The U.S.-China Trade Negotiation: A Contract Theory Perspective

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Abstract

International trade negotiations have traditionally been viewed as a two-level political bargain between trading nations and among domestic interest groups. While this bargaining model is helpful for predicting the political dynamics in trade negotiations, its focus on politics tends to obscure the economic consequences of trade agreements. Drawing upon insights from contract theory in economics, this Article analyzes three ingredients of transaction costs that lead to the incompleteness of a trade agreement—the unforeseen contingencies, cost of enforcing the contract and the cost of writing the agreement. Using the ongoing U.S.-China trade negotiation as a comprehensive case study, this Article illustrates the circumstances when a trade agreement is difficult to write, unlikely to succeed and impossible to enforce. As an alternative to a trade agreement, this Article advocates instead for greater economic integration as a commitment device. By allowing each country to hold the other’s assets hostage, economic integration can facilitate cooperation between nations when trust is lacking. This Article contributes to the existing literature by proposing an economic framework to analyze the promise and perils of trade negotiations. It also offers a cautionary tale of using economic sanction to force other countries to make legal concessions.
I. Introduction

International trade negotiations have traditionally been perceived as a two-level game: at the international level, trading nations attempt to maximize their national interests while minimizing the adverse consequences from a liberalizing trade agreement; at the domestic level, domestic interest groups lobby for favorable treatments under the trade agreement while politicians seek to strike compromises among different interest groups.¹ Faced with the entanglement of domestic and international affairs, trade representatives will strive to reach an agreement that can be ratified at home.² This bargaining model, which focuses on the interaction between international and domestic interests, is helpful for predicting the political dynamics in trade negotiations. Yet the focus on politics tends to obscure the economic consequences of trade agreements. Indeed, if the obligations in the agreement will not be closely observed by the trading countries, or if it is foreseeable that they would fail to enforce the agreements, or if it is difficult to put the agreement down into writing in the first place, then any victory with a trade negotiation will prove illusory. Accordingly, the ex post consequences of a trade agreement should be a crucial consideration affecting the ex ante bargain. This economic perspective, however, is often overlooked by trade lawyers.

Drawing upon insights from contract theory in economics, this Article proposes an economic framework to analyze the promise and perils of trade negotiations.³ Oliver Hart, a Nobel-winning economist, has long proposed with his coauthors that the existence of transaction costs makes it impossible for the parties to write a complete contract.⁴ The concept of transaction cost dates back to Ronald Coase’s work on the boundary of a firm and legal entitlements, in which he explains that market transactions could be very costly, considering the costs of finding a transaction partner, negotiating, contracting, and inspection of execution of the contract inter alia.⁵ Jean Tirole,


² Broadly speaking, contract theory refers to the theory of incentives, information, and economic institutions. See Patrick Bolton & Mathias Dewatripont, Contract Theory 2 (2004). Economists have applied contract theory to understand the ex-ante decision of why and how parties make contractual arrangements. This is different from the legal analysis of contract, which takes an ex post perspective by focusing on the consequences of the breach of contract. See Robert E. Scott & Paul B. Stephen, The Limits of Leviathan, Contract Theory and the Enforcement of International Law 62-63 (2009).


⁴ Ronald Coase first proposed the concept of transaction cost in Ronald H. Coase, The Nature of the Firm, 4 ECONOMICA 386 (1937). He later elaborated on the concept in Ronald H. Coase, The Problem of Social Cost, 3 J. L. & ECON. 1, 15 (1960). (“In order to carry out a market transaction it is necessary to discover who it is that one wishes to deal with, to inform people that one wishes to deal and on what terms, to conduct negotiations leading up to a
another Nobel-winning economist, subsequently identified three types of transaction costs that can lead to contracts’ incompleteness: first, unforeseen contingencies—that is, the parties cannot anticipate in advance every contingency that will occur ex post; second, costs of enforcing the contracts—that is, courts must understand the agreement, verify the contingencies in case they occur, and enforce the contract; and third, costs of writing the contract—that is, even if people expect the contingencies, such contingencies are so numerous that it is costly to write them down.  

One illuminating example of how the theory of contract incompleteness can be applied to better understand trade agreements is the ongoing U.S.-China trade negotiation. Since the eruption of the Sino-U.S. trade war in 2018, the United States has been pressing for a rigid trade agreement. The Trump administration is not satisfied with China merely purchasing more of its soy beans; it has also pressed China to make structural economic changes such as removing subsidies for its state-owned enterprises. Above all, it has demanded that China change its domestic law and practices, specifically intellectual property (IP) laws and cybersecurity laws to eliminate forced technology transfer and stop the theft of U.S. trade secrets to foster indigenous innovation. Moreover, the Office of the United States Trade Representative (USTR) has insisted that the trade agreement incorporate more specificities, and that an enforcement mechanism be in place to ensure that China lives up to its promise. More specifically, the U.S. trade negotiators have advocated using tariffs as a continuing punishment threat to China, and China cannot retaliate in kind.

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8 Id.

9 Testimony of Robert E. Lighthizer at the Hearing Before the Committee on Ways and Means of U.S. House Committee of Representatives (hereinafter Testimony of Lighthizer), Feb. 27, 2019, at 14, https://waysandmeans.house.gov/sites/democrats.waysandmeans.house.gov/files/documents/U.S.-China%20Trade%20Hearing%20Transcript%201.pdf (As testified by Mr. Lighthizer: “…our hope is to have specific language on specific issues that is enforceable through a very clear process”).

However, trade agreements, like other contracts, are incomplete.\textsuperscript{11} In fact, the rigid agreement that has been pressed upon by the Trump administration represents a quintessential example of how transaction costs could pose challenges to the drafting, concluding and enforcement of a trade agreement. In the following discussion, I will apply the analytical framework of contract incompleteness to examine the ongoing Sino-U.S. trade negotiation. The rest of the Article is organized into six parts. Part II gives a recount of the U.S.-China trade negotiation since 2017. It provides the backdrop of the trade tension between the two countries, summarizes the legal concessions that China has made prior to the collapse of the trade talk, and describes how the two countries’ row with regard to contract specificities resulted in an impasse.

Part III explains the unforeseen contingencies that might occur during the execution of the Sino-U.S. trade agreement. It first describes China’s astounding success in modernizing its IP laws and institutions over the past few decades; however, foreign businesses continue to complain about inadequate IP enforcement. Such a deficiency in law enforcement is difficult to monitor and almost impossible to verify. As many aspects of law enforcement are not contractible, the Chinese government, particularly the local governments, retain vast discretion in enforcing the laws. As a result, a significant amount of uncertainty may arise when China begins to carry out its obligations under the trade agreement. In fact, the United States and China have engaged in four decades of disputes with each other with regard to IP enforcement, but the intractable problem with slack enforcement persists.

Part IV elaborates on the difficulty of enforcing the Sino-U.S. trade agreement. Unlike ordinary contracts, the trade agreement between the United States and China is above the law. The Trump administration’s unilateral decision to impose tariffs on China risks violating the World Trade Organization (WTO) rules, and it is difficult for the United States to challenge China’s IP enforcement in the WTO. The agreement is not self-enforcing, either. As the economic and trade structures of the United States and China are highly complementary, the U.S. administration is subject to severe political and economic constraints in imposing overtly severe punishments on China. Moreover, U.S. interests and policy toward China are constantly evolving, and these types of bilateral agreements are not renegotiation-proof, as illustrated by the Sino-U.S. intellectual property rights (IPR) negotiations in the 1990s.

Part V discusses the cost of writing a trade agreement. As was widely reported, the U.S. and Chinese leaderships had reached an agreement in principle during the trade negotiation, but they had significant disagreements when the agreement was put into writing.\textsuperscript{12} Contract theorists have

\textsuperscript{11}Henri Horn \textit{et al.}, \textit{Trade Agreements As Endogenously Incomplete Contracts}, 100 AM. ECON. REV. 394, 394 (2010); see also generally Pierpaolo Battigalli & Maggi Giovannini, \textit{Rigidity, Discretion, and the Costs of Writing Contracts}, 92 AM. ECON. REV. 798 (2002).

\textsuperscript{12}Wendy Wu \textit{et al.}, \textit{US-China Trade Deal Within Reach if Xi Jinping and Donald Trump Show Courage at the G20 Summit in Osaka}, S. CHINA MORNING POST, June 21, 2019,
demonstrated that concerns about pride and dignity can cause people to reach an impasse in a bargain. The trade war erupted against a backdrop of growing U.S. hostility against China and there is an overwhelming consensus among Chinese policymakers that the United States is using trade to contain China’s rise. Capitulating to the U.S.’ demand would send a strong signal that China is bowing to the pressures of the United States, leaving an impression that the Chinese government is weak in this situation. Above all, a rigid agreement appears imbalanced, and easily invokes the memory of China’s long and painful history of subjugation by western powers. This could pose a threat to the Chinese Communist Party (CCP), whose legitimacy was built upon its promise to stand up against foreign aggression.

Part VI suggests an alternative to using a trade agreement to bind China to its promises. Based on the economic insights from Nobel laureates Thomas Schelling and Oliver Williamson, this Part explains how hostage-taking can help overcome mistrust and tension between parties and facilitate their cooperation. It argues that economic integration is a form of hostage that can help stabilize the U.S.-China commercial relationship. By addressing the Trump’s administration’s various policy measures to decouple the Sino-US economies, this Part warns that conflicts will be more likely to arise when the two countries have fewer hostages from each other. Part VII concludes and offers three concrete recommendations for U.S. trade representatives to facilitate their negotiation with their Chinese counterparts.

II. The Row Over Contract Specificities

Lawyers and economists have long considered the tradeoffs between rigidity and flexibility in writing a contract. A flexible contract allows the parties to adjust the outcome to the state of nature whereas a rigid contract does not allow the parties’ obligations to be sufficiently contingent

https://www.scmp.com/news/china/diplomacy/article/3015422/us-china-trade-deal-within-reach-if-xi-jinping-and-donald (As Craig Allen, the president of the US-China Business Council, noted: “The top leaders of the two sides have reached agreements in principle, but it is the detail that they have disagreement about”).


15 See Scott & Stephen, supra note 3, at 76-79 (noting that the tension between the need for commitment and flexibility influences the parties’ decision to contract); Robert E. Scott & George G. Triantis, *Anticipating Litigation in Contract Design*, 115 Yale L. J. 814, 840-855 (2006) (explaining that the choice between writing vague or precise terms in contracts is determined by the tradeoff between the front-end transaction cost and back-end enforcement cost); Anne van Aaken, *Between Commitment and Flexibility: The Fragile Stability of the International Investment Protection Regime*, 12 J. Int’l Econ. L. 507 (2009) (cautioning that if international investment law continues to place too many constraints on sovereignty without allowing flexibility, it could precipitate a backlash from states).
on the external state. However, a flexible contract raises issues of moral hazard when the promisor adjusts his future performance in a way that best serves his own interest at the expense of the promisee. This occurs when the promisor has hidden information from the promise, or even if the promisee can observe the action, it is difficult for a third party to verify the action of the promisor. As a result, the promisee is deterred from making relationship-specific investments ex ante, for fear that they would be vulnerable to exploitation ex post. The solution to the under-investment problem is a rigid agreement, which binds the promisor to his commitments to ensure his credibility. This would encourage the parties to undertake relation-specific investments and to take precautions to reduce risk-bearing costs. But a rigid contract has its drawback, as the parties cannot adjust their performance according to the state of the world, leading to ex post inefficiencies.

A similar tradeoff between flexibility and rigidity also exists in the current trade negotiation between China and the United States. While free trade is widely recognized as superior to protectionist policies, countries could engage in “opportunistic protectionism” by failing to abide by the liberalizing trade agreement. Indeed, whatever legal concessions that China ultimately make in a trade agreement will be implemented by Chinese administrative agencies and judiciary, who enjoy superior information advantage to the U.S. government. The information asymmetry between the two sovereigns makes it very difficult for the USTR to closely monitor and verify China’s compliance with the trade agreement. The problem of moral hazard could therefore arise when China fails to exert the best efforts to carry out its obligations but rather shirks some of its responsibilities. This explains why the USTR is insisting on a rigid agreement, as it could pin down more precisely the outcome that China needs to deliver. Another reason why the USTR

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16 I adopt the definition of rigid and flexible contract from Oliver Hart & John Moore, *Contracts As Reference Points*, 123 Q. J. ECON. 1, 2 (2008). (Hart and Moore have proposed an alternative and complementary view that contracts can serve as reference points—that is, the parties’ feeling of entitlement. As people tend to have self-serving biases, the parties to a contract typically hope for the most favorable outcome as allowed by the contract. A flexible agreement could give rise to disagreements between the parties as it allows for multiple outcomes. The party who feels that he is shortchanged can retaliate by shading in performance, causing deadweight loss. Hart calls this “aggrievement cost.” A rigid contract, on the other hand, specifies the exact outcome and so parties get what they expect. This reduces shading and aggrievement cost. Hart and Moore’s model is valid in the absence of noncontractible relationship-specific investments).

17 *See Scott & Stephen, supra* note 3, at 78.

18 *Id.* at 71-72.

19 *Id.* at 76.

20 *Id.*

21 *Id.* at 76.

22 *Id.* at 77. *See also* Hart & Moore, *supra* note 4, at 2.

A. Backdrop

In August 2017, the Trump Administration launched a Section 301 investigation into China’s policies on intellectual property, technology, and innovation. Being one of the most controversial U.S. foreign trade legislations, Section 301 allows the United States to unilaterally impose economic sanction on imports. After the establishment of the WTO in 1994, which created a new multilateral litigation system to handle trade disputes, Section 301 fell into disuse and the United States instead turned to the WTO’s dispute resolution mechanism to resolve disputes. Thus, the Trump Administration’s decision to invoke the Section 301 investigation against China this time represents a sharp departure from previous practice. Following the conclusion of the 301 investigation, the White House released a “Memorandum on Actions by the United States related to the Section 301 Investigation” on March 22, 2018. The memo made four major complaints against China, stating that China had: (1) abused administrative approval process to pressure foreign firms to transfer technology; (2) maintained discriminative licensing practices to force the transfer of U.S. technology; (3) used state capital to strategically acquire cutting-edge technology and IP assets to support China’s industrial policy objectives; and (4) engaged in cyber-intrusion into U.S. networks to steal valuable IP and sensitive business

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24 In the context of sovereign debts, in which the debtors are largely litigation-proof, parties write long and detailed contracts because they anticipate reputation sanction from third parties such as the IMF. See Mitu Gulati & George Triantis, Contracts Without Law: Sovereign versus Corporate Debt, 75 U. CINCINNATI L. REV. 977, 1004 (2007).

25 Wayne M. Morrison, Enforcing U.S. Trade Law: Section 301 and China, CONGRESSIONAL RESEARCH SERVICE, June 26, 2019. (“Sections 301 through 310 of the Trade Act of 1974, as amended, are commonly referred to as ‘Section 301.’ It is one of the principal statutory means by which the United States enforces U.S. rights under trade agreements and addresses ‘unfair’ foreign barriers to U.S. exports”).

26 See generally AGGRESSIVE UNILATERALISM: AMERICA’S 301 TRADE POLICY AND THE WORLD TRADING SYSTEM (Jagdish Bhagwati & Hugh T. Patrick eds., 1990). (As Chad Brown observed: “The US government acted as the police force (identifying the foreign government’s crime), prosecutor (making the legal arguments), jury (ruling on the evidence), and judge (sentencing the foreigner to US rehabilitative punishment). And sometimes cases would involve issues without internationally agreed upon rules.”)

27 Chad P. Bown, Rogue 301, Trump to Dust Off Another Outdated US Trade Law, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS, August 3, 2017 (“Between 1974 and now, the US government has conducted 122 Section 301 investigations, but there has been only one new Section 301 investigation since 2001”).

information.\textsuperscript{29} With the exception of the third channel on outbound investment, the other three channels all concern China’s inadequate protection of IPRs.

The United States has, in the past, relied on bilateral engagements to exert pressures on China to enhance its IP protection.\textsuperscript{30} Before the trade war erupted in 2018, the U.S. and Chinese government had exchanged views on technology transfer at multiple occasions of formal, high-level dialogues.\textsuperscript{31} In each round of these talks, China had committed to stop using technology transfer as a condition for market access and allow businesses the freedom to negotiate and decide on transfer issues voluntarily.\textsuperscript{32} China had further committed to not exert pressures on such technology transfers through regulatory and administrative approval.\textsuperscript{33} But the United States claimed that these dialogues only achieved “isolated, incremental progress” and that the Chinese government had failed to follow through on important commitments.\textsuperscript{34} U.S. businesses complained that even though China got rid of the formal requirements in its rules and regulations, the requirements of technology transfer as a quid pro quo remained a de facto requirement.\textsuperscript{35}

Frustrated by China’s stalling tactics in annual economic dialogues with their Chinese counterparts, the U.S. trade officials have been pressing for a deal that has teeth in this round of the trade talks.\textsuperscript{36} In February 2019, the Chinese side was prepared to sign a memorandum of understanding (MOU), but U.S. President Donald Trump suddenly demanded a more binding agreement.\textsuperscript{37} More

\textsuperscript{29} Id.


\textsuperscript{31} Id., at 6-8. (These dialogues include, among others, U.S.-China Joint Commission on Commerce and Trade, the U.S.-China Strategic Economic Dialogue, and a new dialogue known as the U.S.-China Comprehensive Economic Dialogue).

\textsuperscript{32} Id.

\textsuperscript{33} Id.

\textsuperscript{34} USTR, \textit{2018 Report to Congress on China’s WTO Compliance}, Feb., 2019, at 50. See also Testimony of Lighthizer, \textit{supra} note 9 (As remarked by Mr. Lighthizer: “We at USTR are very aware of the history of our trading relationship with China, and the disappointments that have resulted from promises that were not kept”). \textit{See also} Alan Rappeport, \textit{19th Century “Humiliation” Haunts China-US Trade Talks}, N.Y. TIMES, Mar. 27, 2019 (Senator Charles E. Grassley of Iowa stated that China had a history of breaking promises on trade).

\textsuperscript{35} USTR, \textit{supra} note 30, at 22.


specifically, the USTR wanted to incorporate an enforcement mechanism into the agreement to ensure that China would live up to its promise. This view is widely shared among many American experts, who believe that such an enforcement mechanism is the key to the U.S.’s success in the trade talks. According to Robert Lighthizer, any complaints about China’s violation of the agreement subsequent to the conclusion of the trade talks will have to be resolved through meetings with high-level officials. If those complaints are not handled in a satisfactory manner, the United States can unilaterally take “proportional” actions against China, such as reviving the threat of tariffs. What Mr. Lighthizer has envisioned is a close monitoring system based on complaints from U.S. businesses operating in China, where tariffs are used as a continuing deterrence device. He also emphasizes explicitly incorporating such an enforcement mechanism into the trade agreement to ensure that China will live up to its promise.

B. China’s Legal Concessions

In anticipation of the U.S.’ demand for a credible commitment, China made a number of concessions by quickly and preemptively amending some of its IP-related laws between March and April 2019 to directly address U.S. concerns. As elaborated below, these amendments largely conform to the broad contours of the U.S. demands, although there remain important areas of the law in which China has not taken action.

38 Politi & Yang, supra note 10.


40 Testimony of Lighthizer, supra note 9, at 52-3. (“If we have an agreement there will be a process that has been agreed to where, at the office-director level, there will be monthly meetings, and then I will go through the process and then I will take a step back. At the vice-ministerial level there will be quarterly meetings. And then there will be semi-annual meetings at the ministerial level. That would be me and the vice premiere, who is my counterpart in this. And the idea is two things: one, individual companies will come to us with complaints about practices, and we will be able to work those through the process. In many cases, those are going to have to be anonymous, because companies are afraid to come forward, because they know what will happen if they do. …and then, in addition to that, there will be systemic problems, where we will see patterns developing, and a series of things that we disagree with, and we will bring those through the process. Hopefully, in most cases, they will be resolved at the first or second level. If not, they will be resolved at my level. And if there is disagreement on my level, then the United States would expect to act proportionally, but unilaterally, to insist on enforcement”).

41 Id. at 53.

42 Testimony of Lighthizer, supra note 9, at 52-53.

43 China has not changed the patent law, an area in which the United States has demanded a heavier penalty on infringements and a stricter law to prevent forced technology transfer. Moreover, the Trump administration wants China to modify its cybersecurity law to ease its concern about data theft. See Chris Buckley & Keith Bradsher, *How Xi’s Last-Minute Switch on U.S.-China Trade Deal Upended It*, N.Y. TIMES, May 17, 2019. Since China promulgated its cybersecurity law on June 1, 2017, the United States has been concerned that the law could be pretext for China to steal sensitive data from US businesses. *See USTR, 2018 Special 301 Report 45* (2018). (The USTR was concerned
On March 15, 2019, China passed its Foreign Investment Law, only three months from the publication of the draft rules. The speed in passing the law was unprecedented, as a new law normally goes through at least several rounds of public comments and takes years before approval. With only 41 provisions, the new law is a much curtailed version of a previous draft circulated in 2015, containing more than 170 provisions. The new law replaces the existing three foreign investment laws that were passed in the early years of China’s opening reform. It aims to facilitate and promote foreign investments, and to level the playing field for foreign and domestic investors in China. First, it streamlines governmental approvals and enhances the approval efficiency. Second, it includes stronger language on protecting foreign firms’ IPs. Third, it explicitly prohibits governmental departments from coercing foreign companies to transfer technologies and bans Chinese officials from divulging commercial secrets. The new language also tries to tackle China’s opaque regulatory review process, also known as “conformity assessments” that foreign companies must complete before manufacturing new products or setting up plans in China. However, the new foreign investment law only sets out a blueprint and does not specify clear operational details, leaving them to be addressed by further implantation.


46 Id. See also Lim Yan Liang, China’s Draft Foreign Investment Law: Too Little, Too Fast, Says Critics, STRAITSTIMES, Mar. 8, 2015, https://www.straitstimes.com/asia/east-asia/china-says-new-foreign-investment-law-to-foster-fair-competition (noting that the 2015 draft rules were stalled in the National People’s Congress and never went into force.)

47 Id. The existing foreign investment laws include the Sino-Foreign Equity Joint Venture Law, the Sino-Foreign Contractual Joint Venture Law, and the Foreign Invested Enterprise Law.

48 Foreign Investment Law of the People’s Republic of China, supra note 44, art. 9.

49 Id. art. 19.

50 Id. art. 22 (replacing a phrase about encouraging technology cooperation based on voluntary principles and commercial laws in the previous draft).

51 Id. arts 22-23.

52 Id. arts. 24-25.
The response from foreign businesses was lukewarm at best, noting that the law, passed without sufficient consultation, had failed to go into the specifics of the issues that were challenging foreign businesses. Others expressed concern that the broad and vague terms in the new law would leave room for discretionary implementation of the law.

On March 18, 2019, China abolished several highly controversial provisions in the State Council’s 2002 Technology Import and Export Regulation, and the Sino-Foreign Equity Joint Venture Law Implementing Regulations. These regulations used to impose contractual restrictions on the licensing of foreign technology into China, by requiring mandatory indemnities against third party infringement and mandatory ownership of improvement by domestic licensees, as well as forcing technology transfer where the foreign investor chooses to license the technology to the joint venture. The United States had repeatedly urged the Chinese government to revise these provisions but to no avail and even challenged these regulations at the WTO. China’s abolition of these provisions thus seems to directly address the U.S.’ longstanding concern about these regulations. As a complement to the Foreign Investment Law, on April 23, 2019, China amended the Administrative Licensing Law to tackle the issues of forced technology transfer during administrative approval and licensing.

53 Amanda Lee, *Chinese Premier Li Keqiang Says Foreign Investment Law Shows Beijing Is Serious about Opening Economy Further*, S. CHINA MORNING POST, Mar. 15, 2019, at https://www.scmp.com/economy/china-economy/article/3001926/chinese-premier-li-keqiang-says-foreign-investment-law-shows (According to Premier Li Keqiang at a press conference, the law is only a basic law and the State Council will introduce further implementation guidelines.)

54 See Xin, *supra* note 45; see also Liang, *supra* note 46.

55 See Liang, *supra* note 46.

56 See Hogan Lovells, *China Breaks New Ground with Foreign Investment Law-related Intellectual Property Reform*, Apr. 2019, https://www.engage.hoganlovells.com/knowledgeservices/viewContent.action?key=Ec8teaJ9VarM3M3vQ0dgfa%2FdwxZ0l6NkpBiaRvcQ1%2B0trYQ6QELAnKE%2BtBuQ3%2BHDX%2BwQYOTEw3eMk%3D&nav=FRbAN%3EcS95NMLRN47z%2BeeQgEFt8EGQ0qFioEM4UR4%3D&emailtofriendview=true&freeviewlink=true

57 USTR, *supra* note 34, at 133 (noting that no similar requirements are imposed among license agreements between two domestic enterprises or upon an exporting Chinese firm).

58 *Id.* See also USTR, *supra* note 30, at 48- 61.

59 See Administrative Licensing Law of the People’s Republic of China (promulgated by the Standing Committee of the 10th National People’s Congress on August 27, 2003, last amended on Apr. 23, 2019), arts. 5 & 31. See also Dan Prudhomme, *Reform of China’s “Forced” Technology Transfer Policies*, OXFORD BUSINESS LAW BLOG, July 22, 2019, https://www.law.ox.ac.uk/business-law-blog/blog/2019/07/reform-chinas-forced-technology-transfer-policies (noting that the revised Administrative Licensing Law prohibits individuals involved in the administrative licensing process from disclosing applicants’ trade secrets or other confidential information except under exceptional circumstances; allowing the applicants to object to the sharing of confidential information under such exceptions; prohibiting government agencies to make technology transfer as a condition for licensing).
In addition to technology transfer, the Chinese legislature also made drastic legal changes to address the U.S.’ concern about trade secret protection. Trade secret protection has been a top priority for the United States during rounds of Sino-US bilateral exchange. The main legislation on trade secrets is found in the Anti-Unfair Competition Law (AUCL), which was amended in November 2017 and became effective on January 1, 2018. However, the United States was not satisfied with the 2017 amendments, noting several impediments for claimants in launching suits in the Chinese courts. The United States also pointed out that the 2017 amendment failed to address obstacles to injunctive relief and the need to allow for evidentiary burden shifting in appropriate circumstances.

On April 23, 2019, the Standing Committee of the National People’s Congress promulgated the amendments to the AUCL and the Trademark Law. Since the AUCL had only been amended a year ago, the new amendment was widely recognized as a move to satisfy the U.S. demand to step up protection of business secrets for foreign companies operating in China. The amendment broadened the scope of trade secrets, which not only relate to technology and business information, but also other commercial information. Moreover, it clarified the scope of infringers. The new AUCL also greatly alleviated the burden for plaintiffs to bring suits in the Chinese court.

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60 USTR, supra note 34, at 37.


62 Id. at 133 (For instance, the definition of trade secrets is so narrow that it could potentially exclude certain types of proprietary information from its scope of protection; the protection of trade secrets was only afforded to business entities engaged in commercial activities rather than any natural or legal persons; the law fails to provide a higher sanction for willful infringement.)


65 Anti-Unfair Competition Law, supra note 61, art. 9.

66 Id. In the pre-existing regime, individuals were excluded from the scope of infringers; the new amendment makes it possible to hold individuals who facilitate trade secret infringements, such as employees or ex-employees, liable if they were found to have disclosed the trade secrets of the business.

67 Anti-Unfair Competition Law, supra note 61, art. 32. (Instead of requiring the trade secret owners to demonstrate that the alleged infringer has had access to the trade secret and that the information used by the infringer is substantively the same as the trade secret, the new law provides that the right owner proves that it has taken confidentiality measures to protect the trade secret and that the trade secret has been infringed. The burden of proof will also be shifted if the plaintiff can show that the defendant has ways to obtain the trade secrets and the information used by the defendant is substantially the same, or if the plaintiff has evidence that the defendant has used or is about to use the trade secrets).
obtain conclusive evidence of infringement in trade secret cases. Some practitioners have pointed out that this requirement is too onerous for the defendants and indeed has gone to the other extreme. Lastly, the new law set forth a punitive damage, allowing the court to impose up to five times the amount of the actual damages or profits obtained by the infringer if damages cannot be ascertained. It also increased the statutory compensation in case of unascertainable damages from RMB 3 million to RMB 5 million. All these new amendments seem to have been made to satisfy the U.S. demands.

Another major change is the amendment of the Trademark Law. For years, U.S. businesses have complained that they are subject to malicious legal challenges by third parties whose registered trademarks are identical or closely similar to those of the existing U.S. brands. China amended its Trademark Law in 2013 and specifically added a provision to combat bad-faith trademark filing. However, it did not seem to be effective, as the number of bad-faith filings had gone up and owners of such bad-faith marks had become more aggressive. On April 23, 2019, the same day China released the amendment for AUCL, China amended its Trademark Law, in a clear attempt to address the U.S.’ concern about bad-faith trademark hoarding. The latest amendment authorizes the trademark office to take a proactive measure to reject bad-faith trademark applications during the examination stage. Moreover, the new law explicitly prohibits trademark agencies from facilitating bad-faith trademark filings, and punishes malicious trademark litigants. Similar to the AUCL, the new law significantly increases the statutory compensation and allows courts to award punitive damage.

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69 Author’s interview with a senior judge in China, April 2019. (Noting that a more reasonable request would be for the defendant to show that he has not had access to the trade secrets and that he has obtained the information independently).

70 Anti-Unfair Competition Law, supra note 61, art. 21.

71 Id.

72 USTR, supra note 34, at 134. (These Chinese parties filed lawsuits using squatted trademarks to extract exorbitant license fees or to force settlements of unreasonably high prices.)

73 Id.

74 Id.


76 Id. art. 4.

77 Id. art. 19.

78 Id. art. 63. (The new law significantly increases the statutory compensation to RMB 5 million and allows courts to award a punitive damage up to five times the loss incurred by the trademark owners or profits of the infringers. To prevent counterfeit goods from being put back into commercial circulation once the trademarks are removed, the
The lightning speed at which the Chinese government rushed through the legislative changes and the amendments being specifically directed to address concerns expressed by the U.S. administration demonstrate that they were strategically amended to mollify U.S. concerns. They also seem to be a stone that kills two birds: First, these legal concessions send a signal to the U.S. negotiators that China is willing to commit to address U.S. concerns over inadequate IP enforcement; and second, since these provisions have already been amended, they will not be incorporated into the trade agreement, thus it will be “face-saving” for the Chinese government. Among the changes that have been made, the most significant are the provisions strengthening the protection of trade secrets and the trademark law. These provisions have made it easier for foreign businesses to obtain legal relief in China and shall greatly enhance private enforcement in these areas. In fact, some have expressed concern that in some places, the amendments may have gone to the other extreme. However, the other provisions involving technology transfer, particularly those involving public administrative authorities, are vague. It is understandable that foreign businesses are doubtful that these provisions will result in substantive improvement in practice. As will be elaborated in Part III (B) below, it is very difficult, if not impossible, to verify the action of the administrative enforcement.

C. The Impasse

The spate of legal concessions that China made during the period of March to April of 2019 appears to be helpful in facilitating the trade talks. In late April, both the U.S. and Chinese trade representatives cited progress in issues related to IP protection and forced technology transfer, and that they were approaching the final leg of the trade talks. However, the two sides had a severe disagreement regarding the details to be incorporated into the final agreement. The United States wanted the agreement to look hawkish, inserting as many details as possible, including the reservation of the rights to impose future tariffs. With the presidential reelection approaching in 2020, the Trump administration wanted to claim a victory from the trade deal. The USTR reportedly had demanded “enormous, even hundreds” of changes to Chinese laws to protect amended law also explicitly provides that these goods, and all moulds and materials used for production, be destroyed at the request of the trademark owner).


80 Martina, supra note 36.

81 Id. see also Lingling Wei et al., Frustration, Miscalculation: Inside the U.S.-China Trade Impasse, WALL ST. J., May 13, 2019. (Mr. Mnuchin was quoted as saying that “[w]e were in the process of planning for a signing summit with President Trump and President Xi upon the completion of this agreement.” According to the Trump aides, “one of the issues was where to hold the celebratory moment: Washington or Mr. Trump’s golf estates in Mar-a-Lago, in Florida or Bedminster, N.J.”)

82 Lo, supra note 16.

83 Id.

84 Id.
In order to bind China to its promise, the USTR demanded that these legislative changes be passed through China’s national legislature. The U.S. insistence on the codification of law through national legislature is a means for the United States to more credibly bind China to its commitments. For a commitment to be credible, the promise must be irreversible and observable to the other player. Since national laws are implemented by many actors, including the various administrative agencies and the judiciary at both the local and central levels, it would be more difficult for China to renege on such commitments.

China rebutted. As it asserted in the White Paper: “the more the U.S. government is offered, the more it wants.” The Chinese side did not want to reveal the details of the agreement, and was particularly sensitive to wording that may suggest that the United States was dictating these terms to China. The Chinese negotiators instead wanted any proposed legal concessions to be executed through regulatory and administrative actions rather than through changes made by the Chinese legislature. According to people who were privy to the negotiation, Mr. Xi had demanded a substantial recast of the draft trade agreement by May 1, 2019. As a consequence, the 150-page draft trade agreement was riddled with track changes from the Chinese side and China deleted its commitments to change law to resolve the complaints from the United States such as IP theft and

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85 Huang & Jeong-Ho, supra note 37. (According to Shi Yinghong, a prominent international relations expert from Renming University, the U.S.’ demand to make hundreds of changes to Chinese law was one of the key factors leading to the collapse of the trade talk). See also Testimony of Lighthizer, supra note 9, at 31 (As Mr. Lighthizer testified before the Committee on Ways and Means of U.S. House Committee of Representatives: “if we have an agreement, the IP section alone will be about 27 or 28 pages. It is going to be—this is long, detailed.”). Humeyra Pamuk & Ben Blanchard, China Defiant Towards U.S. on Trade, Kudlow Urges Strong Enforcement Step, STAR ONLINE, May 13, 2019, https://www.thestar.com.my/news/world/2019/05/13/us-and-china-at-impasse-over-trade-kudlow-says-new-tariffs-will-remain (White House economic adviser Larry Kudlow was quoted saying: “We would like to see these corrections in an agreement which is codified by law in China, not just a State Council announcement. We need to see something much clearer.”)

86 Id.


89 Pamuk & Blanchard, supra note 85 (According to Larry Kudow, the sticking point was Beijing’s reluctance to put into law changes that had been agreed upon.)

90 The State Council Information Office of the People’s Republic of China, CHINA’S POSITION ON THE CHINA-US ECONOMICS AND TRADE CONSULTATIONS 13, June 2019 (“Resorting to intimidation and coercion, it [the US government] persisted with exorbitant demands, maintained the additional tariffs imposed since the friction began, and insisted on including mandatory requirements concerning China’s sovereign affairs in the deal, which only served to delay the resolution of remaining difference”).


92 Wei et al., supra note 81 (noting that the Chinese do not want to commit to changing laws, objected to publishing all details of the agreement and preferred a summary instead).

93 Buckley & Bradsher, supra note 43.
trade secrets, forced technology transfer, competition policy, access to financial services, and currency manipulation.\textsuperscript{94}

The other major sticking point is the enforcement mechanism, particularly the timeline for lifting the tariffs. One suggestion was for the United States to reserve the option to impose the tariffs unilaterally without China’s retaliation.\textsuperscript{95} Some in the United States have hoped that such a one-sided outcome-based measure to ensure China’s compliance will serve as an example of a new methodology of dealing with the differences with China.\textsuperscript{96} The Chinese government strongly objected to such a proposal. Wang Shouwen, China’s vice-minister of commerce noted that any enforcement mechanism should be “two-way, fair, and equal” and China should be allowed to retaliate with tariffs if the United States is overreacting.\textsuperscript{97} The Chinese government also insisted upon the removal of all the trade tariffs that the two countries have previously imposed on each other as a precondition to concluding the trade deal.\textsuperscript{98} The disagreement with regard to contract specificities thus resulted in significant tension between the two parties and the two sides reached an impasse. As Shi Yinhong puts it: “From early May, China has begun to think no deal might be better than a bad deal, and right now China and U.S. have fundamentally contradictory attitudes as to what would be a good deal.”\textsuperscript{99}

This Article argues that the U.S. trade negotiators overestimated the benefits of a rigid trade agreement while underestimating its cost. In weighing the costs and benefits of a rigid trade agreement, it is important to recognize the incomplete nature of contracts. As will be elaborated in Parts III to V, the unforeseen contingencies, the difficulty of enforcing the trade agreement, as

\textsuperscript{94} Id. See also David Lawder et al., Exclusive: China Backtracked on Almost All Aspects of U.S. Trade Deal-Sources, REUTERS, May 8, 2019, https://www.reuters.com/article/us-usa-trade-china-backtracking-exclusive/china-backtracked-on-almost-all-aspects-of-u-s-trade-deal-sources-idUSKCN1SE0WJ


\textsuperscript{96} Martina, supra note 36. (Stratford, a lawyer and former assistant U.S. Trade Representative who has worked in China for more than three decades, was quoted as saying: “The deal doesn’t need to revamp China’s economy. But it does need to provide a new methodology for dealing with our differences”).

\textsuperscript{97} Miao Han & James Mayger, China Warns U.S. That Trade Deal Enforcement Must Be “Two-Way,” BLOOMBERG NEWS, Mar. 9, 2019, https://www.bloomberg.com/news/articles/2019-03-09/china-warns-u-s-that-trade-deal-enforcement-must-be-two-way; see also Huang & Jeong-Ho, supra note 37 (State Council advisor Shi Yinhong commented that China could only agree to a “relatively weak enforcement mechanism” without too much scrutiny, and that China would not agree to an enforcement mechanism where it could be subject to automatic penalty for violating the agreement).

\textsuperscript{98} Politi & Yang, supra note 10.

\textsuperscript{99} Huang & Jeong-Ho, supra note 37.
well as the cost of writing the trade agreement, have all worked together to render a rigid trade agreement highly incomplete.

III. The Unforeseen Contingencies
Any trade agreement reached by the United States and China will have a part that is more observable and easy to monitor, and a part that is less so. On the surface, Chinese IP laws have achieved significant progress, both in terms of form and substance. However, U.S. businesses continue to voice significant complaints and objections to the Chinese practice, reporting that the de facto legal practice has not actually improved. Indeed, even if the United States pins down the exact legal provision that China needs to amend and the specific procedure that China needs to change, there will inevitably be many aspects of the law enforcement that are not contractible. As such, there remain many legal and extralegal channels through which the government can obviate the U.S. demand. Importantly, as much of the enforcement power has been delegated to the local governments, the local governments possess vast discretion in deciding on how to enforce the laws, despite the formal laws and procedures that have been prescribed by the central government. In the 1990s the United States repeatedly threatened China with trade sanctions and pressured it to provide more adequate IPR protection for U.S. businesses. After intense and protracted negotiations, China offered extraordinary concessions, culminating in three rigid trade agreements with the United States. However, as will be elaborated below, although these agreements were successful in helping China transform its IP law regime, China has largely failed to follow through with enforcement.

A. China’s Visible Legal Improvement
Chinese legal scholars have observed a perplexing dual legal system in Chinese law. On the one hand, the CCP has maintained, and in recent years, strengthened its control over every apparatus of the Chinese society, usually through substantively extra-legal methods. On the other hand, there exists a normal legal system that provides the basic legal infrastructure governing

100 See infra Part (III)(A).
101 See infra Part (III)(B).
102 See infra Part (III)(C).
103 Id.
104 Id.
105 Hualing Fu, Editorial: Duality and China’s Struggle for Legal Autonomy, 1 CHINA PERSPECTIVES 3, 3 (2019); see also generally KAI HANG NG & XIN HE, EMBEDDED COURTS: JUDICIAL DECISION-MAKING IN CHINA (2017); Randall Peerenboom, China’s Long March toward Rule of Law (2009); ALBERT H. Y. CHEN, AN INTRODUCTION TO THE CHINESE LEGAL SYSTEM (5th ed. 2019).
106 Fu, supra note 105, at 3.
economic transactions. As Fu succinctly observes: “In solving ordinary cases related to the bread-and-butter issues of ordinary people, the court operates in a large realm of freedom within the parameters set by the Party while factoring political considerations into the exercise of judicial discretion.” 108 Indeed, despite the bitter complaints from U.S. businesses about inadequate IP protection, China has made significant progress in modernizing and enforcing its IP laws in the past three decades. 109 Such progress, to a great extent, has to do with the exogenous pressures from the U.S. government. 110 From 1992 to 1996, the United States and China entered into three bilateral agreements on IPR protection. 111 These trade agreements greatly accelerated Chinese legislative efforts of amending a series of IP laws and regulations, and facilitated the overhaul of the legal institutional support for law enforcement. 112 On the heels of China’s accession to the WTO, China further revamped its entire IP legal regime and introduced a series of implementation guidelines, administrative rules, and judicial interpretations. 113

Today China’s IP enforcement is typical of a developing, middle-income nation. 114 In the 2018 International IP index released by the U.S. Chamber of Commerce, China is ranked 25th out of 50 major trading nations of the United States in terms of its protection of IP rights. 115 China is ranked immediately behind Malaysia but before other major trading countries such as Turkey, Columbia, Pakistan, and others.

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107 Id.

108 Id.


110 This point, however, is not without controversy. Although the United States argues that foreign pressures, particularly those from the United States, were crucial in pushing China to develop its IP laws, the Chinese officials believe that Chinese developments occurred independently of these pressures. See ANDREW C. MERTHA, THE POLITICS OF PIRACY, INTELLECTUAL PROPERTY IN CONTEMPORARY CHINA 3 (2005).


Chile, and Russia.\textsuperscript{116} In the past decade, China’s payments of licensing fees and royalties for the use of foreign technology have been steadily increasing, and reached almost USD $30 billion in 2017, a four-fold increase compared with 2007.\textsuperscript{117} In 2017, China ranked fourth in the amount of royalty payments to foreign countries, just immediately after the United States.\textsuperscript{118} Chinese payments for the use of U.S. IPs also soared significantly to USD $8.3 billion in 2017, with its payments growing faster than its GDP.\textsuperscript{119}

Even the United States has publicly acknowledged the improvement in Chinese IP enforcement in recent years.\textsuperscript{120} One notable example is the increased sanction, particularly the more frequent application of criminal sanction to IP infringements. According to statistics in 2000, only 45 cases that were registered with the Chinese State Administration of Industry and Commerce were subsequently referred to the Public Security Bureau for prosecution.\textsuperscript{121} In 2016 alone, there were 8,352 first-instance criminal cases, involving 10,431 persons.\textsuperscript{122} Another significant improvement is the increased transparency. In 2014, the Chinese Supreme Court launched the China Judgements Online, which made it possible for the public to search for Chinese judgments online.\textsuperscript{123} One source indicates that a Beijing IP court published 95% of its cases.\textsuperscript{124} In addition, China established specialized IP courts in Beijing, Shanghai, and Guangzhou, and in 2018, created a specialized IP court within the Supreme Court.\textsuperscript{125} Lawyers have observed that judges in these courts possess greater competence and expertise than those in other Chinese courts, and these IP courts have also engaged in notable experiments to improve their independence and efficiency.\textsuperscript{126}

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\textsuperscript{116} Id.
\textsuperscript{118} Id. (citing data from the IMF).
\textsuperscript{119} Anna Maria Santacreu & Mackenzie Peake, \textit{A Closer Look at China’s Supposed Misappropriation of US Intellectual Property}, 5 ECONOMIC SYNOPSES (2019).
\textsuperscript{120} USTR, supra note 43, at 39. \textit{See also generally} Dan Prud’homme & Taolue Zhang, \textit{China’s Intellectual Property Regime for Innovation: Risks to Business and National Development} (2019) (finding that China’s IP regime for innovation has achieved significant improvement over time, but reforms are needed to address many aspects of its IP enforcement).
\textsuperscript{124} Cohen, supra note 122.
\textsuperscript{125} USTR, supra note 43, at 41.
\textsuperscript{126} Cohen, supra note 122. (As observed by Cohen, the Beijing IP court has conducted reforms such as “citation to cases and use of case law; drafting of shorter and more to-the-point judicial opinions; the introduction of dissenting opinions and en banc decisions by judges; experimentation with amicus briefs; and diminished role of behind-the-scenes adjudication committees,” many of which have long been sought after by US bar and businesses).
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China has also opened several internet courts, including the first internet court in Hanzhou in August 2017, one in Shenzhen and one in Beijing. Several studies have found that foreign companies fare well in Chinese trials and appear to be treated equally. In March 2018, the Chinese government conducted a significant overhaul of its government structure. Several IP-related government functions were consolidated with an aim to enhance IP protection and enforcement in China. There is an overwhelming consensus in the IP legal community that China’s IPR legal regime is now largely consistent with international norms.

B. The Unverifiable Legal Deficiency

While China was willing to make substantial concessions during the Sino-U.S. IPR negotiations in the 1990s and ratified them in subsequent legal amendments, the actual enforcement pattern has remained largely intact. In fact, slack administrative enforcement continues to be a vexing issue that besets foreign investors in China. But such a deficiency is largely unverifiable. Upon its accession to the WTO, China explicitly committed not to condition market access based on technology transfer. China further committed to afford the same level of protection of IPRs to foreign firms as it did to its domestic companies under the TRIPs Agreement. However, since China’s accession to the WTO, U.S. businesses have noted that many of the previous practices and policies with regard to forced technology transfer have become “implicit” and are carried out

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130 Id.
131 Id.
132 MERTHA, supra note 110, at 8.
133 See Massey, supra note 109, at 236.
134 See Protocol on the Accession of the People’s Republic of China (WT/L/432, November 23, 2001), ¶7.3 and the Report of the Working Party on the Accession of China, ¶ 203 (WT/ACC/CHN/49, October 1, 2001)(“...would not be conditional upon performance requirements set by national or sub-national authorities, or subject to secondary conditions covering, for example, the conduct of research, the provision of offsets or other forms of industrial compensation including specified types or volumes of business opportunities, the use of local inputs, or the transfer of technology”).
“behind closed doors.” The opacity in China’s regulatory system has made it extremely difficult for the U.S. government to monitor and verify China’s compliance.

According to the complaints by U.S. companies and associations, there are a wide range of informal channels through which the Chinese government is able to pressure foreign firms to transfer its technology. One common means is through the relatively opaque administrative approval process. It has been observed that Chinese officials have avoided explicit requirements in writing, and instead resorted to oral instructions or informal “administrative guidance” to exert pressures on foreign firms to transfer such technology. As the Chinese government (often through its state-owned firms) is a key player in many industry sectors, it can leverage its market power in purchasing and sales to pressure foreign firms to transfer technology without any formal directives. For example, a foreign investor in a pharmaceutical joint venture (JV) was told that the Chinese government would only purchase its products if they were manufactured in China. As the Chinese government is one of its major clients, the foreign investor had no choice but to transfer technology to the JV in which it was only a minority shareholder. Some have speculated that Chinese airlines preferred to purchase from Airbus than from Boeing because the latter had been unwilling to shift production to China. They have suggested that the Chinese authority slowed down the regulatory approval for Airbus in order to pressure it to produce more in China. Indeed, China’s unique state-led economy, with the state commanding a dominant position in a number of strategic sectors, provides the government with various channels to carry out its industrial policy agenda without any formal directive. U.S. businesses have also found that in

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136 USTR, supra note 30, at 19-20.

137 Id.

138 Id. at 20.


140 Id. (quoting ITIF, Submission, Section 301 Hearing 5-6 (Oct. 25, 2017).); See also Robert D. Atkinson et al., Stopping China’s Mercantilism: A Doctrine of Constructive, Alliance-Backed Confrontation, INFORMATION TECHNOLOGY & INNOVATION FOUNDATION 37 (Mar. 2017).


142 See U.S. Chamber of Commerce, supra note 139, at 40.

143 Id.

144 Id. See also USTR, supra note 30, at 33.


146 Wu, supra note 141, at 8-9; see also generally Mark Wu, The “China, Inc.” Challenge to Global Trade Governance, 57 HAR. INT’L L. J. 284 (2016); Li-Wen Lin & Curtis J. Milhaupt, We Are the (National) Champions, 65 STAN. L. REV. 697 (2013).
many cases, it was their business partners, rather than the Chinese government, that put such pressures on them to transfer technology.\footnote{147} Given the informality of such practices, it is very difficult for the United States to gather sufficient evidence to challenge China’s practice.\footnote{148} What exacerbates the situation is that, very often, foreign companies themselves are reluctant to report such practices to the U.S. government for fear of retaliation from the Chinese government, which has various means to penalize a firm that it deems ill-behaved.\footnote{149}

The above U.S. findings, however, are mostly based on anecdotal evidence. The only systematic evidence thus far is based on survey evidence. The most recent survey conducted by the U.S.-China Business Council conducted in 2017 reveals that 19 percent of the respondents had been subject to forced technology transfer.\footnote{150} Among them, 33 percent indicated that the request had come from a central government entity and 25 percent from a local government.\footnote{151} A further survey quoted by the Section 301 report was a 2017 survey of the U.S. integrated circuit design and manufacturing industry, in which 25 U.S. integrated circuit companies noted that they would have to form JVs with Chinese companies to transfer intellectual property in order to obtain access to the Chinese market.\footnote{152} China, on the other hand, adamantly denies its practice of forced technology transfer. During the course of investigation, the Chinese trade associations and the law firms representing Chinese interests vehemently dismissed such allegations, claiming that the technology transfer was the product of voluntary exchanges rather than coerced government interventions.\footnote{153} As the Chinese spokesperson stated: “There is no forced technology transfer in China…the United States failed to provide a single piece of evidence, some of these claims were pure speculation.”\footnote{154}

\footnote{147} \textit{Id.} (quoting USCBC, 2017 MEMBER SURVEY 9 (2017).)


\footnote{149} USTR, \textit{supra note 30}, at 9. \textit{See also} U.S. Chamber of Commerce, \textit{supra note 139}, at 40.


\footnote{151} \textit{Id.} (noting that more than 67 percent stated that the request was made directly by the Chinese partner rather than the Chinese government). The annual survey conducted by the American Chamber of Commerce in China suggests similar findings. In a 2013 survey of 325 companies in various sectors, more than a third of the respondents reported that they were concerned about “de facto” technology transfer as a condition for market access. Such a concern becomes more acute for those in advanced technology sectors, in which 42 percent of the respondents expressed such a concern. Only 3 percent of the respondents reported a decrease of such technology transfer, whereas 37 percent indicated that it was in fact increasing and 26 percent indicated that the status quo had remained. USTR, \textit{supra note 30}, at 22 (quoting Am. Chamber of Commerce in China, China Business Climate Survey Report (2013)).

\footnote{152} \textit{Id.} (quoting U.S. Dep’t of Commerce, Bureau of Indus. & Security, Assessment of the U.S. integrated Circuit Design and Manufacturing Industry (forthcoming)).

\footnote{153} USTR, \textit{supra note 30}, at 21.

C. The Government’s Residual Control

As the above analysis demonstrates, most of the complaints from U.S. businesses relate to administrative enforcement. Thus, a successful implementation of the trade agreement hinges on the improvement in administrative enforcement. Yet as Andrew Mertha succinctly pointed out, economic pressures from the United States, even if they result in changes in official laws and regulations, must still “pass through China’s byzantine network of bureaucracies” before they are “translated into actual policy outcome.”

Meanwhile, administrative enforcement of IPRs is highly decentralized and fragmented in China. While politics are centralized in Beijing, the economic power of governance and legal enforcement have been delegated to the local governments. Thus, even if the national government is willing to commit to the trade deal, significant uncertainties remain when the law is implemented at the local level. The chasm that divides policymaking and actual enforcement explains the repeated failed attempts by the United States to use economic sanction to pressure China to enforce against piracy in the 1990s.

In late 1980s and early 1990s, China was placed on the “priority watch” list of countries under Special 301 provision. U.S. businesses voiced fierce complaints to Washington, alleging that the lack of copyright protection in China had cost them USD $400 million in lost revenue each year. The USTR threatened to impose tariffs on USD $1.5 billion of a wide range of Chinese imports in 1992. Given the economic pressures from the United States, China agreed to the “Sino-American Memorandum of Understanding on the Protection of Intellectual Property” in 1992. Being the most formal among IPRs-related agreements signed by the two countries in the 1990s, the 1992 agreement specifies a number of legislative commitments by China. It contains seven Articles, touching on issues concerning patent protection, copyright law protection, trade secrets, enforcement, and consultation. China largely satisfied the U.S. demands, and afforded foreign IPRs the protection level as mandated in the MOU.

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155 Mertha, supra note 110, at 5.


157 Mertha, supra note 110, at 5.

158 Michael P. Ryan, Knowledge Diplomacy: Global Competition and the Politics of Intellectual Property 80 (1998). (“Priority watch” list includes countries that have onerous or egregious IP policies or practices but are not yet the target of deadlined negotiations).

159 Id. at 57-66.

160 Id.


162 Id.

163 Mertha, supra note 110, at 45-46.

164 Mertha & Pahre, supra note 161, at 701.
The 1992 MOU focuses on legislation rather than enforcement. By 1994, Chinese IP infringements were estimated to amount to USD$1 billion and were expected to rise rapidly.\(^{165}\) China’s lackluster enforcement of its IP law then prompted another round of intensive Sino-U.S. negotiations in 1994 and 1995.\(^{166}\) To assuage business criticism, in 1994, the Clinton administration renewed a Section 301 investigation into China’s IP practices.\(^{167}\) The USTR threatened China again with economic sanctions and attempted to impose higher tariffs on USD $2.8 billion Chinese imports, and China retaliated.\(^{168}\) The two sides eventually reached an agreement on February 26, 1995.\(^{169}\) In a letter from the then Chinese premier Wu Yi to USTR Kantor (Exchange of Letter), the Chinese government promised significant restructuring of the enforcement structure to increase enforcement at the manufacturing and retail levels.\(^{170}\) An enforcement-based “Action Plan” was also attached to the agreement, specifying the detailed enforcement structure and the concrete steps to disseminate information, provide training, as well as improve the environment for enforcing the IP law.\(^{171}\) Specifically, the Exchange of Letter mandated the establishment of task forces at all levels of the Chinese government that would include personnel from various administrative agencies in charge of IP protection.\(^{172}\) The task forces would coordinate and organize enforcement activities among various government departments, monitor the implementation of the IPR laws and regulations, instruct and organize the relevant authorities to provide education and publicity for IPR-related laws, and ensure the consistency of legal sanctions for IPR infringements.\(^{173}\) The task forces would also be authorized to conduct investigations and impose sanctions in case of infringements.\(^{174}\) The Exchange of Letter also specified a “special enforcement period,” in which China had committed to use extensive resources to enhance the enforcement of IPR throughout China.\(^{175}\) Some commentators

\(^{165}\) RYAN, supra note 158, at 81.

\(^{166}\) Mertha & Pahre, supra note 161, at 702.

\(^{167}\) RYAN, supra note 158, at 81-82.

\(^{168}\) Id. at 83

\(^{169}\) 1995 Agreement, supra note 111.

\(^{170}\) Mertha & Pahre, supra note 161, at 50 (The Chinese government promised to enforce the Action Plan attached to the Wu Yi’s letter and to impose criminal sanctions for IPR violations, to enhance enforcement at the manufacturing and retail stages and allow revenue-sharing arrangements with US manufacturers, and to continue bilateral training programs and other consultative exchanges).

\(^{171}\) Id. at 702; see also MERTHA, supra note 110, at 50-1 (The first section of the Action Plan institutionalized the formation of China’s Intellectual Property Rights Working Conference at the national and subnational levels, as well as a series of IPR “task forces” to enhance the enforcement of intellectual property in China. It also outlined a “special enforcement period,” in which extensive resources would be brought to bear on increasing the enforcement of IPR throughout China. The Action Plan also discusses extensively the concrete steps to enhance enforcement in copyright-related administrative enforcement).

\(^{172}\) 1995 Agreement, supra note 111; see also RYAN, supra note 158, at 83; MERTHA, supra note 110, at 102-104.

\(^{173}\) 1995 Agreement, supra note 111.

\(^{174}\) Id.

\(^{175}\) Id. See also Mertha & Pahre, supra note 161, at 702.
were surprised that China was willing to make such extraordinary concessions to build national institutions to enforce the IP law, as it ran the risk of undermining national sovereignty.176

Despite the far-reaching scope of the Exchange of Letters and the progress that the Chinese authorities had shown in enforcement during the negotiation of the agreement, enforcement did not make much headway.177 The Exchange of Letters did not put a stop to the manufacturing and sales of IPR-violating goods, which grew almost immediately after the agreement was signed.178 In May 1996, the USTR threatened to impose tariff sanction on USD $3 billion of Chinese goods.179 Thus, less than a year after the Exchange of Letters, the United States and China found themselves back at the negotiation table again.180 The negotiation ultimately culminated in an agreement entitled “Report on Chinese enforcement actions under the 1995 IPR Agreement,” signed in June 1996.181 The 1996 agreement largely restated many provisions in the 1995 Exchange of Letters, a sign that the previous agreement was poorly executed.182 During the winter of 1996 to 1997, the Chinese authorities worked with their U.S. counterparts to shut down three dozen manufacturers in Guangdong that produced illegal CDs, CD-ROMs, and disks.183 The closure of these plants provided the Clinton administration with a tangible way to measure China’s compliance with the agreement.184 Thus, although China did not implement other provisions in the 1996 agreement, this partial implementation helped ease some of U.S.’ concerns about copyright infringements and kept the United States from escalating economic sanctions against China.185

Many experts have attributed China’s lackluster IP enforcement to its complex and intricate economic and political institutions, the multifaceted and layered levels of bureaucracy responsible for the enforcement of IP laws, a great degree of heterogeneity among different regions, and a significant conflict of interest among different departments and regional governments.186 Indeed,

176 Mertha, supra note 110, at 51.
177 Mertha & Pahre, supra note 161, at 704
178 Id. at 702. See also Ke Zeng, Trade Threats, Trade Wars: Bargaining, Retaliation, and American Coercive Diplomacy 169 (2004) (“On the whole, it seems fair to say that the United States has by and large failed to achieve its objective of obtaining improved IPR protection for American industries”).
179 Ryan, supra note 158, at 84.
180 Mertha & Pahre, supra note 161, at 702.
181 1996 Agreement, supra note 111.
182 Mertha & Pahre, supra note 161, at 702; see also Mertha, supra note 110, at 52.
183 Id.
184 Id.
185 Id. at 703.
186 Mercurio, supra note 121.
the actual implementation of the trade agreement requires cooperation from the local administrative agencies, which are beholden to the local governments that control their budget and personnel appointments.\textsuperscript{187} Moreover, the bureaucratic apparatus in charge of enforcing the IPR at the local level tends to “be convoluted and opaque.”\textsuperscript{188} Typically, the central government instructs the local governments in the form of nonbinding notices, and thus the local governments have significant discretion in determining the level of effort that they will exert on implementation.\textsuperscript{189} But even binding laws and regulations do not guarantee full implementation. Local officials still have broad discretion in determining the levels of fines and penalties in case of infringements, and thus could impose trivial fines without sufficient deterrence.\textsuperscript{190} Some scholars have suggested that China was only willing to make such extraordinary concessions to the United States by signing a wide-ranging trade agreement in the 1995 precisely because it knew that it would only partially implement the agreement.\textsuperscript{191} In fact, partial implementation helped the national leadership, particularly the core leader Jiang Zemin, appear stronger in the eyes of other constituents in the government and the CCP at that time.\textsuperscript{192} If Jiang had guaranteed the United States full implementation, the agreement would have been perceived as weak and lost its strength vis-à-vis the provinces.\textsuperscript{193} The U.S. negotiators, on the other hand, also anticipating partial implementation only, were realistic about China’s compliance and only pressed on the core issues.\textsuperscript{194}

IV. The Enforceability of the Agreement
The issue of enforceability is another contributing factor for the incompleteness of the trade agreement. By invoking a 301 investigation against China, the United States risks violating its WTO commitments, making it impossible for it to directly enforce the trade agreement in a WTO court. It is also extremely difficult for the United States to win a case against China for inadequate IP protection at the WTO. As such, the trade agreement is largely above the law. Meanwhile, the trade agreement will not be self-enforcing. The complementarity of the U.S. and Chinese trade structure and the integration of the global supply chain act as strong counteracting forces against trade sanctions on China. Tariff sanction is a costly punishment device and the United States cannot simply inflict harm on China without also injuring itself. Given its constantly changing political and economic interests, the U.S.’ threat of imposing sustained tariff sanctions on China appears incredible. As the trade agreement is not enforceable, there are no effective means to

\textsuperscript{187} Mertha, supra note 110, at 15.

\textsuperscript{188} Id.

\textsuperscript{189} Mertha & Pahre, supra note 161, at 716.

\textsuperscript{190} Id.

\textsuperscript{191} Id. at 719.

\textsuperscript{192} Id.

\textsuperscript{193} Id.

\textsuperscript{194} Id. at 718.
ensure China’s compliance. Accordingly, the Sino-US trade agreement is a weak legal instrument and will not be sustainable.

A. The Agreement Is Above the Law

One of the distinctive features of the trade agreement that the United States is negotiating with China is that it cannot be enforced by a third party. The Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU), part of the WTO rules, explicitly prohibits unilateral determination or retaliation against another WTO member for WTO violations.\(^{195}\) The TRIPs Agreement also explicitly mandates that disputes arising under the Agreement are required to be settled through the mandatory dispute resolution process of the WTO.\(^{196}\) A WTO panel ruling in 1999 noted that unilateral actions under Section 301 are inconsistent with WTO obligations except under limited circumstances.\(^{197}\) Since the inception of the WTO, the United States has rarely invoked a Section 301 investigation against another WTO member.\(^{198}\) In a dramatic departure from its previous practice, the Trump administration resorted to self-help by unilaterally launching a Section 301 investigation into China’s IP and innovation policy in 2018.\(^{199}\) Such a move risked violating the WTO rules and threatened to undermine the global trading system.\(^{200}\) Since April 2018, China has filed three requests for consultation at the WTO on the impending tariff sanction that the U.S. government has threatened to impose on certain Chinese goods.\(^{201}\)

\(^{195}\) The Understanding on Rules and Procedures Governing the Settlement of Disputes, art. 23.

\(^{196}\) Agreement on Trade-Related Aspects of Intellectual Property Rights, Apr. 15, 1994, art. 64 (prohibiting a member state from taking counteractive measures against another member state before it has exhausted all alternative actions as permissible under the rules). See also Yu, supra note 113, at 924.


\(^{198}\) Morrison, supra note 25. (noting that since the United States joined the WTO in 1995, the “USTR still brought a few Section 301 investigations but then brought the issues at hand to the WTO for dispute resolution. After 2010 [and before 2018], the USTR brought all trade disputes involving WTO members directly to the WTO for adjudication”).

\(^{199}\) USTR, supra note 34, at 6.

\(^{200}\) See Rachel Brewster, The Trump Administration and the Future of the WTO, 44 YALE J. INT’L L. ONLINE 6, 9 (2019). See also Robert Z. Lawrence, How the United States Should Confront China Without Threatening the Global Trading System, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS POLICY BRIEF, Aug. 2018. On the other hand, the United States can strategically claim that its current dispute with China falls outside of WTO. Such framing can serve two purposes: first, it helps the United States achieve more negotiation freedom without having to involve the WTO; second, it helps preserves the integrity of the WTO without infringing its rules for multilateral resolution of disputes. See Rachel Brewster, Analyzing the Trump Administration’s International Trade Strategy, 42 FORDHAM INT’L L. J. 1419, 1424-425 (2019).

\(^{201}\) United States-Tariff Measures on Certain Goods From China, WT/DS543/1, Apr. 5, 2018; United States-Tariff Measures on Certain Goods From China II, WT/DS565/1, Aug. 27, 2018; United States-Tariff Measures on Certain Goods From China III, WT/DS587/1, Sep. 4, 2019; United States-Tariff Measures on Certain Goods From China III, WT/DS587/1, Sep. 4, 2019 (In these suits, China claimed that the impending tariff would violate the most-favored-nation treatment obligation under GATT 1994 and the US Schedule of Concessions and Commitments. In addition,
As an alternative to directly enforcing the trade agreement in the WTO, the United States can also separately challenge China’s inadequate IPR protection through the WTO. However, the ambiguity of the WTO rules, the difficulty to amass evidence, as well as the structural barriers to challenging China’s inadequate IP enforcement at the WTO have all posed challenges for the United States in winning such cases.\(^{202}\) As illustrated in the preceding Part (III)(B), because many of China’s requirements for technology transfer are implicit rather than explicit, it is almost impossible for a third party like the WTO to verify the U.S. allegations. As such, it is exceedingly hard for the United States to seek WTO remedies for combating deficiencies in enforcement rather than the black-letter law.\(^{203}\) Indeed, many U.S. policymakers have long held suspicions against the WTO that it is too costly, too slow, and inefficient.\(^{204}\) The U.S. chief negotiator Mr. Lighthizer has been one of the most outspoken critics.\(^{205}\) In a testimony given to the USTR in 2010, Mr. Lighthizer expressed frustration with the WTO resolution mechanism, complaining about its inefficiency, its inability to deal with broad policy issues, and the uncertainty about China’s compliance with its WTO obligations despite the United States’ success at the WTO.\(^{206}\) Indeed, the United States has brought twenty-three challenges at the WTO against China, but only two are IP-related cases and both were targeted at the legal provisions rather than the enforcement.\(^{207}\)

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\(^{202}\) Yu, supra note 113, at 923. Some experts have suggested that the United States consider bringing the “non-violation, nullification and impairment” case to handle those Chinese cases that are not explicitly deemed illegal. However, others have noted that such an innovative approach may be very challenging to implement in practice given the difficulty of satisfying the evidentiary burden in a WTO proceeding, the coordination that it requires with allies, and the time-consuming nature of such litigation. See Art. 64.2 TRIPS agreement. See also World Trade Organization, Non-Violation Complaints (Art. 64.2), https://www.wto.org/english/tratop_e/trips_e/nonviolation_e.htm; Wu, supra note 141; Ton Zuijdwijk, Understanding the Intellectual Property Dispute between China and the United States, CENTER FOR INTERNATIONAL GOVERNANCE, Innovation, May 15, 2019, https://www.cigionline.org/articles/understanding-intellectual-property-disputes-between-china-and-united-states


\(^{204}\) US policymakers have long held suspicions against the WTO. See Wu, supra note 141, at 266-67 (noting that many western commentators have been skeptical about the WTO and urged their governments to move beyond the WTO to deal with China); see also Testimony of Lighthizer, supra note 9, at 24; Phoenix X. F. Cai, Think Big and Ignore the Law: U.S Corn and Ethanol Subsidies and WTO Law, 40 GEO. J. INT’L L. 865, 911 (2009).

\(^{205}\) Shawn Donnan, Lighthizer Vows to Crack Down on Unfair China Practices, FIN. TIMES, Mar. 15, 2017, https://www.ft.com/content/5300b8f2-08f6-11e7-97d1-5e720a26771b (Mr. Lighthizer was quoted stating that WTO is ill-equipped to deal with China’s industrial policy and called for creative alternative approaches instead); Susan Ariel Aaronson, Is China Killing the WTO? INTERNATIONAL ECONOMY, Winter 2010, at 41, http://www.international-economy.co; Stephen J. Ezell & Robert D. Atkinson, False Promise: The Yawning Gap between China’s WTO Commitments and Practices, INFORMATION TECHNOLOGY & INNOVATION FOUNDATION, Sep. 2015. But there were also scholars that objected to the unilateral approach. See Testimony of Jennifer Hillman, supra note 203.

\(^{206}\) See Testimony of Lighthizer, supra note 9, at 24.

\(^{207}\) In April 2007, the United States launched an action against China in the WTO, accusing it of inadequate criminal procedures and penalties for counterfeiting and piracy in China, improper disposal of infringing goods confiscated by customs authorities, and denial of copyright protection to works that have not been authorized for publication in China.
Moreover, there is a limit to what the United States can achieve through the WTO litigation, as the WTO cases are only effective against a limited area of Chinese practices. The WTO rules were not written in anticipation of China’s distinctive economic structure today, which is fundamentally different from that of other countries and is also very different from that of China at the time of its WTO accession. Some in the United States believe that China has unabashedly employed its own economic system to exploit loopholes in the WTO. In recent years, China has increasingly resorted to retaliatory trade remedies, deterring other WTO members from speaking against China. Thus, while the United States has become more circumspect about the WTO, China is actually seeking to empower the WTO Appellate Body. Now, the Trump administration is strategically blocking the appointment of Appellate Body to prevent it from functioning. The various moves of the United States send a strong signal that it is shifting from a rule-oriented trade diplomacy to a power-oriented one. Accordingly, it seems highly unlikely that the Trump administration will return to the multilateral settlement mechanism to resolve its current dispute with China.

The United States was only partially successful in its claims against certain Chinese customs and copyright provisions; its demand for increasing criminal sanctions and penalties was not supported by the WTO panel. See China-Measures Affecting the Protection and Enforcement of Intellectual Property Rights, Report of the Panel, WT/DS362/R, Jan. 26, 2009. In March 2018, the United States initiated a WTO dispute against China, alleging that China’s technology transfer regulations discriminated against foreign patent holders and prevented them from enforcing their patent rights or negotiating licensing contracts on market-based terms. As discussed in the preceding Part II, China abolished several of the measures targeted by the WTO case and adopted a new Foreign Investment Law that restricts forced technology transfer during the spring of 2019. In light of these new legislative developments, the United States formally requested that the WTO panel suspend its proceedings in June 2019. See China-Certain Measures Concerning the Protection of Intellectual Property Rights, Communication from the Panel, WT/DS542/10, June 14, 2019.

208 Wu, supra note 141, at 12.
209 See Wu, supra note 141, at 265-266 (explaining that China’s rise and its distinctive economic structure have posed a systemic challenge to the WTO and that the Chinese economy has undergone significant transformations since its accession to the WTO).
212 USTR, supra note 34, at 23.
214 See generally John H. Jackson, The Crumbling Institutions of the Liberal Trade System, 12 J WORLD TRADE L 93 (1978) (Jackson proposed that there are two types of peaceful settlement of international disputes: settlement by negotiation with reference to relative power of the countries, the so-called power-oriented diplomacy, and settlement with reference to the agreed rules and norms, the rule-oriented trade diplomacy.)
215 Shaffer, supra note 213, at 52. (noting that “[t]he Trump Administration will unlikely agree to binding panel or arbitral decisions in disputes that it considers sensitive, particularly disputes brought by China”).
B. The Agreement Is Not Self-Enforcing

While the Sino-U.S. trade agreement is unenforceable by a formal legal institution, it could still work if the parties choose to rely on self-enforcement. A self-enforcing agreement between two parties remains in force as long as the parties believe that they are better off keeping the agreement than terminating it. As no third party will enforce the agreement, it is up to the two parties to determine whether there are any violations. Accordingly, a self-enforcing agreement is possible only if the expected gains from adherence to the agreement exceed the gains from violating the agreement. The threat of punishment from violation must be renegotiation-proof. Self-enforcing contracts are common, as Stuart Macaulay has long documented in his empirical investigation of business dealings. Reputation and the repeated interactions among the parties have been shown to be effective in enforcing contractual arrangements in the absence of formal enforcement.

For the Sino-U.S. agreement to be self-enforcing, the U.S. punishment under the trade agreement must be a credible one to deter China from deviating from its commitments. Such credibility hinges upon the costs and risks for the United States in administering such punishment. But it is highly costly and risky for the United States to impose sustained trade sanctions on China. To begin with, the United States and China are each other’s most important trading partner. The economic and trade complementarities between them undermine U.S. credibility to impose sustained tariff sanctions on China. The United States is endowed with rich arable land, readily usable water, and other natural resources while China is not. China’s comparative advantage

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217 Telser, supra note 216, at 27.

218 Id. at 42.

219 Self-enforcing agreements are quite common in sovereign debts. See Kenneth M. Kletzer & Brian D. Wright, Sovereign Debt As Intertemporal Barter, 90 AM. ECON. REV. 621,622 (2000); see also generally Ugo Panizza et al., The Economics and Law of Sovereign Debt and Default, 47 J. ECON. LITERATURE 651 (2009).


222 Schelling, supra note 14, at 6.


224 ZENG, supra note 178, at 238. (A trade relationship is considered complementary when two countries engage in the export of different sets of commodities wherein they each have their own comparative advantages, and they trade them for cheaper imports). See also generally JOHN A.C. CONYBEARE, TRADE WARS: THE THEORY AND PRACTICE OF INTERNATIONAL COMMERCIAL RIVALRY (1987).

225 LAU, supra note 223, at 99.
lies in its large surplus of labour which the United States lacks. The two countries are also at different stages of development—the United States has been a mature and developed economy for over a century while China is still a developing country in terms of real GDP per capita. The United States is far ahead of China in science and technology capabilities, and China will continue to rely on significant technological support from the United States. These differences between the two countries enable them to derive large gains from trading with each other. The Sino-U.S. trade complementarities therefore imply a low elasticity of demand for each other’s products and high costs in case of a disruption in trade.

In the 1990s, when the U.S. government threatened economic sanctions on Chinese imports, it faced stiff opposition from many domestic interest groups. Although companies in copyright industries, which were adversely affected by Chinese piracy, were calling for sanctions against China, many other retailers and manufacturers that had developed a high degree of reliance on the Chinese imports strongly opposed closing the American market to the Chinese manufacturers. These U.S. importers, retailers, and manufacturers voiced fierce complaints to Washington that punitive tariffs would force many retailers to raise prices, as they could not source the goods from elsewhere or at a similar price. These strong oppositions from businesses weakened the position of the USTR and prevented it from further escalating the dispute. In contrast, the U.S. sanction on Japanese electronic products in the mid-1980s won solid endorsement from the U.S. business community. Due to the competitive trade structure between the United States and Japan, the trade sanction on Japanese imports enjoyed support from both export-seeking domestic manufacturers who were seeking to expand access to the Japanese market, as well as domestic industries who were facing stiff competition from Japanese imports.

The current business reaction to the Trump administration’s tariff threat on China is a case of déjà vu. According to the survey by the American Chamber of commerce, nearly 69 percent of the 434

226 Id. at 99.
227 Id. at 154.
228 Id. at 107.
229 Id. at 154.
230 CONYBEARE, supra note 224, at 47.
231 ZENG, supra note 178, at 16.
232 Id. at 170.
233 Id. at 172.
234 Id. at 171.
235 Id. at 5.
236 Id. at 16.
respondents to the annual China Business Climate Survey opposed the tariffs, while only 8.5 percent backed them. In June 2019, 320 representatives from U.S. manufacturers, retailers, and other companies and trade groups flocked to Washington to appear in a seven-day hearing on Trump’s proposed tariffs on China. Most of these companies opposed the tariff, noting that the importers would bear most of the costs while some would be passed down to consumers who would pay higher prices. In a letter to Trump in June 2019, six-hundred retailers, including Walmart and Target, urged the president to return to the negotiation table with China, noting that the tariffs had hurt American businesses and consumers rather than China. Indeed, as the negotiation unfolded, the Trump administration came under strong pressure from a large segment of the business community to soften its position against China. The U.S. Chamber of Commerce, the American Chamber of Commerce in China, as well as the political network for Koch industries, one of the largest and most influential Republican donors, have all denounced Trump’s unilateral sanction on China and launched aggressive campaigns against tariffs. Congress has also begun to propose bipartisan legislation to curtail the president’s authority to impose tariffs. Even within the Trump administration, there is a division between the globalists, as represented by Secretary of the Treasury Steven Mnuchin, who seek to restraint tariff sanction and to limit demands on China, and the nationalists, as represented by USTR Robert Lighthizer and White House trade advisor Peter Navarro, who believe multilateral institutions are inadequate in dealing with problems with China and who advocate for tariff sanctions instead.


239 Id.


244 Cafruny, supra note 241, at 10-11 (noting that Trump needs to mediate between the nationalists and the globalists within his administration).
The global supply chain imposes another constraint on tariff sanctions. In today’s global economy, many products are no longer exclusively produced in one country. A typical product, even labelled as “made in China,” could be assembled in China but sourced from many other countries, including the United States. For instance, Chinese national champions such as ZTE and Huawei rely heavily on U.S. manufacturers for a significant percentage of their individual parts. In fact, a quarter of Huawei’s products are supplied by leading American technology companies such as Qualcomm, Intel, Broadcom, and Flex, and these American suppliers derive over USD $1 billion annual revenue from sales to Huawei. As the second largest smartphone makers in the world, Huawei also relies on Google for its Android operating system. Meanwhile, successful U.S. companies such as Nike and Apple relies heavily on the Chinese manufacturers for assembling or manufacturing their components. As acknowledged by Tim Cook, Apple’s CEO, China is integral to Apple’s success not because of its price but quality—it is exceedingly hard for Apple to find an alternative to Chinese labour and skills in any other country. For these reasons, Geoffrey Garrett is optimistic about the Sino-US trade relationship: “America and China are co-dependent on each other with supply chain interconnections amounting to a dense thicket of ties binding the two countries together.”

Above all, the trade sanction is not renegotiation-proof, as illustrated by the Sino-U.S. IPR negotiations in the 1990s. When China was found to be in violation of the trade agreement, the two sides would find themselves back at the renegotiation table and then would accept a new agreement. After all, the political and economic interests of the United States are always changing. In a bargaining game, the player who is more patient will have an important

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247 *Id.* See also Emily Feng, *U.S. Move to Isolate Huawei Sends Ripples Through Global Supply Chain*, NPR, May 16, 2019.

248 *Id.*

249 *Id.*

250 *Id.* (As Tim Cook remarked: “The products we do require really advanced tooling, and the precision that you have to have, the tooling and working with the materials that we do are state of the art. And the tooling skill is very deep here. In the U.S. you could have a meeting of tooling engineers and I’m not sure we could fill the room. In China you could fill multiple football fields”).

251 *Id.*

252 ZENG, supra note 178, at 171.

253 James D. Morrow, *The Strategic Setting of Choices: Signaling, Commitment, and Negotiation* in INTERNATIONAL POLITICS, IN STRATEGIC CHOICE AND INTERNATIONAL RELATIONS 92 (David A. Lake & Robert Powell eds., 1999). (“commitment is a problem when actors’ incentives change over time”).
advantage over the other player. The U.S. political system is notoriously impatient, with the media, interest groups, and political parties constantly putting pressures on the administration to deliver quick results. Shang-Jin Wei pointed out the United States has been more willing to cooperate with China to try to spur a global recovery during its downturn. A prominent example is the last U.S. recession in 2008-2010, when the Sino-U.S. ties improved partly due to China’s status as the only major economy that was able and willing to boost the global demand. Wei therefore predicted that Trump’s stance toward China may soften if a recession materializes. Zhiwu Chen also predicted that Trump will be under more pressures to strike a deal with China to help his reelection bid after October 2019. As much of the damage to China’s supply chain has already been done, Chen believes that China is in no hurry to reach a trade agreement any more.

Consider the following scenario: The United States and China come to a trade agreement but it turns out that China has violated its obligations. The United States then decides to punish China with a tariff sanction. However, the sanction also harms the interest of many U.S. consumers and firms that depend on imports from China. They lobby the U.S. administration against adopting overly punitive measures against China. Meanwhile, China retaliates by curbing the operation of U.S. businesses in China, reducing its holding of U.S. treasury bonds, and curtailing rare earth supply to the United States. The Chinese economy suffers significant damage, affecting the global economy, and the United States enters into a recession. Spooked by the market turmoil, the U.S. administration backs down on the tariff sanctions and restarts a new round of negotiation with China. This scenario is not remote at all. Trade sanction is a costly punishment mechanism for the United States. A recent report by the U.S. Chamber of Commerce and the Rhodium Group estimates that the United States GDP could decrease by $64-91 billion per year in the next four years, equivalent to 0.3-0.5 percent of the total U.S. GDP. Since September 2019, there has

254 DIXIT et al., supra note 87, at 683.

255 Id. See also Qinn Slobodian, You Live in Robert Lighthizer’s World Now, FOREIGN POLICY, Aug. 6, 2018 (As Robert Lighthizer acknowledged during his testimony: “[the Chinese] do take a longer view, which by the way, I think it is the right view. To the extent we can, we ought to be taking it. I realize we have a political system that makes it difficult, but nonetheless, the reality is an awful lot of our senior politicians do take a long view”).


257 Id.

258 Id.


260 Id.

been a growing market consensus that the trade war is seriously damaging the U.S. market, and speculation abounds that the U.S.-China trade war will drive the U.S. economy to the brink of recession.\textsuperscript{262}

Thus, even if an enforcement mechanism is incorporated into the final trade agreement, it is not irreversible and there is no guarantee that the punishment will be implemented. The United States has left too much discretion for itself in determining whether and how to carry out the threat in case of China’s breach of contract.\textsuperscript{263} This undermines its credibility—China therefore reckons that the United States will be unlikely to enforce its threat of trade sanctions on China when the time comes, as doing so could have significant political and economic ramifications for the United States.\textsuperscript{264} Since the United States has problems committing to its punishment mechanism, there seems to be little benefit in incorporating such an enforcement mechanism in the first place. Indeed, the U.S.’ insistence on such a mechanism has caused significant disagreement and delay in the negotiation between the two countries, and is one of the major factors contributing to the current impasse.\textsuperscript{265}

V. The Price of Dignity
The cost of writing the contract further contributes to the incompleteness of the Sino-US trade agreement. The trade war did not occur in a vacuum but against a backdrop of growing unease and anxiety about China’s rise in American society. As the rigid contract that the United States is demanding appears imbalanced and is highly visible to the Chinese audience, this could entail a loss of dignity to the Chinese government. Indeed, the trade talk not only involves economic interests, but also concerns national pride and dignity.\textsuperscript{266} Economists have long found that the concern with pride and dignity can lead people to negotiation impasse and to shift the blame onto


\textsuperscript{263} SCHELLING, \textit{supra} note 14, at 40. (“It is essential, therefore, for maximum credibility, to leave as little room as possible for judgement or discretion in carrying out the threat”).

\textsuperscript{264} Id. (“If one is committed to punish a certain type of behaviour when it reaches certain limits, but the limits are not carefully and objectively defined, the party threatened will realize that when the time comes to decide whether the threat must be enforced or not, his interest and that of the threatening party will coincide in an attempt to avoid the mutually unpleasant consequences”).

\textsuperscript{265} Rappeport, \textit{supra} note 34.

Acceding to the U.S. demand would send a signal to the Chinese people that China is the loser in the bargain and that the government is too weak to stand up to foreign aggression. This would directly threaten the legitimacy of the CCP. In the following sections, I will first explain how the self-serving bias can lead the negotiating parties into an impasse. I will then move on to explain how China’s long and painful history of subjugation to western powers becomes a constraint for the Chinese government in acceding to the U.S. demand.

A. Self-Serving Bias

Behavioral economists have identified the self-serving bias, the tendency for parties to make decisions that conflate what is fair with what benefits oneself, as a major cause of bargaining impasse. Research has shown that bargainers not only care about what the other party offers, but also the other party’s motives. People will deem it fair to be nice to those who are nice to them, and to be mean to those who are mean to them. Emotions therefore matter in a negotiation. An aggressive bargaining can be interpreted as an exploitative attempt to gain an unfair advantage over the other party, rather than an attempt to get what the party perceives as fair.

The United States and China have divergent beliefs of what they think that they are entitled to and what they perceive as fair. For more than a thousand years until the end of the seventeenth century, China was one of the most advanced and powerful nations in the world. In 1820, China accounted for a third of the global GDP and dominated the world economic landscape. However, the country began to lag behind in the eighteenth century, while the West was achieving impressive technological developments with the beginning of the Industrial Revolution. By the mid-

267 Benabou & Tirole, supra note 13.


270 Rabin, supra note 269, at 1281.

271 Id.

272 Babcock & Loewenstein, supra note 268, at 110.


274 Id. at 1.

275 Id. at xiv.
nineteen century, China fell behind as a backward agrarian country. Therefore, the Chinese are indomitably determined to reclaim their past glory and they think their country “morally deserves its moment of renaissance after its terrible modern history.” As Chinese President Xi Jinping put it: “To realize the renaissance of the Chinese nation is the greatest dream for the Chinese nation in modern history.”

To achieve its rejuvenation as a great nation, the Chinese leadership has deemed innovation and technological development as the top priority. Indeed, despite its huge trade surplus with western countries, China serves as the world’s factory for low-value products, whereas the greatest profits are reaped by foreign companies. Driven by a growing disillusionment with the inability of Chinese companies to capture a larger share of the high-tech industries, the Chinese leadership trumpeted the goal of making China the “master of its own technologies,” urging greater innovation in core technologies. President Xi also believed that China has an inherent comparative advantage over its western counterparts due to its concentration of power and its ability to pool resources. It is against this background that China promulgated China 2025, an industrial policy plan that aims to close the gap with western high-tech prowess and lessen China’s dependence on imported technology.

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276 Id. at 55.
278 Alice Su, As Trade War Escalates, Chinese Remember “National Humiliation,” L. A. TIMES, May 13, 2019, (quoting Kerry Brown, noting that “the biggest perception gap between the United States and China lies in both sides’ sense of entitlement…China feels like it morally deserves this moment of renaissance after its terrible modern history, and doesn’t feel like the West has the right to stop it. America feels like it’s been giving too much and never been getting what it really wanted”).
280 See Chris Buckley, Xi Urges Greater Innovation in “Core Technologies,” N.Y. TIMES, June 10, 2014 (noting that the CCP’s policy of encouraging “indigenous technologies” dated back to Jiang Zemin).
282 Id.
But many in America, including President Trump, believe that China’s rise in technology poses a threat to the United States and challenges its status as the global hegemon.\(^{286}\) For the first time in the past four decades, the United States sees China as a serious rival that must be contained and beaten.\(^{287}\) The United States is particularly wary of the 2025 Report, which outlines China’s ambition to be a technology superpower.\(^{288}\) The United States sees China as leveraging such technology superpower to move itself closer to the world’s center stage.\(^{289}\) It has accused China of using government subsidies, mobilizing state-owned enterprises, and implementing forced technology transfer to achieve its ambitious 2025 plan.\(^{290}\) It has further claimed that these tactics undermine China’s stated commitments to the international trade rules and pose a security threat.\(^{291}\) In recent years, the United States has limited Chinese investment in key U.S. technology sectors, blocked Huawei and ZTE from doing businesses in the U.S. markets, and introduced measures to control the sale of critical technologies.\(^{292}\) On July 6, 2018, the Trump administration started implementing 25 percent tariffs on $34 billion worth of Chinese goods, targeting 818 products central to the Made in China 2025 initiative.\(^{293}\)

Thus, many in China see the United States as invoking the trade war to contain China and to prevent it from rising up to be a superpower that will rival the United States.\(^{294}\) As the Global Times remarked: “The root cause of the deterioration of Sino-U.S. relations is that China’s rise has reached a level that the United States cannot accept...the strategic resistance of the U.S. to


\(^{288}\) USTR, *supra* note 30, at 10-16.

\(^{289}\) Id.


\(^{292}\) Adam Segal, *Seizing Core Technologies: China Responds to US Technology Competition*, CHINA LEADERSHIP MONITOR, June 1, 2019.

\(^{293}\) Id.

\(^{294}\) Deng, *supra* note 287.
China’s rise is hard to change.” Chinese policymakers and analysts overwhelmingly believe that Washington is pursuing a strategy of containment to slow China’s progress in science and technology and that trade is not the real target. Such a belief is also shared among many American intellectuals. The arrest of Meng Wanzhou, chief financial officer (CFO) of Huawei Technologies Co., in Canada in December 2018 further fueled such public sentiments. On May 15, 2019, the U.S. Department of Commerce further restricted the sales of U.S. technology to Huawei when such “sale or transfer would harm U.S. national security or foreign policy interests.” Many Chinese see the anti-Huawei offensive as further evidence that the United States is trying to stop China’s rise. Given the domestic political sentiment against the United States, the Chinese government will need to appear tough in defending China’s interests. Accordingly, it will be extremely challenging for Chinese negotiators to agree to the rigid terms that the United States is currently demanding.

B. The Historical Memory

China’s historical memory further constrains the Chinese government’s capacity to make concessions to the United States. In March 2018, when the U.S. delegates first presented their demands to their Chinese counterparts, it immediately touched off the Chinese people’s sense of historical suffering and fighting spirit. Even Martin Wolf, the chief economic commentator for the Financial Times, has called the U.S. demands a “humiliation” for China. Global Times, a party mouthpiece, lambasted the U.S. request as outrageous and accused the United States of...

295 Hu Xijin, Weibo Post, Oct. 8, 2018, 9:35pm, https://m.weibo.cn/status/4292963502736291; See also Segal, supra note 292.

296 See Segal, supra note 292.

297 Geoffrey Garrett, Why the U.S.-China “Trade War” Is Really About the Future of Innovation, Apr. 9, 2018, (“...what is really going on is not about trade; it is about who will lead global innovation in the 21st century.”), https://knowledge.wharton.upenn.edu/article/u-s-china-trade-war-really-future-innovation/; Stephen S. Roach, Japan Then, China Now, PROJECT SYNDICATE, May 27, 2019 (noting that Americans have made China the villain just as it portrayed Japan as the greatest economic threat to the United States three decades ago), https://www.project-syndicate.org/commentary/for-america-china-is-the-new-japan-by-stephen-s-roach-2019-05?barrier=accesspaylog

298 Isabel Hilton, The Huawei Story, PROSPECT MAGAZINE, July 18, 2019. (The United States wanted to extradite Ms Meng, the daughter of Ren Zhenfei, the founder of Huawei, for allegedly violating US sanctions on Iran).


300 Hilton, supra note 298.


303 Martin Wolf, Donald Trump Declares Trade War on China, FIN. TIME, May 11, 2018. (“No great sovereign power could accept such a humiliation. For China, it would be a modern version of the ‘unequal treaties’ of the 19th century”).
mistaking China for the country that it was in 1840. \(^{304}\) Behind China’s strong pushback is China’s painful experience of the “century of humiliation,” marked by military defeats, economic colonization, and political subjugation. \(^{305}\)

In the early 1830s, a large trade deficit existed between Britain and China—Britain purchased large quantities of Chinese silk and tea while China bought little in return. \(^{306}\) Britain then decided to smuggle Indian opium into China, and the Qing government resisted. \(^{307}\) In 1839, the British sent gunboats to compel China to open their ports and markets to the opium trade, triggering the First Opium War. \(^{308}\) After its military failure, China signed the Treaty of Nanking with Britain. \(^{309}\) China was forced to open several new trade ports, allowing British merchants to trade with low tariffs and extraterritorial privileges. \(^{310}\) China also handed over control of Hong Kong to Britain. \(^{311}\) By the 1950s, China had signed similarly unequal treaties with the United States, Russia, and France, and China continually ceded and leased territories to foreign powers. \(^{312}\) When the CCP rose to power in 1949, it vowed to end the century of national humiliation by western powers. \(^{313}\) In fact, the CCP portrayed itself as the only modern Chinese political party with the power to stand up to foreign aggression. \(^{314}\) Every schoolchild in China was taught the shameful experience of this “century of humiliation” and learned the mantra “never forget our national humiliation.”\(^ {315}\)

Not surprisingly, hardline sentiments in China has been growing since the trade war erupted. \(^{316}\) In June 2018, China relaxed investment restrictions on foreign companies in 22 areas including

\(^{304}\) Rappeport, supra note 34.

\(^{305}\) Id.

\(^{306}\) ZHENG WANG, NEVER FORGET NATIONAL HUMILIATION 49 (2014).

\(^{307}\) Id.

\(^{308}\) Id. at 49-50.

\(^{309}\) Id. at 50.

\(^{310}\) Id., at 61.

\(^{311}\) Id.

\(^{312}\) Id. at 61-66.

\(^{313}\) SUSAN SHIRK, CHANGING MEDIA, CHANGING FOREIGN POLICY IN CHINA 227 (2007).


\(^{315}\) ALLISON, supra note 277, at 113.

\(^{316}\) Lingling Wei & Bob Davids, Trump, Xi Face Pressure at Home Over Trade: Concerns Are Rising at Home that Xi Jinping and President Trump Will Try to Make A Quick Deal, WALL ST. J., Feb. 21, 2019.
automobiles, banks, securities, electricity grids, etc. Some have called these new measures the “22 demands,” comparing them to the 21 demands that the Japanese government imposed on China in 1915 during World War I. Chinese nationalists were angry with Liu He, the vice premier and chief Chinese negotiator, for making too many concessions to the United States. They made unflattering comparisons between Liu and Li Hongzhang, a powerful Qing dynasty figure who was labeled a “traitor” for signing the humiliating treaty with Japan in 1895 that ended the first Sino-Japanese war.

The Chinese government’s sensitivity toward the issue of dignity was revealed during the Sino-U.S. trade negotiations in the 1990s. Although China offered extraordinary concessions, all three trade agreements that were signed during this period were informal. The 1991 agreement was in the form of an MOU, the 1995 agreement was an exchange of letters, and the 1996 agreement was a report. Among them, the 1995 agreement offers the starkest example. First, the agreement was structured as an exchange of letters between then-Premier Wu Yi and the then-USTR representative. For the Chinese, this was a face-saving tactic. China did not want another MOU, as it would suggest that it had failed to implement the previous 1992 MOU and was now forced into signing another one. The form of an exchange of letters was a way to downplay the importance of the agreement in front of the domestic audience. Moreover, most of the details of the Chinese concessions were tucked into the Action Plan, which was attached as an annex to Wu Yi’s letter, thus further obscuring the concessions that China had made.

In the current trade negotiation, however, the United States is unwilling to compromise on the form of the agreement. First, the United States wants the agreement to look very hawkish, while China wants to downplay the formality of the agreement. As Liang Ming, director of the institute of international trade at the Ministry of Commerce, noted: “China does not want to see many strong and forceful words such as ‘must’ and ‘should’ in the trade agreement, and seek[s] a more balanced

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320 Id.

321 See supra note 111.

322 MERTHA, supra note 110, at 14.

323 See 1995 Agreement, supra note 111.
Form is very important for the Chinese leadership, as the language of the texts could stir up public sentiments and threaten the legitimacy of the Chinese government. However, the United States insists that China write into law the promises that it makes in the agreement as part of the negotiation. Writing the agreement into law touches a sensitive nerve in China and is deeply offensive to many Chinese. That explains why the Chinese government wants to accomplish such changes through the State Council or Ministry decrees, which are less visible.

Second, the United States insists upon an enforcement mechanism that guarantees China’s full performance of the agreement. However, none of the three previous Sino-U.S. IPR trade agreements in the 1990s included contingency clauses for enforcement. Instead, renegotiation was used as a substitute for the deliberate omission of the enforcement mechanism. In fact, the USTR had expected that China would only partially implement its agreements signed in the 1990s. When China was found to be in violation of the agreement, the two countries would find themselves back to the negotiation table. Thus, these types of trade agreements are constantly renegotiated. In this round of the trade talks, however, the U.S. administration called for an enforcement mechanism to be specified that would allow the United States to impose unilateral tariffs that cannot be counteracted by a tariff from China. Such an aggressive request, for many Chinese people, aroused the stinging memories of unequal treaties that China signed with western powers in the 19th century. A member of the Chinese negotiation team was also quoted as feeling “humiliated” by the aggressive U.S. requirement for quarterly compliance reviews by independent organizations. The USTR has therefore underestimated the price of dignity for the Chinese negotiators. If the Chinese government caves to the U.S. demand for a one-sided enforcement mechanism, it will not only look weak, but the national humiliation could also cause social instability that would threaten the legitimacy of the CCP.


327 *Id.*


330 *Id.*

331 Rappeport, *supra* note 34.

332 *Id.*

333 Perkowski, *supra* note 326.

334 Gogoi, *supra* note 266.
VI. Using Hostages to Facilitate Cooperation

Writing an agreement in the context of the current U.S.-China trade negotiation is a daunting task. Driven by a legalistic approach, the U.S. trade negotiators are attempting to write a rigid contract that incorporates as many details as possible into the trade agreement. As a rigid contract reduces China’s discretion in executing the agreement, the Trump administration has hoped that this would curb China’s opportunistic behavior and commit China more credibly to its promises. However, a rigid contract remains highly incomplete. Given the futility of a rigid trade agreement, is there any alternative solution for the United States to bind China to its commitment? Indeed, the crux of the problem in the current Sino-U.S. trade conflict essentially boils down to the following question: how can two countries who distrust each other resolve their conflict and have a peaceful and constructive commercial relationship? It is important to first recognize that the Sino-U.S. conflict is a variable sum game rather than a zero-sum game—that is, the sum of the gains for the players is not fixed, and the gain of one player does not necessarily mean the loss for the other. As in many international conflicts, “there is a common interest in reaching outcomes that are mutually advantageous.” However, there is no international court, arbitration tribunal, or any third party that has the authority to intervene in case of contract breach. If China violates the agreement, the only recourse for the United States is to terminate the agreement.

Thomas Schelling has identified some common features between international relations and the underworld. Similar to the Sino-U.S. conflict, trust and good faith are lacking among gangs and ancients, and there is no neutral third party that adjudicate their disputes. The strategies that were traditionally employed to avoid conflict include exchanging hostages, drinking wine from the same glass to demonstrate it is safe from poison, and even exchanging spies to facilitate the transmittal of information. Such private ordering has clear economic rationale—Oliver Williamson has long pointed out that the institution of hostage-taking is efficient as it helps facilitate trade between parties when trust is lacking. Economic hostage-exchange can be viewed as a form of preemptively committing to abide by the terms of the negotiated agreements and to abstain from opportunistic behavior. Giving hostages raises the cost of opportunism and signals an intent not to behave opportunistically. The provision of hostages can take various forms. Economic integration, broadly speaking, is a form of giving hostages. The more integrated

335 SCHELLING, supra note 14, at 5.
336 Id.
337 Telser, supra note 216, at 27.
338 SCHELLING, supra note 14, at 20.
339 Id.
340 Id.
341 Willison, supra note 14, at 521-22.
342 Yarbrough & Yarbrough, supra note 23, at 10.
343 Id.
and interdependent is the Sino-U.S. economy, the more hostages that each country then will have of each other. As remarked by Judge Posner, the fact that China is willing to invest in the United States is a hopeful sign for the Sino-U.S. relationship, as otherwise it would not be willing to spend so much on assets that are ultimately under the control of the U.S. government.  

Consider Huawei, a prominent example of an economic hostage. On December 1, 2018, Meng Wanzhou, Huawei’s CFO, was arrested in Canada upon an extradition request from the U.S. Department of Justice (DOJ). The DOJ alleged that Huawei had engaged in a fraudulent financial scheme that violated the U.S. export laws. The fact that the United States was able to charge Huawei for criminal violation of U.S. laws has to do with economic integration—Huawei’s business presence in the United States, as well as its banking activities through U.S. financial institutions have subjected it to U.S. long-arm jurisdiction. In fact, all the Chinese companies that are conducting businesses in the United States can be held hostage by the US government, as they need to comply with U.S. laws and regulations. For instance, Chinese companies listed in the U.S. stock exchanges, many of them state-owned, have voluntarily bound themselves to the higher standard of U.S. accounting and transparency requirements. Steinfeld suggests that in doing so, the Chinese government is outsourcing the governance of its national champions to U.S. legal institutions. In a similar vein, American companies doing business in China can also be held hostage. Qualcomm, a company that derives more than 60 percent of its revenue from the Chinese market, represents a stark example. In 2015, the company was subject to almost a USD $1 billion fine for antitrust violation in China and volunteered to give a 35% discount for some of its products. Qualcomm’s proposed acquisition of NXP recently collapsed due to its delay in obtaining merger approval from China, despite approvals that it had obtained in eight other jurisdictions, with China being the only jurisdiction to hold up the deal.

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344 RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 1001 (9th eds. 2014) (Posner’s remarks were made in the context of his comments on China National Offshore Oil Corporation (CNOOC), a Chinese state-owned oil and gas company’s failed attempt to acquire assets from Unocal).


346 United States of America v. Huawei Technologies Co., Ltd. et al., Cr. No. 18-457 (S-2) (AMD) (E. D. N.Y., 2019).


Conversely, decoupling the Sino-U.S. economy is dangerous: when neither side has hostages from each other, it is less likely for the two sides to build trust and more likely for conflicts to arise. Thus, the United States should welcome more economic exchange with China, particularly Chinese investments in the United States. Such investments constitute a provision of hostage-exchange that can bind China more credibly to its promises and can give the United States more leverage over China in a bargain. In fact, this seems to be exactly the strategy that the Chinese government has adopted. Despite the deteriorating Sino-U.S. relationship, the Chinese government has not shut its door to curb foreign investments in China. Recent years have witnessed China’s accelerated efforts of opening up and cutting access restrictions for foreign investors. Unfortunately, the Trump administration is doing just the opposite—the various measures and policies that it has adopted are driving the Sino-U.S. economy toward the direction of decoupling.

In an attempt to undermine China’s economic power, the Trump administration imposed tariffs on Chinese imports to force U.S. businesses to reallocate their supply chains and shift their production out of China. This has created an exodus for manufacturers moving their production from China to other South Asian countries. In a survey conducted by American Chamber of Commerce conducted in August 2018, nearly one-third of the American businesses have relocated or are considering moving their manufacturing facilities out of China. Meanwhile, Chinese technology companies such as Huawei and other artificial intelligence companies have been restricted from commercial dealings with U.S. companies. This has forced them to move toward “de-Americanization” to decouple themselves from American supplies. News has been spreading that the Trump administration is pondering blocking Chinese companies from listing in

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351 China’s nationwide negative list of restricting foreign investment has been cut down to 40 in 2019, compared to 63 in 2017. See Freshfields Brukhaus Deringer, supra note 317 (noting that the nationwide negative list was cut down to 48 in 2018 from 63 in 2017); China Focus: China Opens More Sectors to Foreign Investment with New Negative Lists, XINHUA, June 30, 2019, http://www.xinhuanet.com/english/2019-06/30/c_138186392.htm (noting the nationwide negative list was cut down to 40 in 2019 from 48 in 2018).

352 Chen & Dieter, supra note 259.


the U.S. stock exchanges. The White House is also considering limiting U.S. pension funds’ investments in Chinese stocks, and possibly blocking all U.S. financial investments in China. The threat of financial decoupling is deterring Chinese companies from seeking to tap into the U.S. capital market. And the tougher U.S. regulatory restrictions and a less hospitable investment environment are chilling Chinese investments. Data collected by the Rhodium Group shows that Chinese foreign direct investment in the United States fell to only USD $5.4 billion in 2018—an over 80% drop from USD $29 billion in 2017. The Trump administration’s imposition of the trade sanction and a series of other restrictive measures on Chinese companies are pushing the U.S.-China relationship to the brink. As warned by Garrett: “Advocates promote decoupling in the name of national security. I believe the opposite would be true. Decoupling would profoundly harm America’s national security by reducing the costs of war with China and hence making military conflict more likely.”

VII. Conclusion and Policy Implications

Drawing upon the insights from contact theory, this Article proposes a framework for analyzing the incompleteness of trade agreements. In particular, it focuses on analyzing three ingredients of transaction costs that are barriers to drafting, concluding, and enforcing a rigid trade agreement. Using the ongoing U.S.-China trade negotiation as a comprehensive case study, this Article illustrates the circumstances when a trade agreement is difficult to write, unlikely to succeed and impossible to enforce. Corresponding to each of the three ingredients of transaction costs, this Article also offers concrete policy recommendations to the U.S. negotiators.

First, even if the U.S. government is successful in pushing China to commit to a laundry list of changes to its national law, it will only alleviate the symptoms on the surface without resolving the problems at root. Much of the legal deficiency in Chinese IP enforcement as alleged by U.S. businesses is difficult to monitor and almost impossible to verify. Unless China fundamentally revamps its state-led economic structure, the government has significant leeway to obviate the

362 See Garrett, supra note 246.
formal legal requirements to achieve its policy goals. Indeed, many aspects of the law enforcement are not contractible, and the Chinese government retains residual control in enforcing its laws. The potential misalignment of interest between the central and the local governments in China presents further challenges to the successful implementation of the laws. Accordingly, the U.S. government should not overestimate the benefits of forcing China to rewrite its national laws. This is not to say that legislative improvements are not helpful at all. China has made great strides in enhancing private enforcement of IPRs. However, the problem of slack Chinese IPR enforcement persists primarily due to the deficiency in administrative enforcement. Therefore, the U.S. priority should be to help China enhance due process and inject more transparency into the administrative process.

Second, the trade agreement is a weak legal instrument and will not be sustainable. The Trump administration’s unilateral trade measures against China represent an attack on the legitimacy and authority of the WTO rules. Thus, any Sino-U.S. trade agreement that will be concluded will not be governed by international economic rules, nor will the agreement be self-enforcing. One of the major factors leading to the collapse of the trade talks is the U.S.’ insistence on incorporating an enforcement mechanism which allows it to impose tariff sanction on China unilaterally without China’s retaliation. However, the U.S. administration faces severe political and economic constraints in applying overly severe punishment on China. Indeed, the enforcement mechanism was deliberately omitted from the three Sino-U.S. IPR trade agreements in the 1990s precisely because these types of trade agreements are constantly renegotiated in light of the ever-changing political and economic circumstances. Since the Trump administration lacks commitment power to impose a sustained tariff sanction on China, there is little benefit in insisting upon a punishment mechanism in the first place. A more practical solution is to try to get as many concessions as possible from China before an agreement is signed. China is keen on securing a trade deal, as demonstrated by the spate of legal concessions it made during the spring of 2019. This is also face-saving for the Chinese government, as concessions that are made during the trade talks tend to be less visible than those that are incorporated into the agreement.

Third, writing a rigid trade agreement is very costly, as the Chinese government would be seen as caving in to U.S. aggression and coercion. There is an overwhelming consensus among Chinese policymakers that the U.S.’ motive for triggering the trade war is to contain China’s rise in power. Moreover, a rigid agreement would easily trigger China’s historical memory of over a hundred years of colonial rule under the unequal treaties signed with western powers. The U.S. government should understand the semantic significance of the trade agreement, and its impact on the emotions and feelings of the Chinese people. The Chinese government does not want to be perceived as the loser in the bargain. For China to both satisfy the U.S. demand and appease its domestic audience, it would make sense to downplay the form and the tone of the trade agreement in order to make it appear less formal and less rigid. A nod to the Chinese sensibilities will not materially affect the substance of the agreement, but will greatly facilitate the talks and reduce the transaction cost for the Chinese government in acceding to the U.S. demand. Indeed, the presence of the cost of dignity has rendered it impossible for the two sides to reach an agreement in the first place.
On October 11, 2019, President Trump announced that the United States was in the process of reaching a limited, phase-one deal with China, delaying a tariff increase due the following week. Yet many thorny issues are outstanding and remain to be resolved in subsequent negotiations. This Article predicts that even if the two sides are able to reach a phase-one deal, subsequent negotiations for a more comprehensive deal will be met with insurmountable challenges, and any trade agreement committing China to improve its legal practices is inherently unstable.

Above all, the Trump administration needs to recognize the limit of what it could achieve through a trade agreement. As Mark Wu asserted: “[W]e ought to abandon any pretense that commitments obtained through a trade agreement can solve problems once and for all.” A rigid contract cannot fundamentally resolve the moral hazard problem that the Trump administration has been concerned about, thus the marginal benefit of writing a rigid contract is rather small. As was illustrated by the Sino-U.S. IPR negotiations in 1990s, even if China gives up extraordinary legal concessions, a rigid trade agreement has little impact on the actual enforcement. The transformation of China’s IP legal regimes did not stop the complaints from U.S. businesses, and the row between the two countries regarding IP protection continues to this day. The information asymmetry between the two sovereigns is far too high—it is not only costly for the United States to monitor and verify the conditions of compliance in China, it is also difficult for China’s central government to effectively bind its local governments to adequate compliance.

In short, from an economic standpoint, the U.S. negotiators have overestimated the benefits of a rigid agreement while underestimating its cost. In the presence of the prohibitively high negotiation and enforcement costs of a rigid trade agreement, the United States is better off allowing more flexibility in the agreement. While this would make it difficult for the Trump administration to claim a glorious political victory, it will significantly ease the tension between the world’s two largest economies and allow global businesses to breathe a sigh of relief. In addition, contrary to the Trump administration’s agenda to decouple the Sino-U.S. economy, this Article advocates instead for greater economic integration. By allowing each country to hold the other’s assets hostage, economic integration can facilitate cooperation when trust is lacking. Therefore, integration is more conducive to promoting peace and prosperity in the Sino-U.S. relationship than a rigid trade agreement.

That said, economics may not be the sole consideration for central policy-makers during a trade negotiation. A whole host of other factors involved in the Sino-US relation could play a role in


364 Id.

365 Wu, supra note 141, at 10.
affecting the negotiation outcome, and the Trump administration may well have other policy objectives in its calculation. 366 This Article, elaborating on some of the challenges posed to the Sino-US trade agreement, is not in a position to predict whether the two sides will reach an agreement or what the ultimate agreement will look like, nor is this the primary objective of this Article. The goal, however, is to expose an inconvenient truth of the trade war: economic sanction is unlikely to be an effective tool to deal with the Sino-U.S. IPR disputes, whether the trade agreement ultimately culminated is written in a flexible or rigid manner. This Article therefore offers a cautionary tale of using economic sanction to force other countries to make legal concessions.

366 For instance, President Trump initially pressed for a rigid trade agreement in order to appear tough against a rising and assertive China. With re-election looming, President Trump softened his stance by considering a phase-one agreement, which includes China’s commitment to purchase U.S. agricultural products, in an apparent attempt to appease his voters. See Heather Timmons & Andrea Shalal, No “Phase Two” U.S.-China Deal on the Horizon, Officials Say, REUTERS, Nov. 25, 2019.