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# Introduction

China's accession to the World Trade Organization (WTO) has presented the increasingly globalized economic system with a conundrum. Are the contributions of China's high-growth, export-oriented economy a win-win—an unalloyed benefit for both the People's Republic and its trading partners? Or, as seems increasingly to be the prevailing opinion, has China's markedly different economic system, combined with its perceived tendency to bend or even break the rules of international trade, made it a problem that needs solving?

China's participation in the WTO has provided it with almost uninhibited access in 163 markets, the United States among them, and China has profited immensely from its participation in the world trading system. Recording unprecedented growth rates, it has transformed itself from a low-income, developing country to a global power in one generation. This is not, of course, due solely to its trade performance; China has long been a central player in global geopolitics and its economic potential has loomed large throughout East Asia and, indeed, the rest of the world. In recent years, that potential has been realized as China has profited from globalization to become a trade powerhouse. Its export-led growth model has perfectly positioned it to take advantage of the elimination of trade barriers for its products worldwide.

The rest of the world has profited from China's growth as well—at least in part. China's unprecedented export growth has benefited foreign consumers and stimulated capital gains for foreign investors. And yet, the silver

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lining of cheap Chinese consumer goods and corporate capital gains is tinged with gray. Accusations have surfaced and proliferated that China's success is due not only to its industry but also to other factors, and most notably, the suggestion that it simply does not play by the rules, whether by engaging in illegal subsidization or by counterfeiting, as just two examples. Such accusations are probably expressed most vociferously in Washington, D.C., but not only there. With varying degrees of vehemence, many of China's trading partners, especially the big players like the United States, the European Union, and Canada, have voiced their views of China's trading practices that range from general concern to pointed critique. Typically, these voices have criticized the extent of state involvement in the Chinese economy and argued for stricter enforcement of the current multilateral rules regulating international trade.

The Trump administration has preferred to take justice into its own hands. President Trump's decision to "take on" China has been making headlines since the summer of 2019, accompanied by a roller coaster of announcements of tariffs on specific products, followed by the imposition of some of them, retaliation by China, subsequent announcements veering toward peaceful resolution of the dispute, then renewed belligerence, and finally a deal. These are not dull times, as far as international trade news is concerned.

Of course, we are not here to judge the usefulness of similar tactics (antics?) when it comes to possible political exploitation. Our interests instead are the repercussions that similar actions have on the multilateral edifice of international trade. To us, what matters most is whether this is the most appropriate way to resolve the China issues.

But the world is not unanimous in criticizing China's trading practices. For one, there is a silent majority of trading nations, the smaller players, who have other fish to fry. Israel, for example, has not joined the chorus of critics. And then there are those, such as economist Dani Rodrik (2018), who claim that the current situation should not be of concern to the WTO at all, as China, its idiosyncratic elements notwithstanding, should simply be accommodated within the four corners of the current multilateral edifice. All the more so, the argument goes, since China's growth has contributed to the growth of many other nations. The world trade community, stakeholders and academics alike, have advanced various proposals to address the China problem. Some say, "Do nothing." Others advocate increased and stronger enforcement of existing rules. Still others insist, "Hit them where it hurts."

But to reach a long-term solution, we first have to decide if China is, in fact, acting outside the legitimate practices of world trade. In other words, what exactly is the “China problem”?

### **The China Problem: Myth and Reality**

If China plays by the book, then there should be no problem—its trade practices, alien as they might appear to some since they are not consonant with trade practices followed by most market economies, should be accommodated like any other country’s. But considered from another angle, China must be doing something wrong; otherwise there would be nothing to complain about—“Where there is smoke, there is fire,” as the old adage has it. In the pages that follow, we understand the “China problem” as the sum of claims that various trading nations (and most comprehensively and loudly the United States) have mapped out.

A major difficulty in assessing the situation is that this problem is a moving target—claims continually appear, disappear, and reappear again. Let us take the accusation that China is a currency manipulator as just one example. The Trump administration branded China a manipulator, the president withdrew the accusation a few months later, he reintroduced it once again sometime later, and then the administration succeeded in reaching a deal with China.

Two complaints, however, surface with some regularity and have withstood the test of time: that Chinese state-owned enterprises (SOEs) benefit from unfair trade advantages and that Chinese companies (both private and state owned) impose forced technology transfer (TT) deals on foreign businesses as a condition for accessing the Chinese market. In this volume, we focus on these two claims, which are central both to the way the Chinese economic system operates and to the difficulty that foreign economic operators encounter in their dealings with Chinese firms inside and outside China.

### **How to Deal with China?**

Essentially, we argue that the courses of action advanced to deal with the “China problem” are inappropriate or, at best, only partly efficient. We explain why bilateral solutions only advance short-term, narrow interests aiming to redress trade imbalances as opposed to systemic interests that address the cause of concern or effect change in the medium term. The

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world trading community's interests would be better served by a different approach—namely, amending the current trade law regime and bringing it into line with the original “liberal understanding” of the General Agreement on Tariffs and Trade (GATT). In our view, only a legislative amendment will allow the WTO membership to solve the problems posed by SOEs and forced TT. Implicitly, thus, we believe that there is merit in the concerns raised. We also believe, though, that the eventual solution to the current problems should not be China-specific. Concerns about SOEs and forced TT are not unique to China. Similar problems exist with regard to other current or potential WTO members. Multilateral solutions are, therefore, necessary. We argue that China, because of its size, simply exacerbated a problem that already existed.

To avoid misunderstandings as to the scope of our endeavor, we should emphasize that we do not purport to offer a complete blueprint to reform the WTO in all its dimensions. We leave this much-needed, but ambitious, task to others. Our goal is more modest. We seek simply to propose WTO reforms that we consider essential to lessen the tensions in the trading system arising from China's size and the nature of its economic system.

In the pages that follow, we will argue against the two extreme solutions to the “China problem”: unilateral measures against China to force a change of its economic regime on the one hand, and staying idle on the other. We concede that some of the concerns raised can be addressed through more active enforcement of the current WTO regime. When we say that some of the concerns about China can be handled effectively within the four corners of the existing WTO regime, we adhere to the view expressed elsewhere that a stricter enforcement of the Protocol of Accession for China might yield satisfactory results.

The bulk of the other concerns can only be addressed if new obligations are added to the current WTO regime. This is, in our view, particularly important, for even if we can imagine how a well-intentioned, imaginative WTO judgment might deflate the current state of uneasiness, such a judgment would be case specific. Furthermore, decisions made by WTO judges carry less weight than formal legislative amendments. In an era of doubt as to the legitimacy of the WTO Appellate Body, it is probably wiser (even though, we readily admit, more cumbersome) to opt for legislative solutions.

The GATT/WTO is, of course, the (legal) benchmark to judge the adequacy of the existing regime to address the two concerns mentioned above. As we explain in chapter 5 in detail, the GATT is an incomplete contract regulating trade transactions based on a “liberal understanding” of the law

and economy.<sup>1</sup> Suffice it to state for now that the GATT was part of the wider International Trade Organization (ITO) project, which contained disciplines on both state and private restraints to trade. The GATT was a chapter of the ITO (Chapter IV) and regulated only state barriers to trade.

The GATT entered into force on January 1, 1948, while awaiting the advent of the ITO. Even though the formal negotiation of all issues involved had been finalized, the treaty repeatedly failed to get through the U.S. Congress, and no other nation was prepared to ratify it without U.S. approval. Politics got in the way, and the ITO never saw the light of day. It never will, as the WTO has taken its place. The GATT disciplines, nevertheless, were part and parcel of a wider understanding on how to liberalize trade, which is predicated on respect for private rights and limited and controlled state intervention in the economy. This was explicitly contracted in the ITO, as we show in chapter 5.

But the obligations that were explicitly contracted in the ITO were almost never explicitly incorporated in the GATT text. Article XXIX is an exception, even though it only requests a best endeavor to observe the obligations. The implicit, rather than explicit, adherence to the ITO obligations on private rights and limited state intervention constitutes the “liberal understanding” of the GATT.

The GATT “liberal understanding” implicitly assumes that in all GATT/WTO members

- laws, contracts, and property rights will be enforced;
- the state will not undo contractual promises regarding trade liberalization through favoritism (pecuniary or otherwise) toward domestic agents; and
- investment will be liberalized.

None of this was ever translated into legal language in the GATT/WTO agreements, but it formed the essential background against which the multilateral trading system has been operating since its inception in 1948. All

1. In order to avoid any misunderstanding, we do not use the term “liberal understanding” throughout this volume in its possible ideological connotation. We use it simply, as equivalent to “market economy.” Market economies of course differ in the way they approach social policies, among other things. But they all share one common element: they represent an economic system, where (economic) decisions and the ensuing pricing of goods and services are, for all practical purposes, determined by the interactions of private individuals, citizens, and businesses alike. Government interventions are meant to address market failures and not to dictate the way each and every transaction in the economy should take place.

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the big players shared (or at least accepted) the liberal understanding of the law and economy. In Ruggie's (1982) account, this was the era of "embedded liberalism," the post-World War II era, where states were putting together an international system supporting free trade and market economies, while acknowledging the right to regulate in order to combat unemployment and support welfare policies at home. One might add that this was the quintessential reason why the multilateral rules operated so smoothly, despite the increasing number and heterogeneity of GATT/WTO members.

China was not the first, and it will likely not be the last, country to join the GATT/WTO with an economic system different from the liberal system that the main incumbent members have adopted. The GATT had to face a somewhat similar situation when socialist, non-market countries from Central and Eastern Europe joined the club. But these countries were small, and it was relatively easy to negotiate their accession through existing protocols, which imposed specific obligations on the acceding countries. Furthermore, their subsequent transformation into market economies linked to their accession to the European Union removed whatever problems might have existed during their initial years of participation in the world trading system.

Even when Japan wanted to join—a much bigger economy in which the state played a crucial role, even though it was not centrally planned—the GATT liberal understanding was not questioned. Japan was an outlier; it was far from sharing the liberal understanding when it joined the GATT under the protective aegis of the United States. This changed relatively soon afterward, when Japan acceded to the Organisation for Economic Cooperation and Development (OECD) a few years after it had joined the GATT. Through (or because of) its OECD membership, it endorsed the liberal understanding and aligned its regulatory regime to that of the Western countries that dominated the GATT.

India and Brazil, two large and important original signatories that might have been a thorn in the system's side, always accepted the GATT's basic tenets, each gradually welcoming the liberal understanding and thus avoiding clashes with other GATT/WTO members as their economies grew over time. India first in 1991, with the economic reform operated by Prime Ministers Rao and Singh, and Brazil with the adoption of Plano Real of 1994, steered by Presidents Franco and Cardoso, abandoned the heavily interventionist policies of the past and espoused the principles and practices of market economics for good.

In short, until the accession of China, the multilateral trading system was able to cope with increasing variety in economic systems among its members

with little difficulty. This was either because new members were fairly small or, if they were larger economies, because they shared (or subsequently accepted) the liberal understanding that was implicit in the original GATT text and that reflected the fact that its main architects were from the United States or Great Britain.<sup>2</sup>

This time, it is different. China is neither small nor willing to reform its one-party political system and everything it entails in terms of state participation in the working of the economy, as many of its partners had hoped it would have done within a relatively short period of time after joining the WTO.

## **Outline of the Book**

Chapter 1 serves as background information so that the reader can better appreciate the concerns voiced against China. In this chapter, we provide some data regarding the development of the Chinese economy in recent years and discuss the reactions of the world community to the new situation. We will highlight the worldwide euphoria when China entered the WTO frame, the antithesis of the more recent dysphoria that is gaining pace across the industrialized world.

In chapter 2, we begin by examining the claims against China presented by the U.S. authorities (based on discussions in the Trilateral group, where officials of the European Union, Japan, and the United States participate), the most vehement critics of Chinese policies, and then focus on the central issues: SOEs and TT, which lie at the core of complaints against China's trade and investment regime. They represent the high-priority items for the Trilateral group<sup>3</sup> but also for a few others and are therefore salient concerns of all of China's major trading partners.

2. See Irwin, Mavroidis, and Sykes 2008 and Tumlrir 1984. Japan presented the world trading regime with challenges as a result of its monumental growth rates in the 1960s and 1970s. Complaints against Japan were raised not only at the moment it acceded to the GATT but also a few years after it had joined. Already at the moment of its accession, it managed to provoke a record number of invocations of the non-application clause. Eventually, however, Japan became "one of us," and its ascension to Quad status is the best proof to this effect. We will discuss the Japanese problem in detail.

3. Following the decision of the European Union, Japan, and the United States (the "Trilateral"), during the 11th WTO Ministerial Conference of the WTO, to work together and confront China, they have been focusing on these two issues. See USTR, Joint Statement by the United States, European Union, and Japan at MC II, December 12, 2017; USTR, Joint Statement of the Trilateral Meeting of the Trade Ministers of the United States, European Union and Japan, May 23, 2019.

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Most importantly, by addressing these two concerns, we will be in a position to understand whether the current legal regime applicable to China (that is, the multilateral trade law as reflected in the WTO agreements that bind all WTO members including China, and the Chinese Protocol of Accession, which contains China-specific obligations) suffices to address the concerns raised. If the answer to this question is yes, then we need to explore the reasons for underenforcement. If the answer is no, then we need to ask why the current regime is inadequate and what can be done about it. To determine the answer, we analyze SOEs and TT in terms of the legal regime applicable to China—the multilateral rules as well as the Chinese Protocol of Accession. The combination of these rules provides a benchmark for assessing the ability of China’s current regime to deal effectively with the concerns voiced by the international community.

Our conclusion? In a nutshell, the current WTO rules on SOEs could, in principle, resolve at least some of the concerns raised by the United States and China’s other trading partners, but such a resolution requires a more imaginative interpretation of the existing rules than the WTO has thus far been willing to concede. This entails a reorientation of the current case law, a demanding exercise by any account. Therefore, in our view, a clarification of the rules on SOEs, inspired by existing regulatory solutions at the bilateral and plurilateral level, would go a long way toward addressing the current concerns. A legislative amendment would, by spelling out the details, preempt discretion by the WTO judges and avoid the risk of unsatisfactory outcomes due to unclear rules. In other words, clearing up some of the haziness that has plagued rulings related to SOEs will go a long way toward bringing China into alignment with the goals and policies of the WTO.

With respect to TT, the situation is different: the current rules are not adequate to address the friction over forced TTs. This is largely because requests for TT by private agents are not covered in the current WTO agreements, since these agreements do not deal with private trade deals but exclusively with state barriers to trade. Since similar requests could occur elsewhere as well (and not only in China), an expansion of current agreements to include private TT deals is necessary. But such an expansion raises an important issue: if the concern about TT is new—that is, if it postdates the WTO members’ negotiation with China that led to the conclusion of the Protocol of Accession—then it needs to be addressed now for the first time. If, conversely, the concern predates the negotiation, why has it not been addressed before? Is the concern about TT a new issue, specific to China? If these concerns have caused problems before, why were they

not addressed? Where did the system go wrong? Whatever the answer, we believe that only a negotiation of new rules can help solve the problem of private impediments to trade.

That private impediments could hinder trade liberalization was, of course, common knowledge when the GATT was being negotiated. Therefore, as we will show in more detail later, the ITO, under the aegis of which the GATT was originally supposed to come, contained a chapter dealing with multilateral responses to restrictive business practices (RBPs) by private agents. The degree of state involvement in the workings of the economy varies across trading nations. In principle, however, the original members shared a commitment to the market economy, and thus private impediments would be addressed by domestic competition laws.

The introduction of competition discipline in China is quite recent, and even today, China remains a country with substantial state involvement in the workings of the national economy. Countries with similar substantial involvement, ranging from Japan of the 1950s to Soviet bloc countries like Hungary and Poland, joined the GATT before China did. The parallels with their accession processes are not only relevant but warranted indeed.

For these reasons, in chapter 3, we will be discussing the experience of countries with similarities to China and the ways their accession processes unfolded. We will see that China presented the incumbents with a novel issue: even among similarly situated countries, China was something new. Before its accession, GATT incumbents had only dealt with small countries with heavy state involvement in the economy (like Hungary and Poland) or with big countries with less pronounced state involvement in the market (like Japan) but never with such a huge country that had, at the same time, such extensive state control over its economy.

In the same chapter, we will provide a more detailed discussion of the Japanese accession to the GATT, a choice predicated on a variety of reasons. For starters, the reaction to China's participation in the WTO is reminiscent of the hostility toward the accession of Japan to the GATT in the 1950s and the subsequent attempts to resolve the "Japan problem." Recent complaints against China are very similar to earlier complaints against Japan. Almost identical arguments were raised against the destructive nature of the Japanese "mercantilist trade and investment regime." Furthermore, reliable historical accounts<sup>4</sup> support the argument that Japan's organization of its economy was one of the paradigms that Chairman Deng, the

4. Vogel (2011; 2019) has analyzed this issue probably more comprehensively than anyone else.

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man credited with the transformation of the Chinese economy, aspired to emulate.

Japan has, of course, fully integrated into the ranks of the Western world. This does not, however, mean that, as in the case of Japan, one should expect changes in China soon—we will, in fact, demonstrate the opposite. We want to show the differences between the two countries and why the factors that influenced the transformation of Japan into a market economy are absent in China. We will explore the differences and the similarities between the two situations and draw conclusions.

Other countries with different economic systems have largely aligned themselves with the global trading system, of course, but China differs from these as well. For example, in the WTO era incumbents did have to face a request for accession by Russia and some other ex-Soviet bloc countries that have not joined the European Union and by Arab countries with heavy state involvement in the workings of their economies. Both sets of countries, however, are closer to the smaller ex-Soviet bloc countries that had joined the GATT than they are to China. As a result, although some lessons can be drawn from earlier experiences, the reader should not expect “lock, stock, and barrel” types of solutions here. China is singular, and it requires singular responses. In chapters 4 and 5, we focus on these responses—the courses of action advanced elsewhere, both by the United States and by academia.

In chapter 4, we will be dealing with unilateral threats and tariff increases as the “stick” meant to induce cooperative behavior by China. Relying on the existing research by Bown (2019) and Amiti, Redding, and Weinstein (2019), among others, we will explain why this strategy has already proved to be inefficient. But this is not the end of the story; if similar courses of action are followed in the future as well, countries confronting China risk facing countermeasures and a further weakening of the multilateral regime.

Finally, we will also examine the limits of enforcement of the current regime. Our main conclusion is that where clear rules have been agreed upon (as in the case of regulation of export taxes), complainants against China have scored their biggest victories. Imaginative proposals, such as that of Jennifer Hillman (2018), to pursue nonviolation complaints (NVCs) against China, a legal instrument of ambiguous efficacy anyway, are, in our view, not a recipe for success.

In chapter 5, we will address the thesis of Dani Rodrik (2018) according to which the WTO regime should accommodate players with divergent preferences when it comes to regulating their national economy. Consequently,

the argument goes, the world trading community should stay idle and desist from trying to persuade China to change. We disagree. By doing nothing, problems will persist, and, more important, it is not true that the GATT/WTO regime was designed to fit every country—it is predicated on the “liberal understanding” that we discussed earlier.

Why, then, did the Protocol of Accession not include terms inspired from this “liberal understanding,” which could have been tailor-made for China? In part, we will argue, there was exuberance—the widespread expectation that China would quickly transform into a market economy. In part, it was because there is only so much one can achieve through a Protocol of Accession.

The GATT/WTO regime was not designed with countries like China in mind. The framers of the GATT all shared the quintessential characteristics of market economies. This is what the implicit “liberal understanding” of the GATT amounts to. On the other hand, Protocols of Accession cannot serve as a means to impose choices regarding the organization of a country’s national economy. To prove this point, we will investigate the statutory language regarding the objective function of Protocols of Accession as well as their practice. We will explain why, the legitimacy of claims regarding underenforcement of the Chinese Protocol of Accession notwithstanding, transforming China into a market economy through its Protocol of Accession was legally and policy-wise not an option. It is in this context that we will compare China’s Protocol of Accession to the WTO with earlier GATT accession protocols for countries with significant state involvement in their trade regime.

Our discussion of the issues up to this point will lead us to conclude that none of the courses of action proposed so far can help the world trading community solve the “China problem.” If the world trading community is serious about addressing SOEs and forced TT, then it would be well-advised to change its course of action.

Chapter 6 offers proposals on how to improve WTO rules to deal with China (and other countries with some similar features). We will consider what is actually possible—rather than ideal—in terms of legislative reforms, borrowing from existing examples to which China is most likely to acquiesce rather than devising new rules altogether. Our proposals are counterpoints to the two radically opposed solutions that have been put forward to deal with the existing clashes between the WTO regime and China’s economic regime: on the one hand, demands that China radically change its economic regime to conform to Western ideals; on the other, that the WTO stay out of

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the controversy and that its members accept that they must accommodate China's state-controlled economy. We reject both of these proposals.

We argue that there is a third way that is more promising. In order to retain its principles and yet accommodate China, the WTO needs to translate parts of its implicit liberal understanding into explicit treaty language. We advance specific proposals to this effect that, if adopted, would induce China to change its economic behavior even as it retains its economic regime. In other words, the solution to the problem posed by China to the international trading system is not to demand a change in its economic regime but to induce a change in its economic behavior. In particular, we envisage a situation where China is able to retain its SOEs but where they behave in a market-friendly manner.

We will discuss separately, in chapter 7, the recent pushback against market-oriented reforms that President Xi has masterminded and executed. China today seems a long way from the aspirations to transform into a market economy by 2016 that accompanied its accession process. It is, in our view, an additional reason to strengthen the current multilateral framework so that it acts as a counterbalancing force to constituencies arguing for heavier state (i.e., Chinese Communist Party [CP]) involvement in the economy. If the framework is not strengthened, it may be too late to forestall the CP from instituting even stricter state controls than already exist in China.

Our volume ends with a call for renewed commitment to multilateralism. Unilateral action has increasingly proved to be ineffective. It is time to try the carrot instead of the stick. We do not intend to discuss all the mishaps that the world trading system is currently experiencing, but we would be remiss if we turned a blind eye to the fact that China is a contributing factor.

Globalization has seemed for years to be a fact of life—a new fundamental and permanent foundation for the world economy. But China's accession to the WTO has revealed potential cracks in that foundation. As Bown and Irwin conclude in their excellent article:

The fall of the Berlin Wall and the collapse of communism opened up Eastern Europe and the former Soviet Union to global markets. The reforms of Deng Xiaoping did the same for China. But only in the unipolar moment, which began in 2001, when China joined the WTO, were open markets truly global. Now, the period of global capitalism may be coming to an end. What many thought was the new normal may turn out to have been a brief aberration. (2019, 136)

If there is still some hope to prove this (increasingly realistic) statement wrong, we argue, it is through a return to the values that helped establish the post–World War II multilateral edifice. Although in this book we concentrate narrowly on the “China problem,” it is not a problem that is self-contained. Instead, it has profound implications for the economic ties that bind countries together in a globalized world—or the barriers that thrust them apart. In short, we view this work as a contribution to the much larger project of reinvigorating the multilateral regime.

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