THIRD WAY

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American Tariffs Won't Fix The China Problem

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Takeaways

1. China's acquisition of foreign technologies has given it a leg-up in vital sectors including energy, transportation, and defense.
2. Unilaterally imposing tariffs to "punish" China will do little to address the underlying problem —but it *will* hurt the American economy.
3. Instead, the US should work with allies to challenge China's practices at the World Trade Organization and develop market opportunities outside of China.

China is attempting to become a world leader in high tech-industries by 2025. Though they're expanding their investments in domestic R&D efforts, China is also using less savory tactics like coercive trade practices and covert IP theft to acquire foreign technology. This is bad news for the US and other countries that depend on innovation as an economic driver. While it's clear that something needs to be done to protect US business from unfair Chinese competition, Trump's "America First" tactics of escalating tariffs are not the answer. Though the first shots of the US-China trade war have already been fired, there may still be time to implement a plan which compels China to fundamentally correct its trade malpractice and supports new business opportunities for US innovators.

China is eating the world's technological lunch

China is making a push to replace heavy industry with high-tech manufacturing as a main pillar of its economy. At least on paper, China's tech development policies highlight the need for "indigenous innovation" of "key fundamental technologies." Basically, China is saying it wants to research, develop, manufacture, and export its own high-tech goods instead of relying on foreign technical expertise as it has in the past. But in practice, China has not started from the ground up in this endeavor. The country has engaged in industrial practices which transfer foreign intellectual property—whether willingly, begrudgingly, or unknowingly —to Chinese control. After such transfers, Chinese companies typically "re-innovate" foreign products and sell them abroad at a price that's impossible to beat. In essence, China is taking advantage of innovation in countries like the US, coopting it, and using it to put us out of business. In 2017, the bi-partisan IP Commission reported that Chinese IP infringements could cost the US economy between $225 and $600 billion per year, a monetary loss that is compounded by the millions of jobs that are lost in the process. There are two primary ways Chinese businesses acquire foreign IP:

Overt business practice and economic pressure

As a recent Council on Foreign Relations report notes, China has designed its market to benefit foreign companies who agree to transfer their technology, and to deter companies who refuse to do so. For instance, China uses tariffs and other formal trade measures to make it burdensome to sell foreign-manufactured products in China. And the solution for foreign manufacturers isn’t as simple as building a factory in China—it is difficult to make these kinds of investments if a company isn’t at least partially Chinese-owned. To overcome this barrier, most foreign companies form joint ventures which are, in practice, Chinese controlled. These joint venture agreements are typically predicated on technology transfers from the foreign company to its Chinese partner. Once this transfer is complete, however, the foreign partner may have little control over where their technology is sold and can find themselves cut out of future revenues. One of the most infamous examples of this practice was China’s acquisition of high-speed train technology from Japan.

Many foreign companies who comply with these trade practices are well aware that their IP will likely be “absorbed” and re-exported by their Chinese counterparts. They view this as an unavoidable long-term cost needed to gain near-term access to China’s large and fast-growing markets—it’s a cost of doing business that many companies feel compelled to accept. China sees nothing wrong with this practice, and talks about it openly. Chinese officials quite literally use benign, food-related terminology to describe the process of “introducing, digesting, absorbing and re-innovating” (□□□□ □□□□□□) foreign technology. In Chinese propaganda-speak, they’re essentially owning-up to being copycats, in spite of the fact that copyright infringement has been a sticking point between the China and the WTO in the past.

Covert industrial espionage

Even if companies take the moral high ground and refuse to transfer their technology, there is no guarantee that it won’t end up in Chinese hands by other means. A recent USTR investigation found that “For over a decade, the Chinese government has conducted and supported cyber intrusions into US commercial networks targeting confidential business information held by US firms." While the 2015 cyber agreement between the US and China is thought to have successfully decreased China's cyber-enabled IP theft, Chinese hacking and industrial espionage continue and there has been a reported uptick in since Trump took office. To illustrate, China's largest wind-turbine manufacturer, Sinovel, was recently ordered to pay $59 million for stealing software from its former partner, American Superconductor Corp. This is a small financial penalty given that Sinovel's actions caused American Superconductor's stock price to halve almost overnight, and resulted in a cull of 700 of its American employees. In another recent high-profile case, Chinese government hackers reportedly succeeded in stealing US Navy plans for a supersonic anti-ship missile which was scheduled for deployment on US submarines by 2020. Obviously, China is getting much more than new revenue streams from such technology acquisitions. Any US company designing or manufacturing technology which could be useful to the Chinese economy is a potential target.

Nuclear reactors—a case study

The nuclear energy sector offers one of the most salient examples of China pushing out its competitors with what is essentially their own technology. And the consequences of China's emerging dominance in the sector are huge—building a single nuclear reactor is a multi-decade, multi-billion dollar endeavor that supports a massive supply chain. Add to this the security implications of new nuclear projects in developing countries and it should be clear that China's nuclear exports could have a huge impact on its global influence.

China's exploding electricity demand coupled with its air pollution problem have boosted domestic investment in nuclear power. But as in other tech-sectors, China is also looking outward—it has developed a nuclear reactor export strategy and a full-fledged nuclear industrial enterprise (largely based on foreign technology) to support it. The country recently hit major milestones in this process with the grid-connection of the Taishan 1 EPR and the Sanmen 1 AP1000. These are the first "third generation" nuclear reactors deployed anywhere in the world. And, not surprisingly, neither of these reactors was Chinese designed. The EPR (which originally stood for European Pressurized Reactor) was developed by Framatome and Electricite de France, while the latter reactor, the AP1000, was designed in the US by Westinghouse. In the case of the AP1000s, Westinghouse agreed to transfer its technology to China in order to get them built. Now China has "digested, absorbed, and re-innovated" its own version of the AP1000 that it calls the CAP1400, and which it plans to export along with its other "indigenous" reactors.

By acquiring foreign technologies in nuclear energy and other sectors, China has placed itself on a path to dominate these markets in years to come. For countries like the US, where innovation is one of our greatest economic advantages, our strengths are being used against us.

Trade wars are bad and hard to "win"

If you haven't been paying attention, the US and China are in the beginning stages of what could become a full-scale trade war. The Chinese trade misconduct described above has been one of the main gripes of the Trump administration which has led to its imposition of 25 percent tariffs on $34 billion worth of Chinese products including televisions, aircraft components, and medical devices. The Chinese, in response, have imposed tit-for-tat tariffs of the same dollar value on US products—mostly agricultural. President Trump has threatened to up the ante by placing additional tariffs on hundreds of billions of dollars of Chinese goods, and China has vowed to counter with further penalties of its own. The Brookings Institution recently estimated that Chinese counter tariffs would negatively affect about 2.1 million American jobs in 2,783 US counties. It goes without saying that the economies of the US and China are deeply interlinked and a full blown trade war could have catastrophic effects on both.

President Trump has been adamant about the problem at hand—China's unfair and illegal practices are hurting US businesses, and something needs to be done about it. But the solutions he's turning to won't actually help. Here's why escalating trade tariffs is the wrong way to deal with China:

1. Chinese retaliatory tariffs hurt the US economy

Both Democratic and Republican lawmakers are already criticizing the trade war with China as reckless. In a July 11 th statement, Sen. Heidi Heitkamp emphasized that "...escalation is yet another sign that the administration isn't listening to the needs of rural America...Farmers and ranchers, energy producers, and manufacturers are speaking up that this trade war is bad for their pocketbooks and threatens their industries." Republican Senator Bob Corker has introduced a bipartisan bill which would require congressional approval for executive tariffs of the type the Trump administration is imposing.

And these actions aren't just about political messaging, the US economy is already feeling the negative effects of the emerging trade war. The stock-market has seen volatile shifts with the announcement of each new round of tariffs. Prices of consumer products such as computers and couches are on the rise for many Americans. And US farmers are being hit particularly hard by Chinese counter-tariffs – especially soy, corn and wheat growers, who recently experienced the largest export price drop since 2011. This has a ripple effect on the industries that provide inputs to agricultural production, freight railroads, trucks and barges in the transportation sector that move the goods, and the communities most tied to farming, where a lack of revenue is felt by local small businesses.

The fact that the Trump administration is considering a $12 billion farm bailout should be a sign that things are not going quite as planned. Already, there is great speculation that markets lost at the hands of a trade war will never return, putting at risk massive private investment that supports the production and supply chain associated with this industry.

2. Tariffs don't solve the underlying problem

While tariffs may punish China by negatively impacting the Chinese economy in the short term, they offer no direct incentive to curb Chinese coercive technology acquisition or covert IP theft. At a recent congressional hearing, Jennifer Hillman—who formerly served on the WTO's highest court—made it clear that whatever measures are taken against China, they must be focused on fundamentally changing China's technology transfer and IP related behavior: "Given that the Trump Administration has expended considerable political energy and clout in threatening the imposition of… tariffs on China, it is essential that they emerge from the process with measures to address the many real problems with China rather than simply addressing bilateral goods trade deficit."

3. China could successfully challenge Trump's tariffs at the WTO

China has initiated a formal WTO dispute which argues that the US-imposed tariffs "are a clear violation of the basic WTO principle of most-favored-nation treatment [basically that members of the WTO cannot use tariffs and other measures to discriminate against trade partners] as well as the basic spirit and principles of international law." Frankly, China's argument here is not entirely unjustified. In a recent Cato Institute report, James Bacchus agreed that Trump's tariffs "are not only self-defeating and counter-productive; they are also illegal under international law. Where an international dispute falls within the scope of coverage of the WTO treaty, taking unilateral action without first going to

WTO dispute settlement for a legal ruling on whether there is a WTO violation is, in and of itself, a violation of the treaty."

4. Tariffs risk further US isolation

In the unlikely case that China actually cedes to US demands (i.e. we work out a trade agreement which addresses the trade deficit so detested by Trump), we will likely become more isolated from one or more of our allies in the process. From the Hillman testimony cited above: "Certainly the United States' partners...would raise strong objection to the US accepting an agreement under which China simply agreed to shift its purchases of soybeans from Brazil to the US or its sourcing of energy products from Russia and Central Asia to the United States." In other words, the US should not entertain any trade deal with China that will further sour relationships with other trade partners. Donald Tusk, president of the European Council put it bluntly, but perhaps more effectively: "Dear America," he said, "appreciate your allies. After all you don't have that many." And while Trump is pushing America away from its traditional trade partners with tariffs and bluster over trade deficits, China has been forging stronger economic ties all around the world.

WTO FTW?

Obviously, unilaterally imposing tariffs to punish China for its trade malpractice is, itself, trade malpractice. So what is the alternative? Because the WTO is the final arbiter of any trade dispute among its members, many have argued that a multilateral WTO complaint against China involving a coalition of countries affected by its IP practices is a much better way to actually curb China's behavior. Such a case would avoid the problems with unilateral sanctions discussed above and put far more pressure on China than the individual WTO complaints several nations have already filed.

More importantly, there are good legal grounds to bring such a case up. A complainant (or large coalition of complainants, in this case) would simply need to demonstrate that China's domestic policies and unofficial practices violate the specific commitments it made as a prerequisite to joining the WTO in 2001. And there are some pretty clear examples that complainants could point to. For starters, one of the trade-related commitments China made to the WTO was that "the allocation, permission or rights for importation and investment [in China] would not be conditional upon the transfer of technology." The sheer number of US firms who were coerced into technology transfer agreements to form Chinese joint ventures would suggest that this commitment has been largely ignored in practice. More directly, government backed IP theft is in clear violation of the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The five Chinese military hackers who were indicted by the Department of Justice in 2014 for stealing trade secrets from US energy companies offer a snapshot of the Chinese government's culpability in this regard.

Following a successful case, the coalition of aggrieved nations could implement WTO sanctioned penalties which directly combat Chinese behavior. It's important to note that WTO membership has been crucial to China's economic growth, and the country has, for the most part, adhered to its rulings. As such, the WTO remains one of America's most effective tools for stopping China's unfair trade practices and staying competitive in future technology markets. Instead of undermining multilateral institutions like the WTO at every turn, the President should be working to strengthen and leverage them.

Creating export opportunities beyond China

Whether or not China's trade practices are challenged and corrected through the WTO, the US should be looking to develop domestic business opportunities for tech companies, as well as opportunities in markets other than China. As stated above, many companies who dealt with China were well aware that they would likely lose control of their IP in the process. We should create incentive for such companies to form partnerships with countries who won't engage in industrial subterfuge. This was largely the thinking behind the Transpacific Partnership, which the US spearheaded prior to Trump's withdrawal from it. This agreement would've offered a check against Chinese economic influence and encouraged mutually beneficial trade relationships between the US and non-Chinese partners. President Trump has said he would create new and better trade deals between the US and these partners. For the sake of American businesses, he should follow through on that promise and begin negotiations in earnest.

Conclusion

China's acquisition of foreign technology has given it an unfair advantage in world markets. The US and other affected countries will continue to suffer major economic losses unless China's misbehavior is corrected. That being said, Trump's "America First" tariffs are not the way to go—they hurt American businesses and the US economy, isolate the US from its traditional trade allies, and do little if anything to stop the underlying problem. Though Trump is doing everything he can to withdraw the US from the international order, stronger alliances with other trade partners and a renewed commitment to multinational organizations like the WTO may be the best hope to stop China from eating our technological lunch.

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