

INTELLECTUAL PROPERTY

US Section 301, China, and technology transfer: Law and its limitations revisited (again)

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ARTICLE HIGHLIGHTS

- *Disputes between the United States and China regarding transfer of technology and intellectual property are of long-standing nature.*
- *The more economically significant elements of China's practices addressed by US complaints are not well-addressed by WTO rules. Threatened US retaliatory tariffs would violate WTO norms. Still, Robert Hudec's approach to justified trade disobedience is relevant.*
- *US criticism of China's industrial policy may reflect a fundamental difference in national governance models. Though different, it is not clear why China's model of engaging in detailed industrial policy planning directed towards progressive goals should be viewed as misguided.*
- *It seems reasonable to rebalance concessions that China secured when negotiating entry to the WTO because circumstances have changed in consequence of China's remarkable economic success.*
- *There remains space for political and economic diplomacy near and outside the boundaries of the WTO framework. However, care should be taken that bilateralism does not become the "new normal" as trade fragmentation and power politics have proven problematic in the past.*

On May 20, 2018, US Treasury Secretary Mnuchin [announced](#) that the US and China were “putting the trade war on hold” while the two countries seek to “execute the framework” of a broad agreement [intended to reduce the US trade deficit](#) in goods with China. According to the [joint statement](#) issued on May 19, 2018, “Both sides attach paramount importance to intellectual property protections, and agreed to strengthen cooperation. China will advance relevant amendments to its laws and regulations in this area, including the Patent Law.”

Secretary Mnuchin confirmed that the US was suspending its plans to impose substantial tariff increases on Chinese goods intended to pressure China into modifying its practices. The announcement of an apparent agreement in principle did not expressly address major issues identified in the United States Trade Representative's (USTR) [Section 301 findings](#) regarding China's intellectual property and transfer of technology practices. Given that the next step in resolving the current impasse involves the dispatch of a high-level US delegation to China to work out the details, the contours of the ultimate resolution (if any) of the relevant issues remains uncertain. Nonetheless, at least for the moment, pressures on the multilateral trading system appear to be diminished.

This “episode” in the long-running drama involving China and the US, with the European Union, Japan, and others in supporting roles, illustrates that political and economic diplomacy outside the strict confines of the World Trade Organization (WTO) remains important. The WTO legal system is not so comprehensive as to encompass the entire field of international trade, and it addresses international

investment only in a limited way. Moreover, the current political dynamic in the US is one of immediacy and mutability, neither of which are characteristics of the WTO process. Multilateral solutions are complex, time-consuming, and generally expected to endure. Yet even within the presently chaotic international environment, we should discourage bilateralism from re-emerging as the “new normal,” mainly because experience does not recommend a more fragmented global trading system. Those countries with lesser political and economic bargaining power may be the most vulnerable in a fragmented world trading system.

China’s use of law and policy instruments to “force” technology transfer from high income country enterprises, including those based in the US, has been an issue in international economic law for more than 20 years.[1] It was the subject of substantial negotiation during the process of China’s accession to the WTO, and China made certain commitments in this regard in its Accession Protocol, and incorporated texts.

The US executive administration has pledged to reduce the US trade in goods deficit with China. United States action with respect to technology transfer may be tangentially related to that pledge. It appears more an attempt to restrain China’s domestic technological advance. US strategic-military concerns are part of the equation. China’s massive investments in science and technology are reducing the significance of imported technology as a factor in its progress. The US, Europe, and Japan may be able to affect the arc of China’s emergence as a strategic technological competitor at the margin. Paradoxically, the US course of action may have the effect of encouraging China to increase the scale of its investments in R&D as it seeks to become more independent of foreign influence.

The legal situation under General Agreement on Tariffs and Trade (GATT) and WTO law with respect to technology transfers is not well-defined.[2] Transfer of technology demands are principally made in two contexts. First, technology transfer may be demanded as a condition of purchase of products, imported or otherwise. Second, technology transfer may be demanded as a condition of approval of foreign direct investment.

The US issued a Request for Consultations (RFC) with China as a prelude to formally requesting the establishment of a dispute settlement panel at the WTO, though the US might refrain from requesting a panel pending the outcome of the current negotiations. The US makes some “not entirely implausible” claims in its RFC. The problem, however, is that while the US has identified several intellectual property (IP)-related practices that may affect investments in China, these appear to be minor matters from an economic standpoint, and not matters that go to the principal economic issues that the US is attempting to address through its threatening of trade sanctions. Put another way, there is a rather limited correlation with the allegations laid out in USTR’s Section 301 findings regarding China’s technology transfer, IP, and innovation-related practices. The Office of the USTR as much as concedes this point in electing to identify China’s practices as unreasonable and discriminatory in the 301 findings, which makes them subject to discretionary measures, and at least in the US view (presumably) keeps them out of the purview of WTO dispute settlement.[3]

The Chinese practices about which the US complains in the RFC concern mandatory indemnification by licensors for third-party patent infringement claims against licensees; prohibition against grant backs of technology improvements by licensees to licensors; and, mandating permission to licensees to continue using patented technologies after expiration of licenses. Each of these practices is said to apply to foreign

licensors, but not to local Chinese companies. As noted above, on the scale of economic impact, these seem to be of limited significance.

The main allegations in the 301 findings are that the Chinese government, at the national and sub-national levels, effectively compels foreign investors in China to transfer technology to domestic joint venture partners as a condition of approving inward investments, or in other contexts such as conditioning regulatory approvals. The Office of the USTR argues that to avoid complaints from foreign governments, the Chinese government pursues these practices largely in ways that do not leave a “paper trail,” much in the nature of colluding co-conspirators in antitrust cases. Identifiable US corporate victims of the Chinese practices are unwilling to go on record with specific instances in which they have been affected by these practices, leaving it to industry group representatives to make the case without company-specific details, or at least company-specific details USTR maintains in confidence.

Another broad set of allegations in the 301 findings concerns allegations that China subsidises R&D in various key sectors, though this does not find its way into the RFC as a complaint against prohibited subsidisation. Since a substantial proportion of Chinese companies are state owned, this also potentially raises issues regarding state trading rules.

Finally, the Section 301 findings identify Chinese cyber piracy practices against US industry as unreasonable or discriminatory practices. The Office of the USTR says that these practices, though perhaps scaled back, continue notwithstanding Chinese government assurances they would cease. Such practices, at least in part, are undertaken through Chinese government agencies, which presumably make the pirated technology available to local Chinese companies.

A recent report prepared for the [US-China Economic and Security Review Commission](#), established pursuant to US statute, suggests increasing concern with US federal procurement of Chinese-origin computer equipment, telecommunications equipment, and software which are said to lead to vulnerabilities in US security. An interesting aspect of the problem is that many of the exporters from China to the US are subsidiaries of US-based multinationals that have established production facilities in China. The [report indicates](#) that it is unrealistic to expect US-based enterprises to move manufacturing out of China to allay security concerns (because of the profitability of the Chinese market).

The retaliatory tariff measures that the US proposed, but now suspended, would clearly violate WTO norms. They would be inconsistent with most favoured nation (MFN) treatment under GATT Article I as they apply only to China. Almost certainly they would be inconsistent with US commitments on bound tariffs under GATT Article II.[4] As the US tariff measures would be imposed without the benefit of authorisation by the WTO Dispute Settlement Body, they would be [inconsistent with US obligations](#) under the Dispute Settlement Understanding (DSU).

The Section 301 findings include a compilation by USTR of bilateral commitments said to have been made by China to the US within the framework of the [US-China Joint Commission on Commerce and Trade \(JCCT\)](#) and [US-China Strategic & Economic Dialogue \(S&ED\)](#). There is no suggestion made by USTR that these bilateral commitments – the legal status of which is not spelled out – are enforceable as a matter of WTO law or under some bilateral dispute settlement mechanism.

Even assuming the subject matter of the complaints by the US against China were within the scope of the WTO agreements, at this stage using the DSU as the mechanism to resolve those complaints raises additional questions. The WTO dispute settlement process is not designed to move expeditiously. From

initiation to adoption of conforming measures, a dispute can readily be extended for 3.5 years without any meaningful adverse consequence to the losing party. The present US administration appears to have a short-term political outlook. A 3.5-year time horizon for what may be a modest outcome does not appear consistent with that outlook. Moreover, given the long-standing nature of the US complaints regarding China's practices, that perspective may not be entirely unreasonable in the circumstances. And, since WTO rules as drafted are unlikely to provide solutions to a number of the issues, the potential efficacy of WTO dispute settlement is questionable.

Not for the first time, we can turn to Professor Robert Hudec's argument regarding [justified trade disobedience](#) and ask whether the US would be acting from a "multilateral trade-responsible" standpoint by attempting to force a change in WTO rules that would address the technology issue. The question arises: is the US after new WTO norms as would be part of Robert Hudec's philosophical justification for disobedience?[5]

A multilateral legal solution would seem to entail the negotiation of an investment agreement – inside or outside the WTO – that would address conditions placed on inward investment, such as technology transfer demands. Experience suggests that a broad multilateral investment agreement would be a difficult and long-term exercise. For this reason, the US is more likely to be able to achieve its objectives through a bilateral negotiation with China – though this is not to suggest whether the US will succeed.[6]

It is noteworthy that bilateral and plurilateral trade and investment agreements more recently negotiated by the US, including the Transpacific Partnership (TPP), include provisions in the investment chapter that specifically address transfer of technology demands in a way that might encompass, at least in substantial part, the practices the US complains about with respect to China (for example Article 9.10(f) of the [TPP final text](#)). The US President concluded that the TPP was a terrible deal for the US and withdrew its signature, following which it was replaced by the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). It will be of interest to see whether the forthcoming negotiations with China will generate a solution on technology transfer "less terrible" than the one in the TPP.

A significant element of the US 301 findings is a critique of China's strategic industrial and R&D policies as set out in a number of official documents, including most recently "Notice of the State Council on Issuing 'Made in China 2025'." [7] These documents, according to USTR, target a number of key sectors regarding which China commits to devoting resources towards achieving technological leadership, local production, and global export capacity. These include, for example, artificial intelligence, advanced electric vehicles, aerospace, and biotechnology.

At one level, the dispute involves a basic confrontation between politico-economic ideologies. China is a top-down managed economy and political system which includes detailed planning and implementation of industrial policy. The US is at least nominally a "free market" economy in which the preponderance of business decisions is made by autonomous private entities.

Yet, of course, the characterisation of the US as a free market does not account for the relatively vast role that the government plays in effectively managing important parts of the economy by virtue of the very large federal budget and expenditures, including with respect to R&D that is directed towards the defence and pharmaceutical sectors, and subsidies for the energy and agricultural sectors, among other areas.[8]

The USTR 301 findings are plain in stating that the main complaint of US-based multinational companies is that they should not be deprived of access to the large and growing Chinese market based on Chinese government regulatory policies and practices. The US companies implicitly acknowledge that they could choose to stay away from China, and that decisions to transfer technology in that regard involve exercise of “free will.” China is not forcing these companies to choose China as an investment destination.

It is evident that China has substantial leverage in the present dialogue with the US. Non-technologically advanced investors, consider Starbucks for example, must be deeply concerned that the current tensions will spill over into anti-American sentiment that will change local consumer preferences. As noted earlier, a paradox of the action being taken currently by the US administration is that while a curtailment of US technology transfers to China may slow down China’s advance towards technological parity with the US, it is also likely to result in even greater investment by the Chinese government in developing homegrown technological assets.

On another level, this entire set of issues is rooted in a “dark view” of international relations, including trade relations – a zero-sum game in which Chinese technological advances are at the expense of the US. Over the past 30 years, Chinese economic development has raised large numbers of people out of poverty and towards middle-class prosperity. Advances in technology made in China presumably will benefit individuals in the US, as well as globally. The question is where to strike the balance between encouraging Chinese technological advance while protecting the economic well-being of individuals in the US and elsewhere.

At the time China bargained for entry into the WTO its economy was in a much different circumstance than it is today. Seventeen years after its formal entry, China’s economic posture in relation to the OECD and other developing countries is significantly different. To the extent that concessions were made to acknowledge the long path that China would need to take to become a largely developed country, those concessions would no longer appear to be necessary. It is reasonable for China’s position vis-à-vis the OECD world to be rebalanced. This is in recognition of one of history’s great economic success stories.

This brings us back (again) to Olivier Long’s classic 1985 [Law and its Limitations in the GATT Multilateral Trading System](#). Long, a former Director General of the GATT, argued that legal rules could not address all the complex issues raised within the international trading system, and that there was important room for political and economic diplomacy beyond those legal rules.

One of the driving ideas behind the Uruguay Round was that a comprehensive legal arrangement would move the organisation out of the realm of politics and diplomacy and further embed the rule of law. Yet even with successful conclusion and establishment of a more encompassing WTO, there was no pretence that the WTO agreements address every issue in the field of international trade. International investment is addressed only in limited ways.

There is still room for politics and diplomacy near and outside the boundaries of the framework of the WTO for matters that are unaddressed, or uncertainly addressed, by the norm-system. The “somewhat urgent” question is whether politics and diplomacy can resolve the tension between the US and China before the WTO legal system loses its relevance, and bilateralism becomes the “new normal.” Although the future is famously difficult to predict, fragmentation of trade relations and reliance on power politics has proven problematic in the past.

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With thanks to Pedro Roffe for his insightful reaction to an earlier draft.

[1] It was evident already by the late 1990s that OECD multinationals were willing to risk longer-term protection of their technological advantage in exchange for access to the rapidly growing Chinese market.

[2] In the defense procurement context, the requirement of technology transfer in connection with a purchase and sale is customarily referred to as a “civil offset.” Quite commonly, when a government procures military equipment, for example fighter aircraft, it includes a requirement that part of the production of the equipment take place in the procuring country. Perhaps as a consequence of this common practice, GATT contracting parties were reluctant to incorporate detailed rules on such “conditioned sales” in the agreements. Purchase and sale transactions are typically bargained between private parties. If a purchaser demands that some form of technology transfer accompany the sale of a product, it is for the seller to decide whether it wants to pursue the transaction or walk away. Although conditions on direct investment may be more a function of government rules, a prospective joint venture partner is typically free to bargain over the conditions of investment. Again, a demand for a technology transfer in conjunction with provision of financial contribution or distribution expertise is part of an ordinary business decision-making process, to be accepted or rejected based on a variety of factors.

[3] Presumably relying on the precedent of the [China-Enforcement case](#) of a decade past, China's Ambassador to the US has [responded to the US request for consultations](#) by stating that the US does not have any evidence of actual instances of US firms being targeted for technology transfer demands.

[4] Until the US imposes sanctions an assessment of the relationship between the increase in tariffs and US bound rates is difficult. Given the proposed scope of the sanctions, it seems “likely” that bound rates would be exceeded if imposed, but an assessment is premature.

[5] To paraphrase: First, the dispute should involve one that current rules do not adequately address. Second, the actor (in this case the United States) has tried to accomplish reform and has not succeeded. Third, the unilateral actor will bargain in good faith toward a rule change. Fourth, the unilateral actor will not go beyond what is necessary to accomplish its objectives. Finally, the unilateral actor ultimately will accept the outcome of the judicial process that may address the issue. See also, [Frederick M. Abbott](#).

[6] Given that the European Union, Japan, and other OECD countries have expressed similar concerns with China's transfer of technology practices, a mini-lateral solution is a possibility. But, the current US Administration does not appear to favour working on trade issues together with traditional allies in this area.

[7] Also, National Medium- and Long-Term Science and Technology Development Plan Outline (2006-2020) (MLP), the State Council Decision on Accelerating and Cultivating the Development of Strategic Emerging Industries (SEI Decision). See [301 findings](#) at 10-18.

[8] In addition, if the US is deeply concerned about US-based investors in China exporting products back to the US which incorporate security backdoors in favour of Chinese “bad actors,” logic suggests that the Chinese government should be at least as concerned that the US investors in China are similarly incorporating security backdoors in products sold to the Chinese market in favor of US-based “bad actors.”

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