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# Andersons Policy Bulletin



## “If the US Steps Back from ‘Power-Based’ Bargaining: What are the Implications for Agricultural Trade?”

### Introduction

The rules-based multilateral trading system established under the General Agreement on Tariffs and Trade (GATT) and its successor the World Trade Organization (WTO) is based on two key principles constraining the exercise of bargaining power by powerful countries: reciprocity where member countries seek a balance of concessions in trade negotiations, and non-discrimination through the most-favored nation (MFN) principle.<sup>1</sup> These rules have resulted in progressive reduction of tariffs in the post-war period, and a substantial increase in the global volume of trade.<sup>2</sup>

Recently, economists Aaditya Mattoo and Robert Staiger have argued that US trade policy has switched from one that is “rules-based” to one that is “power-based”, targeting higher “bargaining” tariffs at a country such as China with which it has consistently run a bilateral trade deficit.<sup>3</sup> This switch in trade policy emphasis has been driven by several other well-documented concerns the United States has about its trade relations with China, including the latter’s higher average bound

tariffs, manipulation of its exchange rate, and its violation of WTO rules (Morrison, 2018).<sup>4</sup> A key component of this “power-based” approach is the United States has also disabled the dispute settlement system of the WTO by paralyzing its Appellate Body (AB) (Pauwelyn, 2019).<sup>5</sup>

Superficially, “power-based” bargaining has worked: in signing the United States-China Phase One Trade Agreement (USCTA) on January 15, 2020, China committed to a voluntary import expansion over 2017 baseline levels, implying a combined \$200 billion worth of additional imports of US products (agricultural, manufactured, and energy) for the two-year period January 1, 2020, through December 31, 2021.<sup>6</sup> China’s imports of US manufactured, and agricultural products reached 60 and 64 percent respectively of their commitment for 2020, and through June 2021, they had reached 66 and 87 percent respectively of the year-to-date target(s).<sup>7</sup>

<sup>1</sup> See John Jackson, *The World Trading System* (1989).

<sup>2</sup> See Richard Baldwin, “The World Trade Organization and the Future of Multilateralism”, *Journal of Economic Perspectives* 30(1): 95-116 (2016); Arvind Subramanian and Shang-Jin Wei, “The WTO Promotes Trade, Strongly but Evenly”, *Journal of International Economics* 72(1): 151-175 (2007).

<sup>3</sup> Aaditya Mattoo and Robert W. Staiger, “Trade Wars: What do they Mean? Why are they Happening Now? What are the Costs?” *Economic Policy* 35 (103): 561-584 (2020).

<sup>4</sup> See Wayne M. Morrison, W.M. *China-U.S. Trade Issues*, Congressional Research Service Report RL33536 (2018).

<sup>5</sup> See Joost Pauwelyn, “WTO Dispute Settlement Post 2019: What to Expect?” *Journal of International Economic Law* 22(3): 297-321 (2019).

<sup>6</sup> See Office of the United States Trade Representative, *Economic and Trade Agreement between the Government of the United States of America and the Government of the People’s Republic of China* (2020).

<sup>7</sup> See Chad P. Bown, “US-China Phase One Tracker: China’s Purchases of US Goods”, PIIE Charts, Peterson Institute for International Economics (July 26, 2021).

However, the apparent success of “power-based” bargaining in bringing China to the trade negotiating table, comes at considerable actual and potential cost, and does not substantively contribute to resolution of a fundamental problem facing the WTO: how to deal with China’s current economic model. To paraphrase the prescient testimony of former AB member Jennifer Hillman to the US-China Economic and Review Security Commission in 2018, the US has not avoided “...a narrow, deficit-focused bilateral deal...”.<sup>8</sup>

### Why “Power-Based” Bargaining?

US concerns about China’s trade and other policies have been widely documented,<sup>9</sup> eventually leading to the United States provoking a trade policy “crisis” in 2018. Several reasons have been put forward for the United State taking the step of switching to “power-based” bargaining: first, it no longer believes China is transitioning to a market economy, continuing to use explicit and implicit subsidies to aid both state and privately-owned enterprises;<sup>10</sup> second, WTO-permitted trade remedies such as anti-dumping (ADs) and countervailing duties (CVDs) have not been effective against Chinese trade policies;<sup>11</sup> third, considerable dissatisfaction has been expressed by the United States over some of the WTO’s AB rulings, especially relating to China’s use of subsidies;<sup>12</sup> and, fourth, there is currently a lack of any negotiating function at the WTO which could help develop new trade rules targeted at what has been described as “China

Inc.”<sup>13</sup> Unfortunately, this approach to trade policy has come at some cost.

### Impact of “Power-Based” Bargaining<sup>14</sup>

Escalation of Tariffs: Average US/Chinese tariffs against each other’s imports rose significantly in a short period of time, and currently remain in place, notwithstanding negotiation of the USCTA. Prior to 2018, US-China bound tariff rates toward each other averaged 3.1 and 8 percent respectively. By early-2020, average US tariffs on 58.3 percent of its imports from China had risen to 19.3 percent, while average Chinese tariffs on 66.4 percent of its imports from the United States had risen to 19.3 percent.<sup>15</sup> Essentially, average US tariffs against China have moved in the direction of average tariff levels imposed under the Smoot-Hawley tariff act of 1930.<sup>16</sup>

In implementing tariffs unilaterally against China, the United States made no effort to seek renegotiation of its existing market access commitments to China under GATT/WTO rules. Not surprisingly, a WTO panel ruled in China’s favor on September 15, 2020, that the tariffs were “...*prima facie* inconsistent...” with both Articles I.1 and II of the GATT 1994, i.e., the tariffs are both discriminatory and in excess of the rates “...to which the United States bound itself in its Schedule of Concessions...”.<sup>17</sup><sup>18</sup> Significantly, even though China filed its complaint to the WTO in 2018, it implemented its own tariffs well before the panel ruling, indicating its willingness to retaliate and enter a trade war with the United States.

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<sup>8</sup> See Jennifer Hillman, *Testimony Before the U.S.-China Economic and Review Security Commission*, Washington DC (June 8, 2018).

<sup>9</sup> See Office of the United States Trade Representative (USTR). *Findings of the Investigation into China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974*. Washington DC (2018).

<sup>10</sup> See Chad P. Bown, “The 2018 Trade War and the End of Dispute Settlement as We Knew It”, in *Trade War: The Clash of Economic Systems Endangering Global Prosperity*, ed. Meredith A. Crowley, VoxEU.org Book (2019).

<sup>11</sup> See Chad P. Bown and Jennifer A. Hillman, “WTO’ing a Resolution to the China Subsidy Problem”, *Journal of International Economic Law* 22(4): 557-558 (2019).

<sup>12</sup> See footnote 5, and Chad P. Bown and Soumaya Keynes, “Why Trump Shot the Sheriffs: The End of WTO Dispute Settlement 1.0.”, *Journal of Policy Modeling* 42(4): 799-819 (2020).

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<sup>13</sup> See Mark Wu, “China’s Rise and the Growing Doubts over Trade Multilateralism”, in *Trade War: The Clash of Economic Systems Endangering Global Prosperity*, ed. Meredith A. Crowley, VoxEU.org Book (2019).

<sup>14</sup> See Ian Sheldon, “The US’s Power-Based Bargaining and the WTO: Has Anything Really Been Gained?” Invited Paper presented at Annual Meetings of the Agricultural and Applied Economics Association, Austin, TX (2021).

<sup>15</sup> See Chad P. Bown, “The US-China Trade War and Phase One Agreement”, Working Paper 21-2, Peterson Institute for International Economics (2021).

<sup>16</sup> See Chad P. Bown and Douglas A. Irwin, “What Might a Trump Withdrawal from the World Trade Organization Mean for US Tariffs?” Policy Brief 18-23, Peterson Institute for International Economics (2018).

<sup>17</sup> See World Trade Organization (WTO), *United States-Tariff Measures on Certain Goods from China*, Report of the Panel, WT/DSS543/R (November 26, 2020).

<sup>18</sup> The US appealed the Panel’s findings in October 2020.

Costs of Tariffs: The US-China trade war represents a natural experiment, such wide-ranging increases in tariffs having not been seen since the 1930s. In addition, other key trading US trading partners, including Canada, the European Union (EU), Japan, and Mexico were dragged into the conflict after the United States implemented tariffs against steel and aluminum imports in 2018. During 2018, US tariffs were targeted at 12,043 specific products at the Harmonized Tariff Schedule of the United States (HTSUS)-10-digit level, where in 2017, these imports were valued at \$303 billion, accounting for 12.7 percent of total US imports. The average *ad valorem* tariff increased by from 2.6 to 16.6 percent. In terms of retaliatory tariffs on U.S. exports by Canada, China, Mexico, Russia, Turkey, and the EU, these accounted for \$127 billion of U.S. exports, 8.2 percent of total exports, covering 8,073 products.<sup>19</sup>

Using an applied general equilibrium model of the US economy, Pablo Fajgelbaum and his colleagues report the following effects of the tariffs against China: first, US consumers of imported goods in aggregate lost \$51 billion due to higher prices; second, US exporters saw an increase in their income of \$9.4 billion; and third, US tariff revenue totaled \$34.3 billion.<sup>20</sup> Therefore, the net effect of the trade war was an aggregate loss of US real income of \$7.3 billion. This is very similar to an estimate by Mary Amiti and her colleagues of a US net real income loss of \$8.2 billion.<sup>21</sup> Importantly, both studies found evidence for complete passthrough of tariffs to tariff-inclusive prices borne by US consumers, i.e., Chinese exporters did not reduce their export prices.

The United States also seemingly failed to recognize China would rationally retaliate with discriminatory and targeted tariffs at a range of imports from the United States. In the case of soybeans, with China being the world's

largest importer, it was able to negatively affect US international terms-of-trade, the average US soybean export price falling significantly when tariffs were initially implemented by China in 2018.<sup>22</sup> This put downward pressure on US farm incomes, with a significant amount of trade also being diverted to other exporting countries such as Brazil.<sup>23</sup> In total, it has been estimated that the US agricultural sector suffered annualized trade losses of \$13.5 to \$18.7 billion, China accounting for the majority and severity of the retaliation.<sup>24</sup> This loss of market share, resulted in compensatory payments to US farmers through the Market Facilitation Program (MFP), pushing the United States close to violating its WTO commitments on farm subsidies in 2019 and 2020.<sup>25</sup>

USCTA: Key to the USCTA was China's commitment to expand imports of covered products from the United States by a combined \$200 billion over the two-year period 2020-2021, above 2017 baseline levels, of which \$77.7 billion and \$32 billion would be additional imports of US manufactured and agricultural products, respectively. Translated into annual targets, this implied total product purchasing commitments by China of \$173.1 billion (2020) and \$193.3 billion (2021), manufactured import purchases of \$112.2 billion (2020) and \$123.1 billion (2021), and agricultural import purchases of \$36.6 billion (2020) and \$43.5 billion (2021).<sup>26</sup>

In 2020, China fell short of its annual import target(s) by 42, 40, and 36 percent for total, manufactured, and agricultural products, respectively. In terms of its import commitments, China clearly underperformed relative to the target(s), although this should

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<sup>19</sup> See Pablo D. Fajgelbaum, Pinelopi L. Goldberg, Patrick J. Kennedy, and Amit K. Khandelwal, "The Return to Protectionism", *Quarterly Journal of Economics* 135(1): 1-55 (2020).

<sup>20</sup> See footnote 19.

<sup>21</sup> See Mary Amiti, Stephen J. Redding, and David E. Weinstein, "The Impact of the 2018 Tariffs on Prices and Welfare", *Journal of Economic Perspectives* 33(4): 187-210 (2019).

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<sup>22</sup> See Michael K. Adjemian, Shawn Arita, V Vince Breneman, Robert Johansson, and Ryan Williams, "Tariff Retaliation Weakened the U.S. Soybean Basis", *Choices* 34(1) (2019).

<sup>23</sup> See Colin A. Carter and Sandro Steinbach, "The Impact of Retaliatory Tariffs on Agricultural and Food Trade", Working Paper 27147, NBER (2020).

<sup>24</sup> See Jason H. Grant, Shawn Arita, Charlotte Emlinger, Robert Johansson, and Chaoping Xie, "Agricultural Exports and Retaliatory Trade Actions: An Empirical Assessment of the 2018/2019 Trade Conflict", *Applied Economic Perspectives and Policy* 43(2): 619-640 (2021).

<sup>25</sup> See Joseph W. Glauber, "Is it Time for the United States to Again Show Leadership at the WTO?" American Enterprise Institute, Center for Strategic and International Studies (September 16, 2020).

<sup>26</sup> See footnote 7.

be placed in the context of how the COVID-19 pandemic affected global trade flows in 2020. Focusing specifically on agriculture, prior to the pandemic, some observers suggested that, based on its previous agricultural import growth rate, China would find it difficult to meet the USCTA targets.<sup>27</sup> Although the 2020 target was missed, year-to-date imports for 2021 are currently only 13 percent off target.<sup>28</sup>

Early analysis of the pandemic indicates agricultural trade has been resilient compared to trade in manufactured products, China accounting for 95 percent of the observed \$20 billion increase in world agricultural trade in 2020.<sup>29</sup> The import demand shock, especially for grain and soybean-use in animal feed, has been driven by China rebuilding its hog production capacity devastated by African Swine Fever in 2018. Critically, Chinese tariff exemptions on agricultural imports appear to be fundamentally market-driven, i.e., it is a stretch to claim US “power-based” bargaining has worked exclusively because of a trade agreement.

The overall conclusion is the US-China trade war has come at a cost to US consumers, taxpayers, and exporters. In addition, under USCTA, neither country has committed to returning tariffs back to their pre-2018 bound levels, the Agreement ending in 2021. This has significant long-run implications for the “rules-based” multilateral trading system. First, any initial advantage the United States might have gained by applying “bargaining” tariffs has likely been lost as China and other countries such as the EU have retaliated. This has the potential to undermine the cooperation necessary for multilateral as opposed to bilateral trade negotiations, with implications for enforcement. Second, if the multilateral system is undermined when the United States is the dominant economic power, it may prove harder for China to make

credible commitments to a “rules-based” mechanism when it eventually becomes the dominant economic power.<sup>30</sup>

### Where Does Agriculture Fit?

On the face of it, the US agricultural sector could be deemed “collateral damage” in the trade war after China targeted US exports of key commodities such as soybeans. The compensation offered to US farmers via MFP, and the media focus on China’s import commitments in USCTA would certainly support this view.<sup>31</sup> In addition, the 2018 report to Congress by the Office of the United States Trade Representative (USTR) only touches on agricultural trade insofar as it relates to Chinese actions on technology and investment in the biotechnology sector.<sup>32</sup>

By contrast, the USTR’s 2017 report to Congress on China’s compliance with WTO rules contains considerably more discussion of the agricultural sector.<sup>33</sup> Specifically, the report evaluated China in the context of the disciplines laid out in the Uruguay Round Agreement on Agriculture (URAA): first, with respect to market access, the focus was on China’s administration of tariff-rate quotas (TRQs), its approval process for genetically-modified (GM) crops, and its application of sanitary and phytosanitary (SPS) measures; second, concerns were expressed about China’s increased domestic support for its agricultural sector and its non-transparent method for calculating that support; and, third China’s failure to report all of its export subsidies was noted.

Importantly, in evaluating China’s URAA commitments, USTR noted the United States had already filed two complaints in 2017 to the WTO concerning China’s domestic support and TRQ administration as they related to corn, rice, and wheat. WTO panels were established for both, with rulings against

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<sup>27</sup> See Chad P. Bown, “Unappreciated Hazards of the U.S.-China Phase One Deal”, Trade and Investment Policy Watch, Peterson Institute for International Economics (January 21, 2020).

<sup>28</sup> See footnote 7.

<sup>29</sup> See Shawn Arita, Jason Grant, Sharon Sydow, and Jayson Beckman, “Has Global Agricultural Trade Been Resilient Under Covid-19? Lessons from an Econometric Assessment”, Working Paper 21-01, International Agricultural Trade Research Consortium (IATRC) (2021).

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<sup>30</sup> See footnote 3.

<sup>31</sup> See, for example, the news summaries in *Farm Policy News*, <https://farmpolicynews.illinois.edu/>

<sup>32</sup> See Office of the United States Trade Representative, *Findings of the Investigation into China’s Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation under Section 301 of the Trade Act of 1974* (2018).

<sup>33</sup> See Office of the United States Trade Representative, *2017 Report to Congress on China’s WTO Compliance* (2018).

China in each case, the panel reports being adopted in April 2019 (domestic support) and May 2019 (TRQs).<sup>34</sup>

Despite its shift to “power-based” bargaining, the United States has continued to abide by the WTO’s dispute settlement process when it comes to agricultural trade. Specifically, it has recently sought authorization under the Article 22.2 of the WTO’s Dispute Settlement Understanding (DSU) to suspend market access concessions it has made to China on the grounds that they are not in compliance with the panel rulings relating to domestic agricultural support and TRQ administration.<sup>35</sup> In other words, the United States continues to engage in multilateral governance of agricultural trade at the same time as it has engaged in bilateral bargaining with China through USCTA.

### **Inconsistency In/Logic of US Trade Policy**

The concerns the United States has with Chinese industrial policy relate to its use of “behind-the-border” policies, including lack of protection for intellectual property (IP), forced technology transfer, unfavorable technology licensing restrictions, restrictions on investment, and its use of explicit and implicit industrial subsidies.<sup>36</sup> Currently, the WTO’s disciplines on these types of policy are either non-existent or weak.<sup>37</sup> Surprisingly, while it does contain chapters on IP and technology, the USCTA has no coverage of China’s use of subsidies. For agricultural trade, the focus is on market access and the trade-distorting effects of Chinese domestic support – both subject to WTO discipline(s).

The conclusion to be drawn here is that it is US trade policy choices that have been inconsistent, not the trade issues.

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<sup>34</sup> See Lars Brink, David Orden, and Carl Zulauf, “WTO Dispute Panel Report on China’s Agricultural Support”, *farmedocdaily* (9):40 (March 6, 2019); David Orden, Chaoping Xie, Bowen Chen, Lars Brink, and Carl Zulauf, “WTO Dispute Panel Report on China’s Administration of Tariff Rate Quotas (TRQs) for Certain Agricultural Products”, (9):84 (May 8, 2019).

<sup>35</sup> See World Trade Organization, “China-Domestic Support for Agricultural Producers”, DS511 (July 27, 2021); World Trade Organization, “China-Tariff Rate Quotas for Certain Agricultural Products”, DS517 (July 27, 2021).

<sup>36</sup> See footnotes 4, 11 and 13.

<sup>37</sup> See footnotes 2 and 11.

Importantly, there is substantial agreement among WTO members over China’s economic model, which leads to a key question: why does the United States not pursue WTO dispute settlement across all these issues, and what is the underlying logic for US trade policy choices?

Over the period 2001-17, the United States extensively used WTO-consistent trade restrictions, including ADs targeted at Chinese firms selling at “unfairly” low prices, complemented after 2006 with CVDs targeted at Chinese firms receiving subsidies. This was followed in 2018 by a switch to using US trade laws to target: import surges of solar panels and washing machines (Section 201, Trade Act, 1974), aluminum and steel imports on the grounds of national security (Section 232, Trade Expansion Act, 1962), and \$250 million of imports (Section 301, Trade Act, 1974).

This switch to “special” protection reflected US concerns about the Chinese economic model, especially regarding its use of subsidies: state owned enterprises (SOEs) in China face soft budget constraints;<sup>38</sup> under the influence of the Chinese Communist Party (CCP), and separate from the state, subsidies are directed informally to Chinese firms;<sup>39</sup> and China has had a history of using export taxes and discriminatory VAT rebates on exports, thereby driving down the cost of intermediate inputs.<sup>40</sup>

Given these concerns, the US decision to provoke a trade war with China was driven by the following logic:<sup>41</sup> Chinese trade practices had to be countered; ADs and CVDs had not worked; application to use safeguard tariffs against Chinese imports would have failed WTO scrutiny; and the United States would have been unable to win a substantial case at the WTO due to the problem of “China Inc.”

The counter argument to this is that the United States gave up too soon on formal dispute settlement, instead it should have filed

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<sup>38</sup> See Nicholas R. Lardy, *The State Strikes Back: The End of Economic Reform in China?* Peterson Institute for International Economics (2019).

<sup>39</sup> See footnote 13.

<sup>40</sup> See Jason Garred, “The Persistence of Trade Policy in China after WTO Accession”, *Journal of International Economics* 114(3): 130-142 (2018).

<sup>41</sup> See footnote 10.

a comprehensive WTO case in coalition with its major trading partners.<sup>42</sup> However, this would likely require the AB to deal with interactions in a non-market economy, the burden of proof being too complex.<sup>43</sup>

So why has the United States sought to undermine WTO dispute settlement, especially functioning of the AB? Former US Trade Representative Robert Lighthizer speaking to other WTO members in 2017 stated,

“...Too often members seem to believe they can gain concessions through lawsuits that they could never get at the negotiating table...”

Beyond the rhetoric, the United States does have legitimate concerns about the functioning of the AB, including<sup>44</sup>: repeated rulings by the AB against the US use of trade remedies;<sup>45</sup> the AB ruling removing contributions by SOEs from the WTO definition of proscribed subsidies;<sup>46</sup> and “judicial over-reach” by the AB.<sup>47</sup> However, given the recent success of the United States in winning WTO cases against China with respect to agricultural trade, why prevent the AB from functioning?

### **Stepping Back from “Power-Based” Bargaining**

What are the implications of the United States stepping back from its use of “bargaining” tariffs? A first move would be for the United States and China to reduce bilateral tariffs to their pre-2018 level, which did not happen under USCTA, and where the negotiated import commitments made by China end after 2021. Any impact on market access to China for US agricultural exports will also have to be separated out from the ongoing impact of USCTA, and other factors such as China rebuilding its hog production capacity. Before any future complaints are made to the WTO,

there is a need to find a way out of the AB crisis, allowing the judicial arm of the WTO to operate, i.e., there should be agreement on appointing new members to the AB.<sup>48</sup> However, without changes in the WTO’s rules, and a properly functioning AB, agricultural trade is at risk of being caught again in the “crossfire” of a trade war. Fundamentally, a new modality is required for WTO members to negotiate and update the multilateral trade rules, especially with respect to “China Inc.” and its use of subsidies, something the USCTA singularly failed to achieve.<sup>49</sup>

*Andersons Policy Bulletins are discussions of key trade and policy issues. The author of this bulletin, Ian M. Sheldon, is Andersons Chair of Agricultural Marketing, Trade and Policy in the Department of Agricultural, Environmental, and Development Economics within the College of Food, Agricultural, and Environmental Sciences at The Ohio State University.*

#### **Questions or comments?**

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<sup>42</sup> See footnote 8.

<sup>43</sup> See footnote 13.

<sup>44</sup> See footnote 5.

<sup>45</sup> See footnote 12.

<sup>46</sup> See World Trade Organization, *United States-Tariff Measures on Certain Goods from China*. Report of the Panel, WT/DSS543/R (November 26, 2020).

<sup>47</sup> See Tetyana Payasova, Gary C. Hufbauer, and Jeffrey J. Schott, “The Dispute Settlement Crisis in the World Trade Organization: Causes and Cures”, Policy Brief 18-5, Peterson Institute for International Economics Policy (2018).

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<sup>48</sup> See footnote 5.

<sup>49</sup> See footnote 11.