

**Statement of**

**Robert D. Atkinson**

**President**

**Information Technology and Innovation Foundation**

**Combating Unfair Trade Practices in the Innovation Economy**

**before the**

**Committee on Finance**

**United States Senate**

**May 22, 2008**

Chairman Baucus, Mr. Grassley and members of the Committee, I appreciate the opportunity to discuss the importance of enforcement to counter nations' unfair trade practices against the United States and to comment on the Trade Enforcement Act of 2007. I commend you for addressing this important issue.

I am President of the Information Technology and Innovation Foundation, a non-partisan research and educational institute whose mission is to formulate and promote public policies to advance technological innovation and productivity. Recognizing the vital role of technology in ensuring American prosperity, ITIF focuses on innovation, productivity, and digital economy issues. Because of the importance of trade policy to technological innovation, ITIF has worked actively in this area, and in particular on analyzing how other nations have established and promoted "mercantilist" trade practices designed to gain unfair advantage, particularly in knowledge- and technology-based industries.

## **The Trading System Has Changed; Our Approach to Trade Enforcement Also Needs to Change**

When many of the trade enforcement tools were established thirty or more years ago, the international trading regime was quite different than it is today. Services accounted for a small fraction of cross-border trade. A larger percentage of goods trade was in commodity-type products. Many other nations, especially developed nations, focused their economic and trade policies on promoting natural resource production and commodity goods assembly. Moreover, no nation, not even Japan, was so large that it could dictate terms of trade to multi-national companies. As a result, competition between nations for investment exerted at least some discipline on nations' worst mercantilist impulses. And when countries erected mercantilism trade policies designed to unfairly gain competitive advantage, these usually consisted of tariffs, quotas, or other relatively blunt means of protectionism that were easy to detect and confront. All of these factors worked to keep the U.S. trade deficit at relatively minimal levels.

Thirty years later, the global trading system is significantly different. With the rise of information technology and global communication networks, services trade has expanded significantly. While commodity-based goods are still traded, a growing share of goods trade is now in technology-based products. And with the entry into the global trading system of nations with very large markets, like China and India, the relative balance of power has shifted away from multi-national companies toward these nations, who increasingly use access to their huge and growing markets as leverage to dictate the terms of trade. Moreover, a large share of nations, including developing nations, see the royal road to growth in shifting their economies more toward high value-added, innovation-based goods and services; the very sectors upon which the United States' competitive advantage is based. And indeed, a growing share of nations have turned to discriminatory mercantilist policies to gain jobs in those sectors, and in the process targeted U.S. technology jobs. Not surprisingly, the U.S. trade deficit has ballooned to record levels as we have become the "importer of last resort" for most of the rest of the world.

Because the nature of trade has changed and because the stakes are so much higher, nations are able to employ a much wider array of complex and relatively non-transparent means of gaining unfair advantage in the global trading system and they have much stronger motivations to do so. In short, mercantilist trade policies have become the policy of choice for many nations. Our trade enforcement system has not kept pace with these changes and has failed to adequately respond to either the magnitude or the nature of the challenge.

### **The Rise of the New Mercantilism**

As technology and knowledge-based industries become a more important part of the global economy, and a key source of high-paying jobs, many nations have established policies to grow their technology industries. Many of these policies are quite legitimate and consistent with market-based competition. These include policies such as research and development (R&D) tax incentives; government investment in research; efforts to increase education and skill levels, particularly in science and technology fields; and spurring telecommunications development.

It would be one thing if that were all these nations were doing to compete for technology-based jobs. After all there is nothing inherent about America's competitive advantage in these sectors. If the United States is to maintain our advantage we will have to work for it, in part by boosting our innovation policies, such as expanding the R&D tax credit and increasing support for federal research. But these nations' efforts go far beyond legitimate and market-based innovation policies. Many have decided that to compete they have to erect a whole host of unfair and protectionist policies focused on systematically disadvantaging foreign, including U.S., companies in global competition.

Perhaps the most troubling part of this is that nearly all of the nations engaging in these unfair and distorting trade practices targeting U.S. technology leadership are members of the World Trade Organization (WTO). These nations made a free decision to join the WTO and when they did they agreed

to reduce if not end mercantilist practices. In fact, many of these nations saw membership in the WTO as an avenue to exporting to the United States without committing to their responsibilities as WTO members. In a recent report entitled “The Rise of the New Mercantilists: Unfair Trade Practices in the Innovation Economy,” ITIF documented a wide array of unfair trade practices by a wide range of nations targeted at the technology sector, including the following:

**Tariffs:** Despite numerous multilateral and unilateral trade agreements, tariff protection of technology industries is alive and well. For example, The WTO’s 1997 Information Technology Agreement (ITA) was supposed to eliminate tariffs that distort trade flows on wide variety of high-tech goods, including computers and components; telecommunications equipment; printed circuits, resistors, and capacitors; semiconductors and components; and set-top boxes with a communications function. Nevertheless, ten years after its passage, countries such as India and Indonesia still maintain tariffs on imported IT goods despite being signatories to the ITA and maintaining high trade surpluses with the United States.

But it’s not just developing nations that are violating the letter and spirit of the ITA. The European Union has also decided that it must erect barriers to high-tech imports covered by the ITA. In recent years, it has been slapping tariffs on products, as high as 14 percent, simply because companies have improved those products and added innovative features. These products include computer monitors, set-top boxes and multi-function printers.

**Discriminatory Taxes:** While tariffs are the most straightforward way to shift the cost equation in favor of domestic producers, taxes are less obvious but no less effective. In particular, some nations apply a combination of different types of taxes to support domestic technology producers. However, using taxes to promote exports is complicated by the fact that certain subsidies for goods (but not services) are a violation of the WTO, while other subsidies are not. In particular, the WTO prohibits subsidies that require the companies that get them to meet certain export targets or to use domestic goods instead of

imported goods. A nation that chooses instead to give a domestic (but not foreign) manufacturer a tax break, perhaps through a rebate, for example, may not be violating the WTO. This lack of clarity and the difficulty in proving damage enables mercantilist nations to manipulate taxes to support domestic IT industries while avoiding WTO violations.

Nations also may combine various taxes and duties in a way that may not initially appear to discriminate against imports or favor exports, but could have the same effect. For example, India applies a 12 percent excise duty on computers that local manufacturers (either domestic or foreign) can offset against their value added taxes (VAT). But foreign manufacturers are nonetheless at a disadvantage because they also pay a 4 percent countervailing duty (CVD), which the Indian government has specifically imposed to protect domestic computer manufacturers. China recently created a tax scheme that blatantly violated the WTO when it applied a 17 percent VAT to both foreign and domestically produced integrated circuits (ICs) used in the semiconductor industry, and gave a rebate on most of the VAT only to companies producing ICs in China for export, but not to companies importing ICs. In 2004 the United States filed its first WTO case over the VAT policy and in response China eliminated it the next year.

Not to be deterred, China has since devised another tax policy that favors domestic production of IT goods and services, but is not tied to exports so it may not directly violate the WTO. Similar to India's excise tax scheme, China allows both domestic and foreign companies to deduct the costs of the products they make in China from their corporate income taxes—but only if those products were produced with local parts. While this subsidy may not violate the WTO, it is nonetheless mercantilist since it discriminates against imports. After repeatedly raising concerns about these and other tax policies, the U.S. government filed a WTO case over China's prohibited subsidies in early 2007.

**Anti-Trust:** Antitrust law has proven to be a powerful weapon in the mercantilist arsenal. Mercantilist nations can use antitrust enforcement to force foreign companies selling in their market to redesign products, share technology with competitors, or in some cases to pay exorbitant fines. These tactics raises

their cost of doing business and make their products less competitive. It should therefore come as no surprise that regions like the EU and nations like Korea have instigated anti-trust cases against some leading U.S. technology companies, including Microsoft and Intel.

**Intellectual Property Theft:** As a net exporter of manufacturing know-how as intellectual property, the United States is more dependent on protection of intellectual property (IP) than other nations. Over 50 percent of U.S. exports depend on some form of IP protection, compared to less than 10 percent 50 years ago. But this very strength is also a key vulnerability, for unlike physical property, which is relatively difficult to steal, IP theft or forced transfer is much easier. Many nations either turn a blind eye to IP theft or actually encourage it as a way to gain competitive advantage.

China is one of the most egregious violators. Not only does China fail to enforce its own intellectual property laws, but it also has implemented measures to block the trading and distribution rights of producers of U.S. entertainment products. Even the Chinese government continues to support theft of U.S. intellectual property. For example, although China's State Council ordered all government agencies to use only legal software in 1999, widespread lack of enforcement or monitoring ensures that the Chinese government still favors pirated software, as is reflected in its low levels of government purchases. Computer software theft is just the tip of the iceberg. The entertainment software industry (e.g. video games), which the U.S. leads, suffers from rampant piracy in China. Over 90 percent of video games consumed in China are pirated. But China doesn't just copy them; it is a leading producer and exporter of pirated cartridge-based entertainment software. Yet, China is by no means the main offender. Russia also is a distribution center for pirated entertainment software into Central and Eastern Europe. Malaysia is a primary source of pirated CDs, DVDs and console games with a capacity of producing over 300 million disks per year.

Unfortunately, international rules like the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) offer little if any protection from countries that want to steal U.S. technology, because TRIPS only offers standards on how countries should protect intellectual property, and it's up to each nation to decide how, and whether, to enforce them.

**Blocking or Limiting Market Access:** While mercantilist nations have a variety of policy tools at their disposal to support domestic technology production by blocking or limiting access to their markets to foreign goods and services, they seldom will be so bold as to admit the true reason for these policies. Rather, they will usually claim that the policies are needed to protect consumers. These protectionist policies include mandatory domestic standards, data privacy requirements, government procurement and encryption restrictions, blocking refurbished equipment, and blocking or limiting IT services. For example, China, India, Indonesia, the Philippines, Malaysia, and Thailand all have rules that require government agencies to buy local goods and services. Many WTO member countries willfully ignore their commitments by refusing to force their dominant telecommunications service providers to open up their networks to foreign competitors. Other nations, like China and Russia, essentially block importation of encryption products.

### **The U.S. Trade Enforcement Regime Needs Strengthening**

U.S. trade policy suffers from two major limitations. First, it is largely focused on opening markets through new trade agreements, but has given short shrift to enforcing existing agreements. Second, as documented above, the range of tools other nations can use to erect trade barriers has grown significantly and in many cases they fall under the radar screen of traditional WTO processes. That is why ITIF believes that the Trade Enforcement Act of 2007 is an important step forward. The legislation will send an important signal to USTR specifically and the U.S. government generally that it must rebalance its approach to trade and make enforcement a much larger component of its trade and international policies.

In particular, Title 1 is an important step to ensuring that USTR focuses much more actively on trade enforcement.

There are a number of reasons why USTR has let the balance shift away from enforcement. One reason is that it is simply easier to want to work in cooperation with trade officials from other nations, especially to develop new trade agreements. Taking aggressive action to against mercantilist policies is much harder. It's a natural inclination to want to play the "good cop" instead of the "bad cop" who is complaining, confronting and pressing for change. That is why Title 5 in particular is important. Creating a Chief Trade Enforcement Officer and a Trade Enforcement Working Group institutionalizes within USTR the function of trade enforcement, making it clear that at least one portion of USTR is expected to play the role of the bad cop.

Equally important is Title 5's provision for additional resources for enforcement. In USTR's defense, bringing trade enforcement actions is time consuming and expensive. Boosting their budget by \$5 million and targeting it specifically toward enforcement will help remedy this deficiency.

Toward that end, ITIF would also encourage the Committee to consider an additional tool. Even if Congress gives the USTR more resources, government alone cannot investigate all potential WTO cases. U.S. companies will have to play a larger role. But there are two reasons why U.S. companies don't bring more cases. First, they are expensive. Second, the "free rider" problem means that companies can benefit if they can convince other firms in their industry to bear the burden of helping USTR to bring a trade case. In order to remedy that, ITIF has proposed that Congress should encourage companies to build WTO cases by allowing them to take a 25 percent tax credit for expenditures related to bringing WTO cases. This tax credit could be piggybacked on top of the R&D tax credit.



## **The Trade Enforcement Act Works to Support Free Trade**

In response to calls for tougher trade enforcement some free traders argue that getting tough with other nations over their mercantilist and protectionist trade policies is actually a form of protectionism. Others worry that it's better to be lax on enforcement since being more aggressive risks a trade war. Both views, in our opinion, are wrong.

Aggressively working to reduce other nations' government-imposed trade distortions is in fact the polar opposite of protectionism. Stronger enforcement is important to preserve the integrity of the global trading system and ensure that trade is based on markets and the decisions of consumers and businesses, not on mercantilism and government intervention.

Being more aggressive on trade enforcement will not promote a trade war, for at least two reasons. First, many of the practices being focused on are a blatant violation of existing international trade rules. Second, the fact that the United States is running the largest trade deficit in world history is clear proof that these nations have structured their economies so that they are dependent on the U.S. market, and they risk losing a lot of access if closed to them.

Apologists for the current enforcement system also argue that the United States is hardly in a position to complain. Invoking the Biblical message of "let he who is without sin cast the first stone," they imply that since the United States has mercantilist policies of its own for some sectors, we have no right to complain about other nations' policies. Yet, while we are "not without sin," the U.S. market is perhaps the most open in the world. Moreover, the very fact that we are running huge trade deficits negates any legitimacy of this argument.

Many trade advocates argue that the major response to issues of globalization and trade must be to get Americans to once again support trade and globalization by doing a better job of compensating those who

are hurt from trade. While ITIF believes that better efforts are needed to help individuals hurt by trade, they will not be enough. Regaining American's support for trade and globalization requires that Americans believe that the playing field is level, and that requires significantly stepped up trade enforcement. Americans need to know that their government will stand up for their rights as workers by aggressively fighting unfair, mercantilist trade practices.

In stepping up trade enforcement, the United States will not only help American workers and firms, it will lead the world down the right path by rigorously enforcing international and bilateral trade rules and by showing the world that market-driven commerce is the best way to achieve robust and sustainable domestic and global prosperity. The Trade Enforcement Act of 2007 goes a long way in that direction.

Thank you for letting me share our views, I would be happy to answer any questions you may have.