

Testimony before the U.S.-China Economic and Security Review Commission

Hearing on U.S. Tools to Address Chinese Market Distortions

Chad P. Bown*

Peterson Institute for International Economics

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1 Introduction

A major factor in the rising economic tensions between China and the United States has been the resurgent role of the state in the Chinese economy in recent years. For example, in 2017, three of the top four companies on the Fortune Global 500 were Chinese state-owned enterprises (SOEs).¹ However, it would be incorrect to assume from this statistic China's economy is entirely state-owned, or to conclude that the Chinese system is on the verge of taking over global economic activity.

The reality is more nuanced, of course, as documented by my colleague Nicholas Lardy at the Peterson Institute. Since 2013, the trend away from the private sector and toward state management is clear; the policy climate has discernibly shifted toward more state control. Lardy and other scholars point to declines in private investment relative to state investment.² The trend appears in fact to have inflicted damage on China itself – easy access to credit and diversion of resources toward SOEs and away from the private sector may, in fact, be holding back Chinese economic growth.

China's economic growth in the first decade after its 2001 accession to the World Trade Organization (WTO) was driven largely by the private sector, as Chinese reforms led the state-sponsored sector of the economy to shrink in relative terms.³ Most of the bright spots of the Chinese economy – growth in industrial output, exports, returns on assets – were disproportionately and increasingly arising from private enterprise. Nevertheless, the state and the Communist Party remained major players during this era, even in the private sector.

* Chad P. Bown is *Reginald Jones Senior Fellow* at the Peterson Institute for International Economics in Washington, DC. His previous positions include serving as a senior economist on the White House Council of Economic Advisers and as a Lead Economist at the World Bank.

¹ Walmart topped the Global Fortune 500, followed by State Grid, Sinopec Group, and China National Petroleum. Rounding out the top ten were Toyota Motor, Volkswagen, Royal Dutch Shell, Berkshire Hathaway, Apple and Exxon Mobil.

² Lardy (2017)

³ Lardy (2014).

And the growing role of the state in the economy more recently highlights Chinese concern for objectives other than company profits. In 2003, for example, China created the State-owned Assets Supervision and Administration Commission (SASAC), a single government agency that now controls many SOEs.⁴ As the legal scholar Mark Wu indicates, “In many ways, SASAC operates as other controlling shareholders do. It is happy to grant management operational autonomy so long as it delivers along the agreed-upon metric. The difference is that the metric is not pure profit, but rather *the Chinese state’s interest, broadly defined*” (Wu 2016, p. 272, emphasis added).

These developments pose extraordinary frustrations and challenges for the United States and other countries seeking to sustain an open international trade and investment regime that is inclusive of China. More than 15 years beyond China’s accession into the WTO, it has become clear that China’s SOEs are not going to disappear anytime soon. Thus, ensuring a competitive environment for American firms and workers requires imaginative new approaches and thinking by U.S. leadership.

In this testimony, I want to provide a framework to help set priorities for future U.S. policymakers. I will illustrate why current U.S. domestic policy tools – such as the application of tariffs – have proven insufficient to address the underlying distortions. Importantly, in some instances, I argue that continued reliance on existing tools – including the expansion of tariff coverage beyond China and its SOEs – runs the risk of making matters much worse.

A U.S.-only approach is also bound to fail. And while there is still an important and untapped current role for WTO dispute settlement, I also identify how new and enforceable international rules on SOEs must be developed – through a process of multilateral cooperation – to address these concerns. And because of the nature of international trade, cooperation with like-minded economic allies and political engagement by China must be mobilized to create a sustainable, long-run solution. A final section explains one approach toward achieving this outcome.

2 China’s SOEs through the lens of steel

China’s steel industry can serve as an illustrative case study to motivate why a new approach is needed. The issue of steel has caught the eye of the public and policymakers because of recent U.S. government actions that have created a crisis in the global trading system.⁵

While global capacity for crude steel production increased by almost 80 percent between 2005 and 2017, little of that expansion took place in the Organization for Economic Co-operation and Development (OECD), where capacity increased by only 13 percent. Significant expansion took place in several non-OECD countries, including India, Brazil, and Russia. But by far the largest source of growth in steel capacity was in China, where capacity expanded by 176 percent over this period. China’s share of global steel production capacity went from less than one-third in 2005 to nearly 50 percent in 2017.

⁴ Wu (2016)

⁵ This section draws from Bown (2017).

China's production of crude steel was 1.26 times higher in 2015 than it was in 2005, largely tracking China's overall growth in capacity during this period. Combined production in the rest of the world was essentially flat.

There are two sources of concern arising in the period since the global financial crisis when China's growth has coincidentally also slowed down.

First, as its economy began to slow down, China substantially increased the export share of its production, from 4.2 percent in 2009 to 7.5 percent in 2013 to 13.7 percent in 2015.

Second, relative to most other major exporters, China still exports a relatively small share of its total production. Although it the world's largest exporter of steel products—accounting for 30 percent of world (net of EU-28) exports in 2014, up from 12 percent in 2005—among the major economies, only India currently exports as small a share of its steel production. Japan and South Korea are the next-largest exporters of steel after China, with 13 percent and 10 percent of global exports in 2014, respectively. But the differences are that Japan and South Korea export 35–40 percent of production per year. Foreign steelmakers are concerned with what would happen if China exported the same share of its steel as these other Asian economies.

The Chinese government has recognized periodically its overcapacity in steel production. In early 2016, for example, it revealed plans to transition 500,000 workers out of the steel sector.⁶

However, like many areas of the Chinese economy, the steel sector is a mix of private companies and SOEs. In 2014, for example, private firms accounted for 50 percent of Chinese steel production and steel capacity, up from only 5 percent in 2003.⁷ One challenge for Chinese policymakers seeking to address overcapacity is that they do not have control over the entire sector. A second is, like policymakers everywhere, the Chinese government is highly concerned with the ability of laid-off workers to adjust to take advantage of new economic opportunities.

Despite using the case of steel to inform the analysis undertaken here, a global policy approach toward SOEs should not be based on or limited by the experience of this one industry. The American steel sector has been transforming for decades, first facing new competition from Europe and other countries in Asia beginning in the 1960s, as well as the technological revolution spurred by mini-mills, long before the more recent arrival of competition from China's SOEs.⁸ As such, steel is unlikely to be representative of the “average” American industry that may face competition from state-owned enterprises.

Thus, the next section introduces a more general framework that can account for other economic problems that may arise. Industries with different market structures or conditions of competition may face different sets of challenges arising from China's SOEs. In these sectors, intellectual property protection or research and development may play a more distinctive role.

⁶ Kevin Yao and Meng Meng. 2016. China Expects to Lay Off 1.8 million Workers in Coal, Steel Sectors. *Reuters*, February 29. Available at <http://uk.reuters.com/article/us-china-economy-employment-idUKKCN0W205X>.

⁷ Lu (2016), based on data taken from the China Iron and Steel Association.

⁸ Collard-Wexler and De Locker (2015).

3 The Economic Problems to the United States and Other Countries from China's SOEs

One concern with China's SOEs is that, because of their soft budget constraints, they act like subsidized firms. Unless there are market failures, subsidies incentivize firms to produce too much and to charge too low a price relative to what the market would have delivered. What, if anything, to do about those foreign subsidies requires policymakers have a lot more information and careful consideration of tradeoffs.

A frequent policy response to date has been to try to counteract effects of the subsidy in the U.S. market by imposing a tariff. Interestingly, from the perspective of pure economic cost-benefit analysis, that is not necessarily the best policy prescription. Suppose markets are competitive, so that there is free entry and exit into the industry. Then even though a Chinese subsidy introduces a distortion and hurts some American interests – so that there are some distributional implications within the United States – the gains to American consumers from China's subsidy are larger than the losses to American producers. Under this scenario, on net, the United States is actually better off than if China had not imposed a subsidy.

Nevertheless, the salience of this purely economic outcome is based on one set of underlying assumptions. A more comprehensive cost-benefit analysis is contemplated next, whereby I consider different scenarios so as to investigate how each affects the appropriate policy response.

3.1 Equity and adjustment concerns

Chinese policymakers may prefer SOEs to private firms if the SOEs allow for greater domestic social sustainability; as Wu indicated earlier “the metric is not pure profit, but rather *the Chinese state's interest, broadly defined.*” One possibility is the Chinese state uses SOEs to prevent bankruptcies and layoffs when negative “shocks” arise. This is distinct from more market-oriented economies in which firms and workers may not receive the same state-provided protections.

However, the Chinese approach can have at least two important implications for trading partners.

The first is relevant if there are significant impediments to adjustment – or the reallocation of resources across firms or industries – in the face of “shocks.” Consider a shock to global demand that would be expected to affect firms and workers in all countries equally – i.e., that would lead to an equal reduction in supply across countries. If China's system of SOEs means that it fails to absorb its “share” of such shocks, then China's SOEs impose negative externalities on trading partners by passing along a disproportionate amount of costly adjustment.

The second is relevant if it erodes willingness to participate in the system. American firms and workers may perceive the Chinese system as not only different but one that is unfair, because the American government does not make the same levels of insurance available to them.

3.2 Profit-shifting concerns

Some industries are heavily concentrated and involve very few firms. Commercial aircraft is the quintessential example, for decades the industry has been dominated by the Boeing and Airbus

rivalry. A key feature of such industries is large barriers to entry, typically due to large costs of research and development.

In sectors with such characteristics, it is possible that strategically-timed subsidies could give a Chinese SOE a first mover advantage relative to rivals in foreign countries like the United States.⁹ In the standard set-up, a commitment by the Chinese government to subsidize capacity in an industry could end up discouraging entry by foreign rivals and shift potential profits to Chinese firms.

3.3 Concentration concerns

Even in industries that are not so concentrated that they breed oligopolies, there can still arise concern with excessive concentration of the global industry within the Chinese market. Recent empirical work suggests that while globalization has led to less industry concentration in general, exceptions may arise in sectors where China's SOEs are prominent.¹⁰

The concentration of industry within China could be problematic if China were to then exercise its accumulated market power – say, by implemented policies that encouraged its SOEs to withhold output or raise prices. Unfortunately, there is evidence in which China has exploited its market power when it had it. China has frequently restricted exports of several raw materials and rare earth metals over which it had a significant share of total global extraction. This has led to three different WTO disputes being filed against the Chinese policies.

3.4 Global economic efficiency concerns

One final concern could arise if inefficient SOEs begin to make up too much of global industry in a given sector. Just has arisen within China, too much allocation of resources toward SOEs – if in critical, innovate sectors – could result less investment.

Overall, this could be a concern for global economic growth which relies on innovation to drive increases in productivity and economic well-being.¹¹

4 U.S. Domestic Policy Tools

U.S. reliance on domestic policy tools have been insufficient at addressing the political and economic challenges arising from China's SOEs. The United States' primary domestic policy approach to address side effects arising from China's SOEs has been reliance on trade remedy policies of antidumping and countervailing duties. This has been shown ineffective and counterproductive, and it has been made worse by recent U.S. government imposition of comprehensive import restrictions under other U.S. trade laws. Finally, the American approach to labor market adjustment concerns has also been problematic.

⁹ See, for example, Brander and Spencer (1985) or Maggi (1994).

¹⁰ Freund and Sidhu (2017).

¹¹ See for example, possibilities illustrated in the research of Grossman and Helpman (1990).

4.1 Antidumping and countervailing duties

Consider U.S. use of its trade remedy laws of antidumping and countervailing duties. Figure 1 illustrates my estimates of the coverage of U.S. imports from China over time that have become subject to these import restrictions.¹² It also documents U.S. imports from other trading partners covered by the same sorts of barriers. There are three main results.

First, U.S. application of trade remedies on imports from China has increased steadily over time. In the year prior to China's WTO entry in 2001, the U.S. applied these import restrictions to only 1.4 percent of imports from China. By the end of 2017, the stock of accumulated trade barriers had covered an estimated 9.4 percent of U.S. imports from China.

Second, the increased use of these trade barriers on imports from China has taken place during a broader period of decline in their application toward the rest of U.S. trading partners. Even during the Great Recession of 2008-2009, there was no major uptick in U.S. use of such protection against other partners.

Third, there may be signs that the broader trend of low relative U.S. use of such trade barriers against non-Chinese partners is reversing. While still relatively low in historical terms, U.S. use of these import restrictions against other U.S. partners nearly doubled by 2017 from its low point in 2013.

Figure 2 illustrates these same data, but for the steel and aluminum sectors. Three additional messages emerge.

First, by the end of 2017, nearly 95 percent of U.S. imports from China of steel and aluminum were already subject to U.S. special tariffs under these laws. To clarify, these are the import restrictions in place prior to the U.S. government's recently-imposed tariffs on steel and aluminum under Section 232 of the Trade Expansion Act of 1962. Thus, any new import restrictions imposed on China under Section 232 – as arose in March 2018 – were largely redundant. They were simply another layer of tariffs on China covering products that already had high levels of previously-imposed special tariffs.¹³

Second, for the steel industry, U.S. antidumping and countervailing duties had already covered nearly 80 percent of U.S. imports from China by 2009.

Third, also for the steel industry, there was a considerable increase in U.S. use of antidumping and countervailing duties imposed on other trading partners between 2012 and 2017. The share of U.S. steel imports from non-China covered by these import restrictions increased from 29.5 percent in 2012 to 54 percent by 2017.

¹² Figures 1 and 2 also include use of safeguards. Notably there was no use of global safeguards (Section 201) between the steel safeguard import restrictions imposed over 2002-2003 and those imposed on imports of solar panels and washing machine in January 2018.

¹³ Many of the U.S. antidumping and countervailing duties on imports from China were imposed at such high levels they may be prohibitive. Bown (2016, Table 2) reports that, with respect to imports from China, the average antidumping and countervailing duty in place in 2015 was over 80 percent.

The steel data illustrate the scope of concern arising from the potential problem of Chinese overcapacity and the futility of American attempts to address it through unilateral trade restrictions. While antidumping and countervailing duties may have been effective at shutting Chinese steel out of the U.S. market since 2009, Chinese steel has still been exported to third markets.¹⁴ Excess capacity and production can thus still lead to lower world prices. What likely results is a shift in other exporter's steel sales from third markets to the U.S. market, essentially taking advantage of arbitrage opportunities.

Two recent United States government initiatives seem vaguely intended to address the issue. But because both address only the symptoms, neither is likely to prove sufficiently effective at targeting the underlying cause of the apparent problem of excess global production.

One initiative focuses additional government resources on preventing Chinese transshipment.¹⁵ The transshipment issue involves Chinese steel being exported to country X, relabeled as "made in country X," and then shipped to the United States, thus violating a U.S. antidumping or countervailing duty order. Without denying the criminal nature of the transshipment violation, unfortunately the dedication of resources to this issue is unlikely to materially affect the problem of overcapacity.

Take the following example. Country X has its own steel industry that, with less world capacity, would produce only for its domestic market. The introduction of low-priced Chinese steel into country X means X's production is no longer needed for domestic consumption; it can be exported instead to foreign markets. The United States, with considerable trade restrictions in place and steel prices higher than the world price, is an attractive destination market.

But by construction in this example, there is no illegal transshipment activity. The economic implication is that, for commodities that are relatively homogenous products, the natural economic profit motives creates incentives to take advantage of arbitrage opportunities.

A second initiative involves how the U.S. government has begun applying a "particular market situation" context to the construction of dumping margins in antidumping investigations.¹⁶ Drawing on an example from an actual case, the concern involves U.S. imports of refined, or "downstream" steel products that may use raw Chinese steel as an "upstream" input. In this example, the investigation decided that since South Korea's production of oil country tubular goods (OCTGs) benefit from access to Chinese-subsidized (or SOE-provided) hot rolled steel as an input, that this was unfair and contributed to the finding of dumping. This technique will not only allow for findings of higher dumping margins (equivalent to higher duties) but also an increased likelihood of finding evidence of dumping and thus imposing duties.

The same economic incentives affect other OCTG producers who do not necessarily rely on the Chinese hot-rolled steel as an input, and to whom the particular market situation will not apply. The result is that applying the particular market situation to South Korea will continue to fail to

¹⁴ This phenomenon is referred to as "trade deflection" (Bown and Crowley, 2007).

¹⁵ For example, Presidential Proclamation on Adjusting Imports of Steel into the United States, which indicated "I expect that Canada and Mexico will take action to prevent transshipment of steel articles through Canada and Mexico to the United States." (White House, 2018a)

¹⁶ See Department of Commerce (2018c).

address the source of the underlying distortion. Again, if hot-rolled steel is a commodity and China's overcapacity drives down world prices, the world price for that input will be abnormally low everywhere, and not only in the countries that import the steel from China. Put differently, this approach punishes a country like South Korea even though an OCTG producer in another country may also be benefiting from low world prices of the hot-rolled input, even without directly purchasing the input from China.

The policy focus on transshipment and the particular market situation will thus not eliminate the economic distortion, and new problems are only likely to pop up elsewhere, especially in the case of products with high degrees of substitutability. The only way to address the concern coherently is to focus directly on the underlying problem of overcapacity.

Finally, it is worth noting one other important non-feature of the U.S. antidumping law involving the issue of anti-competitive practices, as this will come up again in Section 6. Ignore, for a moment, the issue of China and its non-market economy status. The law defines dumping as either international price discrimination (selling at a lower price in the U.S. market low than the price in a foreign market) or selling below a constructed measure of the firm's costs. Yet neither definition disqualifies, as an example, the analog behavior of an American firm that may set its prices differentially across two different regional markets in the United States or temporarily sell at a price in the United States below its average cost.¹⁷

Dumping under the antidumping law is defined without reference to anti-competitive concerns or predation. This is a problem. While one potential economic concern with SOEs is when they behave in an anti-competitive manner, U.S. trade remedy statutes are not written so as to screen for such concerns. As such, there is scope to also reform U.S. trade remedy statutes to guide use toward instances in which there is an underlying anti-competitive concern.

4.2 Global import restrictions: Section 201 and Section 232

The failure to address the underlying source of the problem of excess capacity arising from SOEs has led to the spread of trade restrictions beyond China. As Figure 2a indicated in the case of steel, since 2012, the United States has already been increasing the share of imports from non-China that it has made subject to antidumping and countervailing duties.

In 2018, the United States government increased the trade barrier coverage of steel imports by turning to a different trade law. In March 2018, it imposed 25 percent tariffs under the authority granted to the president under Section 232 of the Trade Expansion Act of 1962. Initially, the tariffs were applied to only about one third of all U.S. steel imports in 2017, with temporary exemptions initially granted to seven trading partners. But on June 1, the tariffs were applied to three of those previously exempted economies – the European Union, Canada, and Mexico – and three others were forced to accept quantitative limits on their exports under the threat of U.S. tariffs.

¹⁷ A standard result from economic principles is that it can be profit maximizing for a firm to continue to produce even when the market price is lower than its average total cost in the short run, provided it can cover its average variable cost. Here the short run is defined as the period over which it has some fixed costs that cannot be adjusted – e.g., debt-servicing, long-term contracts, etc. For a discussion, see Blonigen and Prusa (2016).

Similar increases in the coverage of trade protection took place in the aluminum sector. In March 2018, the U.S. government imposed 10 percent tariffs under Section 232 on 46 percent of all U.S. aluminum imports in 2017. Temporary exemptions were initially granted to imports from a number of major economies, but it applied almost comprehensive tariffs and quotas on imports as of June 1.

A third industry example is solar panels. In January 2018, the U.S. government imposed import restrictions (tariffs, tariff-rate quotas) on solar panels as a global safeguard after an investigation conducted under Section 201 of the Trade Act of 1974.¹⁸ Much of the alleged source of the economic concern was again Chinese excess capacity and state subsidies, though no evidence of subsidies was needed to obtain import protection under the law under which the January 2018 trade restrictions were imposed. Similarly to steel and aluminum, the United States had also imposed country-specific import restrictions in 2012 and in 2014 on solar imports from China. Similarly, these did not address the underlying economic distortion and it did not stop trade deflection or low-priced imports from entering into the United States from third markets.

In the steel, aluminum and solar panel cases, most U.S. imports from China had already been covered by antidumping and countervailing duties prior to the new investigations that led the United States to impose “global” import restrictions in 2018. In each, the major new U.S. imports sources facing trade restrictions in 2018 were both military allies and “economic” allies; i.e., market-oriented economies that struggle to cope with the distortions introduced by China’s economic system. Yet, instead of being treated as allies, imports from these countries became the target of U.S. trade restrictions as well.

4.3 Mobility assistance

Any discussion of international trade and economic policy must also reckon with the fact that the United States government has historically done a very poor job at assisting workers needing to cope with shocks – arising from any source – and who need to transition to new opportunities. This is not a China-specific trade policy problem, let alone an issue tied to China’s economic system. Nevertheless, the issue of lack of U.S. labor market adjustment and mobility has received renewed attention due to the “China shock” research in economics. At the high end, imports from China can account for an estimated 20 percent of manufacturing job loss in the United States over the 2000s.¹⁹ The remaining 80 percent of dislocation stems of improvements in technology and productivity, changes in consumer demand for certain products, or other shocks that may have nothing to do with trade or globalization.

U.S. mobility adjustment policy should focus much more on the needs of workers and less on attempts to “save” particular jobs. Programs should focus support on workers irrespective of the source of job loss that is outside of their control. Improving mobility – or the ability to transition to a new job or employer, in the face of any sort of economic shock – also means having a policy environment that eases the portability of incomes and benefits, including health care and retirement.

¹⁸ White House (2018b).

¹⁹ See Acemoglu, Autor, Dorn, Hanson and Price (2016) and Autor, Dorn and Hanson (2016) for a survey.

Lessons can be learned from other countries that have also been confronted with adjustment shocks, but that have better social insurance policies to support workers and communities. But one clear lesson is that improvements should not take place via a limited program of Trade Adjustment Assistance (TAA). TAA would have done nothing to assist the 80 percent of job loss in manufacturing during the 2000s that were not associated with trade. The United States labor market would be better served to stop treating “trade-related” shocks to workers differently from shocks arising because of technology, changes to what consumers want, bad managerial decisions, climate, or numerous other forces beyond the workers’ control.²⁰

5 The Use of WTO Dispute Settlement

The first prong of attack is to deploy WTO dispute settlement to address the systemic concerns with China’s state-owned enterprises. This would enforce existing international legal provisions and Chinese commitments on subsidies and other trade-distorting behavior.

5.1 The historical approach

The United States has filed 22 formal WTO disputes against China since its accession to the multilateral organization in 2001. For context, the United States has filed 39 against the European Union (or its member states), 7 each against Canada and India, 6 against Mexico, and dozens against other countries. The United States and China are two of the most active litigants in the system, which is consistent with research that finds that countries that trade a lot together have more bilateral irritants and frictions, and thus tend to utilize WTO dispute settlement.²¹ The U.S. has brought cases against China over subsidies, intellectual property protection, investment restrictions, trade remedies and other import restrictions, export restraints, and local content requirements. American challenges have involved economic interests in manufacturing – such as autos, aircraft, steel and aluminum – minerals, agricultural and a variety of services industries.

One benefit of deploying dispute settlement resources is the transparency that results. It shines an international spotlight on the Chinese policies that are at the heart of the underlying distortion.

Failing to utilize the WTO, and turning to trade remedies like countervailing duties instead, sometimes creates unintended consequence: the U.S. policy becomes the subject of a WTO dispute settlement investigation. And in such disputes, the global spotlight never turns to the underlying subsidy; the legal procedures keep it focused instead on the U.S. trade remedy response.

There are challenges to using WTO dispute settlement to address subsidies and China’s SOEs. Ironically, one arises because the concerns raised by China’s policies are not limited to affecting the market access interests of the United States.

For example, other countries stand to benefit from a U.S. dispute that would cause China to reign in its subsidies. But this creates the standard “free rider” – or collective action – problem. Each

²⁰ See Alden (2016).

²¹ Bown and Reynolds (2015).

government, including the United States, tends to under-invest in enforcing its individual rights. The result is too few cases are brought forward over these systemic issues.

To address this concern, the U.S. government has frequently chosen not to go at it alone in WTO disputes. Since WTO rules of nondiscrimination extend the benefits to third countries from a U.S.-led dispute against China, the approach has been to engage third countries so that they also bear some of the costs of the enforcement action. In at least a half dozen different disputes against China at the WTO, the European Union, Japan, Canada, Mexico and Guatemala have joined the United States as complainants.²²

5.2 Future use of WTO dispute settlement to address China's SOEs

In the current context, the United States government should pursue a WTO dispute against China over the issues of its state-owned enterprises, and the distortions they are having on U.S. market access. It would be the most direct way of attacking the underlying policy concern.

Even though the United States has brought disputes against China's subsidies before, such a dispute would not be without controversy. There are potentially legitimate concerns that neither the original General Agreement on Tariffs and Trade (GATT) nor the WTO itself were written so as to expressly define rules for state-owned enterprises, as well as various other issues that arise from state planning and non-market economies. Even the lengthy disciplines found in China's 2001 Protocol of Accession into the WTO do not provide useful guidelines for how market-oriented economies would want China's SOEs to behave.²³

Nevertheless, there are broad existing provisions that litigation has yet to fully explore that might address some of the more pressing concerns with China's SOEs. For example, there are rules disciplining the use of subsidies under not only GATT Article XVI, but also the WTO's Agreement on Subsidies and Countervailing Measures. Protection of intellectual property is covered by the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) and foreign investment under the Agreement on Trade-Related Investment Measures (TRIMs). And even if there are not explicit WTO red lines that China may have crossed, WTO members still have access to a final GATT Article XXIII provision that allow "nonviolation nullification and impairment" (NVNI) claims – that China's economic evolution has not allowed benefits expected under the agreement to materialize.²⁴

²² *China – Auto Parts* (DS340, with European Union and Canada), *China – Taxes* (DS358, with Mexico), *China – Measures Affecting Financial Information Services and Foreign Financial Information Suppliers* (DS373, with European Union and Canada), *China – Grants, Loans and Other Incentives* (DS387, with Mexico and Guatemala), *China – Raw Materials* (DS394, with European Union and Mexico), *China – Rare Earths* (DS431, with European Union and Japan), *China – Raw Materials II* (DS508, with European Union).

²³ See Levy (2017)

²⁴ See Staiger and Sykes (2011). Article XXIII(1) reads

If any contracting party should consider that any benefit accruing to it directly or indirectly under this Agreement is being nullified or impaired or that the attainment of any objective of the Agreement is being impeded as the result of

- (a) the failure of another contracting party to carry out its obligations under this Agreement, or

Historically, many WTO members have not pursued this approach to WTO dispute settlement because it was deemed a risky strategy, and there was a fear of losing offensive cases. Alternatively, there was also concern that pursuing such a broad strategy might also put “too much” pressure on the dispute settlement system.

These worries are less salient in this context, given the enormous pressure currently on the WTO to deal with this area of conflict. Unfortunately, the system may now be close to a make-or-break moment anyway. It is under stress from several different quarters and from policies pushing the limits of WTO-consistent behavior, including by the United States government.

A United States government approach of filing such a broad-based WTO dispute would best be done jointly, alongside American economic allies with market-oriented systems that confront the same economic challenges (identified in Section 3) as the United States. The most-willing participants would be the European Union and Japan, as indicated by the joint statements issued in Buenos Aires at the WTO Ministerial Conference in December 2017, in Brussels in March 2018 and in Paris in May 2018.²⁵ But other major players with systemic interests – e.g., Australia, Canada, New Zealand, South Korea, etc. – should also be consulted for engagement.

The benefits of such an approach would begin with the burden-sharing of the costs of enforcement against China. But a joint and collective approach would also not allow China the opportunity to play one trading partner off another – e.g., through implicit or explicit retaliation – that might create discriminatory and preferential market-opening opportunities for other countries in the Chinese market.

In a best-case scenario, the United States and other WTO members “win” such a dispute. They could be collectively authorized to retaliate against China if China were unwilling to bring its policies into conformity with WTO provisions. This would be the rules-based approach to incentivizing Chinese reform.

In a worst-case scenario, the United States and other WTO members “lose” such a dispute, and China is permitted to continue operating under the status quo. This could be the final blow to the WTO. But in the unlikely event that were to happen, it would have been clear that all relevant tools of the organization had been attempted and nothing potentially useful had gone untried. There would also be lessons learned for what new rules and approaches are needed to replace the existing system.

6 Design, Negotiation, and Enforcement of New WTO Disciplines on SOEs

Even if the best-case scenario were to result from a successful WTO dispute, litigation and authorized retaliation will not resolve the problem. This would only be part of a strategy to get China to recognize the seriousness of the issue and to come to the bargaining table to reach a mutually-agreeable, negotiated solution. Just like the status quo may not be working for the

(b) the application by another contracting party of any measure, whether or not it conflicts with the provisions of this Agreement, or
(c) the existence of any other situation

²⁵ See USTR (2017) and USTR (2018a, 2018b).

United States and other major market economies in the trading system, a strategy that dictates to China how it must reform its economy is unlikely to be politically sustainable for China.

What is needed are new and enforceable rules that both address any economic distortions arising from SOEs and that are adopted via an international agreement to which China is a party. The political bargain would be an enforceable agreement on SOE rules, and in exchange, China would be allowed to keep its SOEs. And the best approach would be to negotiate new SOE rules directly with China and within the framework of the WTO.²⁶

There are a several areas in which work to address this issue has been taking place. This final section describes how those experiences can inform negotiation and enforcement of new international rules.

First, an SOE agreement need not be negotiated in the context of full multilateral round or as part of a single undertaking that would include the entire WTO membership. An alternative approach would be to negotiate a plurilateral agreement with a critical mass of countries, including China. Examples of recent agreements in this vein include the first and second Information Technology Agreements.²⁷ Provided the agreement does not discriminate against WTO member non-participants, it should not be objectionable to the multilateral system.

What rules and disciplines should be included in a plurilateral, WTO agreement on SOEs? The provisions negotiated in free trade agreements are one place to start.²⁸

The United States government developed and negotiated to agreement an SOE chapter in the Trans-Pacific Partnership Agreement that it and 11 other countries signed in February 2016. Though it was never ratified by the U.S. Congress, the remaining TPP-11 countries have signed a new Comprehensive and Progressive Agreement for Trans-Pacific Partnership that includes a chapter on State-Owned Enterprises and Designated Monopolies (chapter 17). The European Union has similarly introduced SOE chapters into its free trade agreement negotiations, including as part of the Trans-Atlantic Trade and Investment Partnership (TTIP) talks with the United States. The EU has also introduced such texts as part of trade agreement negotiations with Mexico, and MERCOSUR, among others.

²⁶ Previous work articulating potential U.S.-China trade agreement negotiations includes Bergsten et al (2014).

²⁷ See also the Codes emanating from the Tokyo Round. For a discussion of the potential for adding new plurilaterals within the current WTO framework, see Hoekman and Mavroidis (2015a,b).

²⁸ The OECD has done considerable work on state-owned enterprises and governance. But given that China is not yet an OECD member and that some of the provisions will need to be enforceable, there are reasons to build from the OECD approach and implement it into a formal trade agreement framework like the WTO. Other approaches are arising at the sectoral level, including the OECD Global Forum on Steel Excess Capacity. National aluminum associations from the United States, Canada, Europe and Japan called for establishment of a similar forum at a summit in Montreal in advance of the June 2018 Group of 7 meeting (Metal Bulletin, 2018). In the context of the joint statement released in 2017 and 2018 by the trade ministers of the United States, European Union and Japan, there have also been discussions about the semiconductor industry.

There are many common elements in these SOE texts.²⁹ There are provisions related to nondiscriminatory treatment, commercial considerations, non-commercial assistance, and competitive neutrality. There are also rules involving transparency and corporate governance – a fundamental issue raised by Wu (2016) regarding the issue of Chinese government and Communist Party officials sitting on the board of companies and directing SOE decisions in ways that may be inconsistent with market signals. And on this point more broadly, there needs to be procedures in place to understand what exactly are the noncommercial interests or objectives of the SOE, so that its decisions and performance can be benchmarked and evaluated independently against those interests.³⁰

The SOE chapter in the TPP also includes provisions related to injury and adverse effects. These would be analogs to injury to the domestic industry either in trade remedy investigations due to imports or in subsidy disputes under the WTO due to losses suffered in export markets, including third markets.

Of course, demanding new disciplines for subsidies and SOEs should make the United States government prepared to be willing to address some of its own policy shortcomings. Other countries will certainly point to American subsidies and tax incentives at the state and local levels that can create economic incentives leading to many of the same, distortive economic effects as SOEs.

The final important issue involves enforcement of the new rules. Here, it is important to evaluate whether the traditional WTO approach of member-initiated, state-to-state disputes and committee engagement would be sufficient.

The European Union has adopted an alternative and more extreme approach for integrating different types of economies – many with high levels of SOE participation – into a relatively cohesive trading area. The mandate granted to the European Commission goes well beyond that granted to date to the WTO Secretariat. The EC enforces state aid limits in pursuit of its regulatory approach of managing the terms of competition between EU member states.³¹

Thus, an informed and evidence-based discussion is needed to evaluate the tradeoffs associated with differing approaches to effectively enforce new SOE disciplines arising in the international trading system.

²⁹ See Mavroidis and Janow (2017), Bhala (2017), Kovacic (2017), Wolfe (2017), Wu (2017), Prusa (2017), Mastromatteo (2017), and Sappington and Sidak (2003).

³⁰ Examples of noncommercial interest could be sustaining industry employment or even providing goods or services to underserved households (whereby commercial losses would arise).

³¹ See, for example, European Commission (2016).

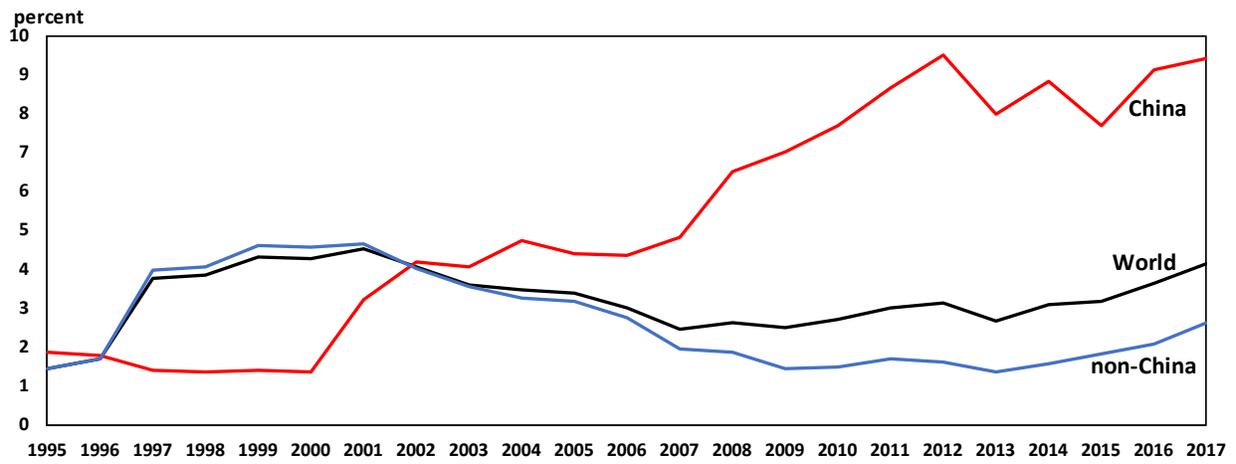
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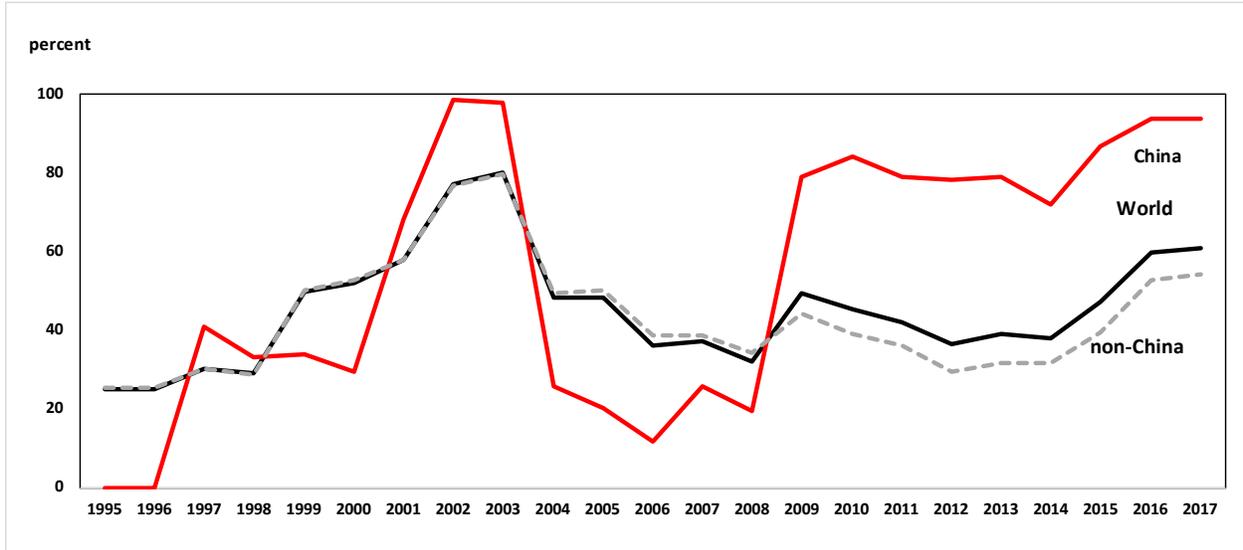
Figure 1. U.S. imports covered by imposed trade remedies by foreign source, 1995-2017



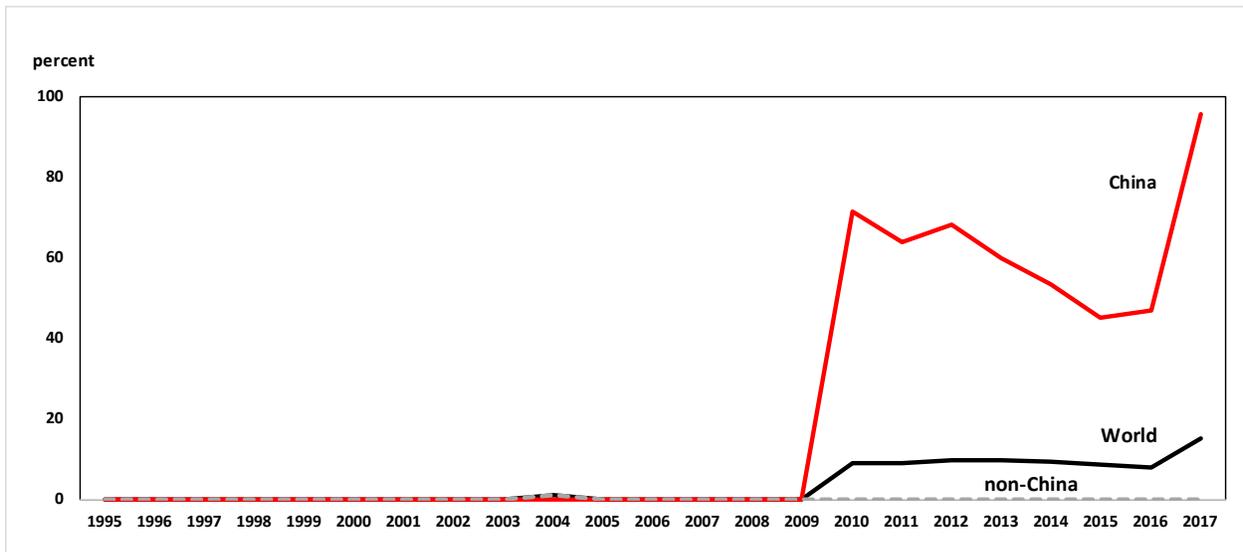
Source: constructed by the author. Trade remedies include antidumping, countervailing duties, and safeguards.

Figure 2. U.S. metals imports covered by imposed trade remedies by foreign source, 1995-2017

a. Steel



b. Aluminum



Source: Bown (2018). Trade remedies include antidumping, countervailing duties, and safeguards. “Steel” and “aluminum” defined as the Harmonized Tariff Schedule product codes identified in the Section 232 investigation reports (Department of Commerce 2018a and 2018b, respectively).