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POLICY BRIEF

How the United States Should Respond to China's Intellectual Property Practices

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April 2019

The United States and China are approaching a critical point in a dispute over China's practices on intellectual property (IP) and other issues. In 2018, the Trump administration began imposing duties on imports from China based on a Section 301 report issued by the Office of the US Trade Representative (USTR) in March that determined that the Chinese practices were unfairly restricting US commerce. A cycle of rising US tariffs and Chinese retaliation has been temporarily suspended while the two governments negotiate a potential deal. The Trump administration has threatened to renew its tariff escalation if no deal is reached, which will likely be followed by renewed Chinese retaliation.

There is widespread agreement in US trade policy circles—among China hawks as well as business groups and free-trade advocates—that China's authoritarian government continues to pursue policies that restrict international trade and investment and that compromise the ability of foreign companies to protect and fully benefit from their right to IP. Disagreements remain over the extent of the threat of those policies to US economic interests and what the appropriate response from the US government should be.

In the eyes of the Trump administration, the danger posed by China's IP practices is grave, threatening the very underpinnings of the US market economy. According to the actions of the administration, the right response is an unprecedented imposition of punitive tariffs, as high as 25 percent and potentially covering more than half a trillion dollars of imported goods from China annually.

Buttressing the administration's case against China's IP practices are a series of reports from the USTR. The four main charges, contained in the USTR's Section 301 report in March 2018 and reinforced in a follow-up report in November 2018, are that China does the following:

1. Requires Western companies investing in China to engage in joint ventures with Chinese firms and to transfer key technology to the domestic partners as a condition for doing business in China.
2. Imposes regulations that force US firms to license technology on non-market-based terms.
3. Acquires controlling interest in US companies to obtain technologies and IP.
4. Engages in or tolerates unauthorized cyber intrusions to steal US technology for both military and commercial purposes.[1]

The response of the Trump administration to these allegations goes beyond any measure the US government has deployed in the past in commercial disputes with major trading partners. Under Section 301 of the Trade Act of 1974, the president is authorized to take "appropriate and feasible action" to eliminate allegedly unfair foreign trade practices, including "an act, policy, or practice of a foreign country that is unreasonable or discriminatory and burdens or restricts United States commerce."[2]

Under direction from President Trump, and after a series of hearings, the USTR in July 2018 imposed 25 percent duties on $34 billion worth of imported goods from China. China immediately imposed retaliatory duties on $34 billion worth of US exports to China. In August 2018, the USTR imposed 25 percent duties on another $16 billion of imported goods from China, which prompted Chinese duties on the same value of US exports.

In response to China's retaliation for the initial round of US duties, President Trump directed the USTR to impose duties on another $200 billion worth of imported goods from China, effective September 24, 2018. Those duties range from 5 to 10 percent, with the threat that the rate will climb to 25 percent if China does not agree to satisfactory terms on the outstanding issues.

This brief concludes that the US government, in its dispute with China over trade and IP practices, should implement a strategy that will lead to the best possible outcome for Americans without violating global trade rules itself or imposing direct costs on the US economy through punitive tariffs.

RESPONDING TO IP THEFT

The most serious of the USTR's charges, arguably, is that China uses cyber intrusions to steal US technology. In its March 2018 main report, the USTR concluded that those cyber intrusions give Chinese actors "access to commercially valuable business information, including trade secrets, technical data, negotiating positions, sensitive and proprietary internal communications."[3] This is not a new charge by the US government. In 2016, the USTR under President Obama concluded that "actors affiliated with the Chinese government have infiltrated computer systems in US and stolen terabytes of data, including firms' intellectual property for the purpose of providing commercial advantage to Chinese firms."[4]

Theft of IP is a clear violation of international law and must be taken seriously. Along with violating legally recognized rights to property, IP theft can deprive the rightful owners of significant potential revenue and, more broadly, it can blunt incentives for innovation by depriving successful creators of their economic rewards.

Despite the indictment from USTR, the evidence against China on IP theft is mixed. Since joining the World Trade Organization (WTO) in 2001, China has made significant progress in both modernizing and enforcing its IP laws. As the 2016 USTR report on China's WTO compliance concludes, "Since its accession to the WTO, China has established a framework of [IP] laws, regulations and departmental rules that largely satisfies its WTO commitments." The report also notes the need for further updating and that effective IP rights enforcement remains a serious problem.[5]

In terms of enforcement, China is more typical of a developing, middle-income nation. The problem is more urgent in China because of its sheer size and the national security concerns it raises. The US Chamber of Commerce (Chamber), in its international IP index, locates China in the middle of the pack, ranking it 25 out of 50 major trading nations in terms of its protection of IP rights. China ranks just behind Malaysia and Mexico in the index, but ahead of such major US trading partners as Turkey, Colombia, Chile, Peru, and Brazil.[6] While the Chamber commends China for patent and copyright reforms and efforts to raise awareness of the need for enforcement, it also finds high levels of IP infringement, barriers to commercialization of IP, and insufficient legal safeguards for trade secrets.[7]

The USTR's *2018 Special 301 Report* on IP rights, released in April 2018, identifies a dozen countries for its IP "Priority Watch List." Along with China, the list includes Canada, India, Indonesia, Russia, and Ukraine. "The IP issues in these countries will be the subject of intense bilateral engagement during the coming year," according to the USTR, although only China has been subject to punitive and escalating tariffs.[8]

China's progress on IP enforcement has been unsteady, with evidence of progress offset by evidence of recent backsliding. The USTR's March 2018 Section 301 report notes in passing "an apparent decline in the observed number of cyber incidents by China,"[9] citing sources in a footnote indicating "a notable decrease in reports by American companies of intrusions from suspected Chinese hackers" well into 2016.[10] In the related area of counterfeit goods, the administration's 2017 report on China's WTO compliance comes to the mixed conclusion that, "Although [IP] rights holders report increased enforcement by Chinese government authorities, counterfeiting in China, affecting a wide range of goods, remains widespread."[11]

The USTR's November 2018 follow-up Section 301 report on China paints a more negative picture of IP theft emanating from China. The report claims that cyber intrusions from Chinese actors have gone up since March 2018. As evidence, the report cites a US Department of Justice indictment of Chinese-based hackers. It also reports specific cases, such as the theft of DRAM (Dynamic Random-Access Memory) chips from the US firm Micron.[12]

Further evidence of China's real—if uneven—progress in the enforcement of IP rights can be seen in the amount that Chinese companies pay to foreign firms for the use of IP. In 2017, according to the US Department of Commerce, China paid $8.7 billion to US companies for the use of IP. That is more than a 10-fold increase from what Chinese companies paid in 2001, before China joined the WTO. China ranks fourth among nations in IP payments to the United States, behind only Ireland, Switzerland, and the United Kingdom.[13] China's IP payments to the rest of the world have also risen sharply. According to analysis by Nicholas Lardy of the Peterson Institute for International Economics, "China's payments of licensing fees and royalties for the use of foreign technology have soared in recent years, reaching almost $30 billion [in 2017], nearly a four-fold increase over the last decade."[14]

The progress that has occurred in China's enforcement of IP rights is not only driven by external pressure from its trading partners but also by internal demands from Chinese industry to protect China's own growing IP sector. According to the 2016 USTR report on China's WTO compliance, Chinese companies themselves are seeking better domestic IP enforcement:

> A domestic Chinese business constituency is also increasingly active in promoting IPR protection and enforcement. In fact, Chinese rights holders own the vast majority of design and utility model patents, trademarks and plant varieties in China and have become the principal filers of invention patents. In addition, the vast majority of the IPR enforcement efforts in China are now undertaken at the behest of Chinese rights holders seeking to protect their interests.[15]

None of this should obscure the fact that agents in China engage in significant theft of IP from American companies and other firms around the world. The evidence does, however, indicate that China is not unique among emerging economies in the lack of full protection of IP rights. Further, China has, over the span of its membership in the WTO, been making measurable progress in modernizing its laws and enforcing them so that both domestic and foreign companies can enjoy rightful protection of their IP rights.

Evidence also shows that Chinese violations of IP rights have imposed costs on certain US producers, but those costs have been exaggerated. At the high end of the cost estimates is the White House National Cyber Strategy document from September 2018, which alleges that China is engaged in "trillions of dollars of intellectual property theft."[16] Other estimates range as high as $600 billion.[17] Those numbers seem unreasonably high.

The US International Trade Commission (USITC), in a more cautious assessment in 2011, estimates that US firms suffered $48 billion in lost revenue in 2009 from IP theft in China.[18] The

USITC report notes that Chinese IP theft reduces market opportunities and profits for US firms by undercutting their sales with lower-cost illegal imitations. Chinese entities have imposed further costs through stolen trade secrets, diminished sales and royalty or license fees, and damaged brand names. The report determined that three-quarters of the $48 billion in losses were caused by lost sales and one-quarter were caused by lost royalty and license payments and other unspecified losses. While the loss is nontrivial in absolute value, it amounts to less than 1 percent of the total sales of US IP-intensive firms doing business in China.[19]

RESPONDING TO TECHNOLOGY TRANSFER REQUIREMENTS

Another pillar in the US complaint against China on IP is China's practice of requiring foreign companies to transfer technology to their Chinese investment partners. As the USTR charges in its Section 301 report of March 2018, "The Chinese government uses foreign ownership restrictions, such as formal and informal JV [joint venture] requirements, and other foreign investment restrictions to require or pressure technology transfer from US companies to Chinese entities." The USTR notes that foreign companies often decide there are few realistic alternatives to the arrangement because of the size and importance of the Chinese market.[20]

This, too, is a legitimate complaint against Chinese policy, but the practice of requiring technology transfer as a condition of doing business in China is of a fundamentally different nature than outright IP theft. Imposing performance requirements on foreign-owned affiliates is not a unique or even uncommon practice in less developed nations. Multinational companies routinely accept such conditions as a cost of doing business in those markets. In contrast to IP theft, the multinational firms ultimately decide on behalf of their shareholders whether or not the arrangement is acceptable.

The USTR's main Section 301 report argues that the Chinese practice of "forced" technology transfer threatens to undermine the profitability of US companies in the Chinese market by allowing the indigenous Chinese companies to eventually produce their own competing products based on the transferred technology. The Chinese knock-off products may even enter into global markets, reducing overall sales of US firms and their reinvestment in research and development of new products. Because of China's technology transfer rules, the USTR warns, US multinational companies "may become less globally competitive in the long-run."[21]

Like all restrictions on foreign trade and investment, China's restrictions on foreign direct investment impede international commerce, reducing the gains from economic integration for both China and its trading partners. But despite the technology-transfer requirements, US companies continue to invest profitably in the Chinese market. According to the US Bureau of Economic Analysis, US firms sold $463 billion in goods and services through their affiliates in China in 2016, almost double the total sales for 2009. Those same affiliates earned $34.5 billion in net profits from operations in China in 2016—more than US companies earned through affiliates in such major trading partners as Canada, Japan, or Mexico.[22] The gains from their investment in China still far outweigh any measurable losses from technology transfer.

The Chinese government itself appears to recognize that investment restrictions are not serving its own economic interests. The trend in recent years, again not always in a straight line, is in the direction of relaxing requirements for joint ventures and technology transfer. In its update on China's IP policies issued in November 20, 2018, the USTR acknowledged China's "relaxation of some foreign ownership restrictions and certain other incremental changes in 2018."[23]

Recent positive reforms on foreign investment include the expansion of the "negative list" of industries in which foreign companies can invest without a joint venture. Without a required Chinese partner, the foreign parent company can own 100 percent of the affiliate operating in China, which means no mandated technology transfer. Recent sectors that China has added to the negative list include important and politically sensitive industries, such as automotive, aircraft, shipbuilding, and certain financial services.[24]

In the auto sector, China has agreed to allow full foreign ownership immediately in the production of "new-energy vehicles (NEV)," such as Tesla electric passenger vehicles. Full, 100 percent foreign ownership will be allowed for production of non-NEV commercial vehicles by 2020 and non-NEV passenger vehicles by 2022. In sectors where foreign ownership is still limited, China has also agreed to scrap the limit on a maximum of two joint ventures.[25]

China's relaxation of investment rules reflects a long-term trend. According to Nicholas Lardy of the Peterson Institute, the share of value of foreign direct investment (FDI) into China that was in wholly foreign-owned affiliates was only about 10 percent in 1987–1988. But Lardy writes,

> By 2000, on the eve of China's accession to the World Trade Organization, almost half of actual incoming FDI was in wholly foreign-owned firms. This share rose to an average of almost 80 percent in 2008–14 before falling to around 70 percent in the last few years, as the composition of FDI shifted toward more restrictive sectors. In a wholly foreign-owned firm there is no transfer of technology, and the foreign firm can take the same steps it would take in any other market to prevent its technology from leaking to domestic firms.[26]

As with IP rights enforcement, China's rules on foreign investment and technology transfer fall short of international expectations. But those rules and their practical enforcement have been generally improving. In the case of technology transfer, the rules are a cost of doing business in China, a cost that has the effect of actually making China a less attractive place for FDI compared with the United States and other economies around the world.

Put differently, these technology transfer requirements are an in-kind tax on foreign companies seeking to do business in China—a tax that, as with all taxes, discourages the taxed activity. Specifically, this tax discourages non-Chinese firms from setting up shop in China, which acts as a brake on Chinese economic growth. Thus, like IP rights protection, the problem contains within itself strong incentives for the government of China to reform its policies in a market-oriented direction if it wants to realize the full benefits of global economic integration.

RESPONDING TO CHINESE ACQUISITION OF US FIRMS

A third area of complaint against China's IP practices is what the USTR calls "China's Outbound Investment Regime"—specifically, its acquisition of US technology through direct investment in US companies.[27] The USTR's main Section 301 report in March 2018 contends that China is actively engaged in "recruiting talent to China" through its acquisitions in the United States. It also argues that Chinese direct investment highlights the "non-reciprocal treatment of US firms and investments in China" and that it is "artificially inflating the prices of potential acquisition targets."[28]

As part of its effort to obtain western technology, Chinese firms acquire a controlling interest in US technology companies and then transfer the firm's technology and recruit its talent to work in China. Like IP theft and technology transfer, China's practices in this area need to be monitored and challenged when necessary, but the potential dangers should not be exaggerated.

Chinese direct investment in the US economy is relatively small and has been declining recently. According to the American Enterprise Institute's "China Global Investment Tracker," China's direct investment in the United States had been rising through 2016 but has dropped sharply since then.[29] China's share of the new FDI in the United States in 2017 was 5.4 percent and its share of the cumulative stock of FDI was 1 percent, according to the US Bureau of Economic analysis. Most of China's investment in the United States continues to be portfolio investment, overwhelmingly US Treasury notes.[30]

If the acquisition of a particular US company by a Chinese investor could negatively affect the US national interest, the federal government has the authority to block the transaction through the Committee on Foreign Investment in the United States (CFIUS). CFIUS is an interagency committee of the federal government that reviews foreign investments in US companies or operations for national security implications. The committee has the authority to block or modify transactions if national security is at risk, pending approval of the US president.

In August 2018, President Trump signed the Foreign Investment Risk Review Modernization Act of 2018 (FIRRMA), which expands the jurisdiction of CFIUS to investigate investments in the United States that do not necessarily involve majority ownership of a targeted US company. Specifically, the new legislation expands the coverage of CFIUS to, in the words of the US Department of the Treasury, investments "in certain U.S. businesses that afford a foreign person access to material nonpublic technical information in the possession of the U.S. business, membership on the board of directors, or other decision-making rights."[31] The expanded CFIUS process should give the US government the tools it needs to protect the United States from any genuine security threat posed by Chinese direct investment in the US technology sector.

An overzealous approach to policing Chinese investment in the United States could deprive Americans of the benefit of investment capital in the US economy generally and the high-tech sector specifically. If Chinese investment really is causing the price of acquisition targets to rise, this has the benefit of rewarding US entrepreneurs who started their companies and early investors who funded those companies' growth. Like other foreign investment, this could stimulate innovation and technological advancement in the United States. If the Trump administration is concerned about the Chinese recruiting technological talent from the United States, one response would be for the US government to make it more attractive and legally possible for high-skilled workers to remain in the United States. That would include Chinese nationals trained at US institutions of higher learning.

THE BEST US POLICY RESPONSE TO CONCERNS ABOUT CHINA IP PRACTICES

The Trump administration's escalating Section 301 duties on imports from China have arguably inflicted more direct damage on American households and companies than any practices by the Chinese government. The scope of the administration's tariff action has been arbitrary, unprecedented, and grossly out of proportion to any actions by the Chinese government.[32]

The appropriate policy would be to immediately suspend all Section 301 duties that have been imposed on imports from China, so as to bring the United States back into conformity with its international commitment to impose duties in a nondiscriminatory unconditional most-favored nation (MFN) basis.[33] And in doing so, the United States would avoid the hypocritical move of itself violating international law in its effort to prevent China from violating international law.

Suspending all 301 duties would yield additional and immediate benefits. Suspending the duties would relieve American households and producers from the costly and distorting effects of the tariffs, remove any justification for China's retaliatory duties on US exports, and build a measure of good will for US-China negotiations going forward. A suspension would also reduce the incentives for American producers to rent-seek—that is, to divert their time and resources away from seeking to improve their products and their firms' operations and toward seeking the special favors of government officials.[34]

Instead of the lose-lose policy of escalating tariffs, a policy of targeted response against specific infractions and more general diplomatic measures to encourage China to move in more proreform direction would yield better outcomes.

One promising alternative to punitive tariffs would be to join with US allies to file joint cases in the WTO to pressure China to fully conform to its existing international commitments. The WTO has proven to be an effective forum for modifying the practices of the Chinese government in a more trade-friendly direction. Since China joined the WTO in 2001, numerous cases have been filed by the United States and other WTO members challenging Chinese trade practices. According to a recent analysis by the Cato Institute, between 2004 and 2018, 41 complaints were filed against China in the WTO dispute settlement mechanism (DSM) covering 27 separate issues (or "matters" in the official jargon of the organization). Of those, five are still working their way through the system. Of the 22 cases that have been completed, 12 resulted in a final judgment from the WTO dispute settlement panels, and 10 were resolved through some kind of "out of court" settlement.

The result, according to James Bacchus, Simon Lester, and Huan Zhu, was overwhelmingly positive: "In all 22 completed cases, with one exception where a complaint was not pursued, China's response was to take some action to move toward greater market access."[35] While China's conformity in each of those cases has not always been complete, Bacchus and his coauthors note that "there are no cases where China has simply ignored rulings against it."[36] At least one of those cases directly involved intellectual property issues and was brought under the WTO's agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). There are a number of current US complaints that could be pursued in the WTO, even though the Trump administration to date has brought only one case against China to the WTO DSM.[37]

Another more constructive US response would be to rejoin the Trans-Pacific Partnership, which has now gone into effect with 11 other nations under the title of the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP). As originally intended by the United States, the CPTPP provides a robust framework of tariff elimination and IP rights enforcement that stands as a regional alternative to China's more state-directed economic policies.

A third alternative to blanket tariffs on imports from China would be targeted legal and administrative action against Chinese parties directly responsible for IP rights violations. Late in 2018, the US Department of Justice filed a number of charges against specific Chinese companies and officials for allegedly violating US IP laws. One charge in October 2018 was brought against the Chinese state-owned enterprise Fujian Jinhua Integrated Circuit and its Taiwanese partners for conspiring to steal technology from the Idaho-based chipmaker Micron Technology.[38] More recently, the US government issued an indictment against the Chinese technology firm Huawei for allegedly stealing trade secrets from its US partner, T-Mobile. These are examples of targeted legal actions that directly address cases of IP theft rather than imposing indiscriminate tariffs that harm Americans but have no direct connection to the alleged Chinese infractions.

The problem of IP theft by China is real but its magnitude should not be exaggerated. The Trump administration's response to the problem has been both excessive and poorly designed to lead to a solution. A more appropriate response as outlined in this brief would be to continue to exert pressure on the Chinese government in the most direct manner possible to reform its practices in a market direction while imposing as few restrictions as possible upon Americans wishing to purchase Chinese goods. The alternative is a continued cycle of broad, arbitrary, and self-damaging tariffs that impose escalating costs on the US economy without addressing the underlying issues with China.

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