDB;
- China National Tobacco Corp., a central SOE that administers a quasi-monopoly in China's tobacco sector;
- China Mobile Communications Corporation, a central SOE and market leader in China's telecommunications sector;
- Beijing E-Town International Investment and Development Co., Ltd. (Beijing ETown), an investment company owned by the municipal government of Beijing,
- Shanghai Guosheng (Group) Co., Ltd., an investment company owned by the municipal government of Shanghai;
- Tsinghua Unigroup, a company owned by Tsinghua University, a public university;
- China Electronics Technology Group Corporation, a state-owned defense enterprise established under the former Ministry of Electronics Industry (now part of MIIT).

A 2017 corporate filing relating to the acquisition of a National IC Fund-invested company disclosed further information on the National IC Fund's shareholders. The list contains 19 entities, the largest of which are the Ministry of Finance (25.95 percent), China Development Bank Capital (23.07 percent), China National Tobacco Corp. (14.42 percent), and Beijing E-Town (7.21 percent). In March 2017, a government-supported "Integrated Circuit Industry Technological Innovation Strategic Alliance" was formed. The National IC Fund serves as a part of this alliance.

It is abundantly clear from the structure of the National IC Fund that state-aided and guided financing is a key component of China's technology financing model.

If Donald Trump wishes to penalize China for its foreign inward investment-related practices, he could impose a variety of tailored restrictions on Chinese inward investment flows and on China-bound U.S. technology transfer flows. The CFIUS (Committee on Foreign Investment in the United States) mechanism as well as the export control process confer wide-ranging authority to the president to impose restrictions or bans on investments in sensitive sectors. **From a competitive economic standpoint, President Trump could decree that the embedded intellectual property of key systems technologies in the strategic advanced manufacturing sectors enumerated in the *Made in China 2025* plan are barred from acquisition by Chinese entities in the U.S. Further, if such core technologies are worked-on in China by a U.S. enterprise, it must take place in the context of a fully or majority-owned investment structure.** Be it batteries, drive systems or control systems in the case of electric cars, advanced materials and flight control systems in the case of aircraft, or chips and power electronic applications in the case of integrated circuits, President Trump could unilaterally proclaim that these technologies must be proprietarily retained in-house and cannot be sold to or shared with a Chinese entity. For Beijing too, an organic learning-by-doing approach rather than mere acquisition or reverse engineering, is a far more durable approach to innovation, especially as it rapidly ascends the advanced technologies ladder.

Imposing such investment-related restrictions would be entirely legal, would not contravene any U.S. treaty obligation and, in all likelihood, would have the desired salutary effect on China's alleged policies and practices. By contrast, going down the tariff route would be illegal and the wrong way to proceed.

## Proposed U.S. Tariffs and WTO Laws, Rules and Principles

The Trump Administration has threatened to impose a 25 percent duty covering 1,333 tariff lines on \$50 billion worth of Chinese exports to the United States. These tariffs are currently on hold, even though a final list of covered imports is expected to be released by June 15, 2018 (White House, 2018 c). If the Trump administration does go ahead and impose the proposed tariffs, the measure will constitute a procedural and substantive violation of international law and the U.S.' WTO treaty obligations.

### Key Substantive Violations

The United States is bound by two fundamental principles of international trade law – **the non-discrimination principle** and the **predictability principle**.

As part of the **non-discrimination principle**, the United States is not allowed to discriminate between trading partners, including China. In principle, if one country is granted a special favor (such as a lower customs duty rate for one of their products), that favor must be extended to all other World Trade Organization (WTO) members. This is known as most-favored-nation (MFN) treatment. Article I.1 of the General Agreement on Tariffs and Trade (GATT), which deals with MFN states that:

*With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III, any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.*

The relevant legal question to be asked, therefore, is this: By unilaterally raising “customs duties” in “connection with importation from China” – **and with regard to China only** – isn’t the United States failing to extend “immediately and unconditionally” to China the “advantage, favor, privilege or immunity” that it has granted to all its other trading partners for “like products?” By raising tariffs against Chinese exports only, the Trump administration would be violating the non-discrimination principle – and, thereby, would be in violation of GATT Article I.1 pertaining to ‘most favored nation’ treatment.

By raising tariffs against Chinese exports only, the Trump administration would be violating the non-discrimination principle.

With regard to the **predictability principle**, the United States is required to bind its market opening commitments and transparently notify these bindings to its trading partners. These bindings amount to ceilings on customs tariff rates. **The United States** is at liberty to lower its “applied” tariff rates beneath

its “bound” levels but it **is not allowed to raise these “applied” rates (against an individual trading partner or against all trading partners) above its “bound” rates**. To change its tariff bindings upwards, the United States must first negotiate that change with trading partners, which could mean compensating them for loss of trade benefits incurred. Simply stated, raising tariffs imposed beyond notified bound levels is a violation of international trade law.

### **The Multilateral Trading System and Bedrock Principles**

On 15 April 1994, the full package of measures that became the Uruguay Round agreements was formally signed in the Moroccan city of Marrakesh. Although voluminous in size and detail (the package was embodied in a document of approximately twenty-six thousand pages), the Uruguay Round agreements and the international trading system is premised on three simple bedrock principles that run throughout the document’s text. These are non-discrimination, predictability, and fair competition.

As part of the **non-discrimination principle**, countries are not allowed to discriminate between their trading partners. If one country is granted a special favor (such as a lower customs duty rate for one of their products), that favor must be extended to all other World Trade Organization (WTO) members. This is known as most-favored-nation (MFN) treatment. Some narrow exceptions apply. For example, countries can set up a preferential trade agreement that applies only to goods and services traded within the group – in effect, discriminating against goods and services from countries outside the group. Equally, as part of the non-discrimination principle, countries are not allowed to discriminate between foreign producers and domestic producers. Once a foreign good or service has cleared the customs barrier at the border, imported and locally-produced goods are to be treated equally from a regulatory and judicial standpoint within the domestic tariff area. This is referred to as national treatment. Simply stated, a country must extend equal treatment to its counterparts – be it a foreign trade partner at the tariff boundary or a foreign product within its marketplace (domestic tariff area).

As part of the **predictability principle**, countries are required to “bind” their market opening commitments and transparently notify these bindings when they open their markets to goods or services of foreign producers. These bindings amount to ceilings on customs tariff rates. Countries are at liberty to lower their “applied” tariff rates beneath their “bound” levels but they are not allowed to raise them above their “bound” rates. To change their tariff bindings upwards, countries must first negotiate that change with trading partners, which could mean compensating them for loss of trade benefits incurred. The purpose of this predictability principle is to instill confidence in foreign companies, investors and governments that trade barriers (including tariffs and nontariff barriers) will not be raised arbitrarily. Thus, the raising of tariffs beyond notified bound levels is a violation of international trade law.

Finally, as part of the **fair competition principle**, countries are allowed, in limited and clearly enunciated circumstances, to impose various remedial or protective measures to discourage “unfair” practices, such as export subsidies and the dumping of products at below normal cost to gain market share. The issues involved are complex, and the rules try to establish what is fair or unfair and how governments can respond by charging additional import duties to compensate for the damage caused by the “unfair” practices. As written into the trading system, the rules come in two forms: (a) rules that enable actions against dumping, i.e. selling at an unfairly low price, and (b) rules on subsidies and countervailing duties to offset the effect of non-compliant subsidies. Apart from the use of anti-dumping and countervailing measures, from a trade protection standpoint, governments are also

allowed to institute safeguards or emergency measures to temporarily limit an import “surge” and thereby safeguard domestic industries.

If any of these three bedrock principles (non-discrimination, predictability, fair competition), as written into the various WTO agreements, are violated by a member country, the affected or “complainant” country can file a “violation complaint” against the former and invoke the WTO’s dispute settlement mechanism.

**Article II.1 (a)(b) of the General Agreement on Tariffs and Trade (GATT)**, which deals with the predictability principle, states that:

*(a) Each contracting party shall accord to the commerce of the other contracting parties **treatment no less favorable than that provided for in the appropriate Part of the appropriate Schedule annexed to this Agreement.***

*(b) The **products described in Part I of the Schedule** relating to any contracting party, which are the products of territories of other contracting parties, **shall, on their importation into the territory to which the Schedule relates, and subject to the terms, conditions or qualifications set forth in that Schedule, be exempt from ordinary customs duties in excess of those set forth and provided therein.** Such products shall also be exempt from all other duties or charges of any kind imposed on or in connection with the importation in excess of those imposed on the date of this Agreement or those directly and mandatorily required to be imposed thereafter by legislation in force in the importing territory on that date.*

By unilaterally setting forth “customs duties in excess of those set forth and provided,” the United States would be in violation of its Schedule of Concessions and Commitments.

By unilaterally setting forth “customs duties in excess of those set forth and provided” in its “Schedule (of bound rates) annexed to the [GATT] Agreement,” the United States would be in violation of its Schedule of Concessions and Commitments. Simply put, if the Trump administration does, in fact, carry out its proposed 25 percent tariff hike against Chinese exports, it will violate its GATT II.1(a) and (b) obligations.

### **Key Procedural Violation**

At the time of the establishment of the World Trade Organization and its Dispute Settlement Body (DSB) in the mid-1990s, there was an appreciation that the United States’ Section 301 *unilateral* enforcement tool was not, in principle, entirely consistent with the multilateral and neutral dispute settlement procedures envisaged within the WTO’s DSB. To ensure consistency, the Clinton administration pledged in a **Statement of Administrative Action** in September 1994 (at the time of ratifying the Uruguay Round Trade Agreement) that in the course of Section 301-related cases where a trading partner has appeared to “violate U.S. rights or deny benefits to the U.S. under the Uruguay Round agreements,” USTR would (Statement of Administrative Action, 1994):

- *invoke DSU dispute settlement procedures, as required under current law;*

- *base any section 301 determination that there has been a violation or denial of U.S. rights under the relevant agreement on the panel or Appellate Body adopted by the DSB;*
- *following adoption of a favorable panel or Appellate Body report, allow the defending party a reasonable period of time to implement the report's recommendations; and*
- *if the matter cannot be resolved during that period, seek authority to retaliate.*

**Essentially, the United States would allow WTO dispute settlement body (DSB) procedures to run their course before the United States took enforcement action, and that enforcement action would be consistent with the WTO DSB's ruling; it would not be unilaterally-determined U.S. action.**

This approach was legally confirmed in WTO jurisprudence a few years later. In November 1998, the EU requested WTO consultations with the United States claiming that procedures based on its Section 301 provision potentially permitted unilateral decisions or measures by the U.S. government without waiting for a WTO panel decision or WTO DSB approval. A WTO DSB panel was established in March 1999 which found that the wording of the Section 301 statute did seem to contravene DSU (Dispute Settlement Understanding) Article 23.2 (World Trade Organization, 2000). However, when read in conjunction with the interpretative guidelines prepared by the U.S. president and other statements by the U.S. government ("*the United States will administer those provisions in a manner that is consistent with its obligations under the WTO Agreement*"), the Section 301 provision was deemed to *not* be in violation of the WTO DSU's Article 23.2. In order to remain in good standing, however, the United States was obliged to strictly adhere to its own interpretive guidelines and statements. **For the United States to maintain consistency with its WTO DSU Article 23.2 obligations, therefore, USTR's utilization of Section 301-based enforcement tools, including tariff increases, have to be aligned with and based on a prior WTO DSB decision and endorsement.**

Now, regarding the Section 301 Investigation findings of China's IPR practices and policies, the essence of the Trump administration's objections is that Beijing uses foreign ownership restrictions (such as joint venture requirements and foreign equity limitations) and various administrative review and licensing processes to abusively coerce technology transfers from U.S. companies, including transfers on non-market terms, that favor Chinese recipients. Conditioning foreign inward investment-related approvals on technology transfer requirements is plainly illegal as per international trade law. Section 7(3) of China's Protocol of Accession to the WTO of December 2001 specifically enjoins that (UN Public Administration Network, 2001):

*China shall, upon accession, comply with the TRIMs Agreement ... **shall ensure that the distribution of import licenses, quotas, tariff-rate quotas, or any other means of approval for importation, the right of importation or investment by national and sub-national authorities, is not conditioned on:** whether competing domestic suppliers of such products exist; or performance requirements of any kind, such as local content, offsets, **the transfer of technology**, export performance or the conduct of research and development in China.*

In plain language, the provision means that China cannot legally condition foreign inward investment-related approvals on technology transfer requirements. China is free to determine how open - or closed - its foreign inward investment regime should be. But investment market access liberalization cannot

be conditioned on foreigners having to explicitly transfer their proprietary technologies to gain market entry. **As such, if the Trump administration’s accusation is that China uses its joint venture requirements and administrative licensing procedures to unfairly or illegally force technology transfers from U.S. companies, then this is clearly a matter that relates to Section 7(3) of its Accession Protocol.** Being a matter related to the Accession Protocol, the United States must stay its hand on enforcement action before the matter is adjudicated before a WTO panel. Any unilateral enforcement action, including tariff increases, which pre-judges a WTO panel’s decision would be in obvious disregard of U.S. legal commitments, as confirmed in the U.S.-EU case of the late-1990s as well as the U.S.’ own Statement of Administrative Action of the mid-1990s.

It is ironic that even as the Trump administration accuses China of forced technology transfer policies and practices (which logically implicate and are banned by Section 7(3) of China’s Accession Protocol), it refuses to bring a case on these grounds at the WTO. The United States thereby implicitly acknowledges that it has no case to mount on its single, largest grievance against China’s IPR policies and practices in a neutral, third-party setting. Given this legal state of play, the wisest course of action for the United States would be to stay its hand on unilateral enforcement action, including tariff raises.

It is ironic that even as the Trump administration accuses China of forced technology transfer policies, which are banned by China’s Accession Protocol, it implicitly acknowledges that it has no case to mount on this grievance in a neutral, third-party setting.

Similarly, if it is the Trump administration’s accusation that China is in breach of two specific ‘national treatment’ related violations in the context of its TRIPs-related obligations, as detailed in its March 23<sup>rd</sup> Request for Consultation at the WTO, then this too is clearly a matter on which a dispute settlement panel needs to weigh in first. The penalties for violation too – if that be the case – are to be determined by that panel. By jumping the gun on this adjudication, the United States would be in violation of Article 23.2 of the WTO’s Dispute Settlement Understanding, the U.S.’ legal commitments, as confirmed in the U.S.-EU case of the late-1990s, as well as the United States’ own Statement of Administrative Action of the mid-1990s. Again, given this legal state of play, the wisest course of action would be for the U.S. to stay its hand on any unilateral tariff raises.

## Conclusion

Ever since his arrival in the White House President Trump has threatened to unleash a trade war against China. That threat kicked into high-gear during the first quarter of 2018, with the imposition of tariffs on steel and aluminum imports (following a Section 232 national security-related investigation) and the proposed imposition of tariffs on \$50 billion of Chinese exports to the United States (following a Section 301 investigation of China's investment and IPR practices). Had the latter measure been implemented, it would have constituted the single most damaging and regressive trade policy measure by a country against a major trading partner since the Great Depression-era Smoot-Hawley tariff increases of the early-1930s. It would have also led to the full-scale breakout of a trade war between the United States and China, which would have caused significant collateral damage and counted casualties far beyond the America's and China's shores.

In mid-May, President Trump's Treasury Secretary, Steven Mnuchin, and President Xi's economic czar, Vice-Premier Liu He, spearheaded and shepherded the two sides towards a win-win outcome which draws the curtain down on the most aggravated aspects of U.S.-China trade, investment and intellectual property rights differences. The trade and tariff issue has effectively been shelved; the investment and IPR-related quarrels have been narrowed. The real test of this will occur during the implementation phase of the joint consensus arrived at by Mr. Mnuchin and Mr. Liu.

For the most part, the relative gains in this win-win bargain are tilted in America's favor. Washington gets to enjoy ramped-up sales in the Chinese market, ensure that Beijing's patent laws are appropriately tweaked, obtain investment liberalization (at a graduated pace) in additional Chinese sectors, and subject Chinese investment in the U.S. to qualitatively more granular checks. From Beijing's perspective, though, the gains are not inconsiderable. Predictability and stability in this key bilateral economic relationship - a necessary condition for its domestic welfare and international rise - now once again remain on track.

Washington gets to enjoy ramped-up sales, ensure that Beijing's patent laws are appropriately tweaked, obtain investment liberalization in China and subject Chinese investment in the U.S. to more granular checks.

The salutary effects of President Trump's pressure on China to liberalize its foreign inward investment regime should also not be dismissed. In the late-1980s, Deng Xiaoping's Coastal Development Strategy irrevocably altered the course of global manufacturing - and China's role therein - by engineering a far-sighted liberalization of China's trading regime. Foreign-invested and export-oriented enterprises in China's coastal regions were at the foundation of this transformation. As their supply chains took root, an ever-increasing share of parts and components began to be sourced domestically, such that China now retains a lock over the development of these supply chains in key medium-technology intensive sectors such as computers and electronics. Thirty years later, under American pressure, should President Xi Jinping engineer a similarly far-sighted liberalization of China's investment regime - much like Deng Xiaoping had engineered of its trade regime three decades ago - China will become the advanced



manufacturing center, and *leader*, of the world by mid-century. Majority ownership of foreign-invested enterprises and full control of their intellectual property is a necessary condition, however, for this transformation to take effect.

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