



Testimony of

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**“Safeguarding the Homeland: Examining Conflicts of Interest in Federal Contracting
to Protect America’s Future”**

Chairman Peters, Ranking Member Paul, and members of the Homeland Security and Governmental Affairs Committee, thank you for the opportunity to testify today. My name is Clark Packard. I'm a Research Fellow at the Cato Institute, an independent, nonpartisan public policy research organization dedicated to advancing the principles of individual liberty, limited government, free markets, and peace.

My work at Cato focuses on U.S. international trade and investment law and policy with a specific focus on the U.S.-China economic relationship. For that reason, I'm especially grateful for the opportunity to testify this morning.

Let me state unequivocally at the outset: China engages in abusive—and at times coercive—international trade and investment practices. These include the forced transfer of technology as a condition of doing business within China; utilizing opaque and unevenly applied licensing procedures; the widespread abuse of intellectual property; state-directed cyber hacking into commercial networks; deploying non-commercially-based outward investment practices; providing large scale subsidies to domestic companies; and forced labor in Xinjiang, among others.¹ Many of these activities are done in support of widespread industrial policies.

My testimony will focus on the potential for abuse of national security-based protectionism and provide suggestions for outcompeting China in the 21st century.

Conflicts of Interest in Government Procurement

While I analyze public policy through a framework that favors openness and skepticism of heavy government intervention in cross-border trade and investment, free traders from Adam Smith to Milton Friedman have understood the need for limited exceptions for national security.

An American firm providing consulting services to the Department of Defense, for example, should not also be advising the Chinese government or the Chinese Communist Party. At the very least, American firms should be required to disclose potential conflicts of interest when bidding on U.S. government contracts for scrutiny by American procurement officials.

To the extent I have suggestions about legislation with such aims, it would be to ensure stringent guardrails are established to avoid stifling legitimate business practices. Too often national security is invoked as a pretext for simple protectionism.

The Trump administration's national security tariffs on steel and aluminum imports, imposed despite President Trump's defense secretary at the time noting the U.S. military required only 3 percent of total domestic steel and aluminum production, is a case in

¹ Office of the U.S. 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](#)," March 22, 2018.

point.² Indeed, the tariffs still apply to steel and aluminum from NATO members and other longstanding U.S. allies like Japan and South Korea. Those tariffs are extremely costly to the U.S. economy, harming industries that use steel and aluminum as inputs, U.S. consumers, and Americans targeted by foreign retaliation such as farmers and ranchers.³ In addition, the tariffs undermined confidence in the U.S. as a reliable trading partner. Imposed under the guise of national security, the tariffs inflicted considerable economic damage — the expected result of protectionist measures — while doing nothing to bolster the country’s defense.

Likewise, national security-based arguments are being invoked as the rationale to block Nippon Steel’s acquisition of U.S. Steel, but there’s no security risk at all. Japan is the largest provider of foreign direct investment (FDI) in the United States. U.S. Steel has no military contracts. For more than 60 years, Japan has been one of the United States’ strongest allies and today hosts more than 55,000 U.S. military personnel and thousands of DoD civilian contractors. It is incongruent that the United States would deploy nuclear weapons if necessary to defend Japan from attack, yet simultaneously claim Japanese investment is a national security threat. Today, Japan receives 90 percent of its defense-related imports from the United States. Simply put, Nippon would not pay a premium to purchase U.S. Steel only to shutter it. Indeed, Nippon would most likely provide the investment necessary to strengthen the firm.

A Smarter Approach to Competing With China

Turning to Beijing: it is worth noting that the Chinese economy is struggling and faces significant short-and-longer term headwinds that will surely constrain future growth.⁴ We should not overestimate its strength. Right-sizing the challenge is imperative to sound policy. That said, Beijing does pose very serious challenges to the United States both economically and strategically.

The United States should not respond to those challenges by turning inward and hiding behind protectionist walls. Instead, policymakers should work to strengthen trade and investment ties with close allies, particularly those in the Asia-Pacific region. While flawed, the Trans-Pacific Partnership would have created an American-led trading bloc to offset China’s gravitational pull in the region economically and established higher-quality trade and investment rules and norms.

² Bureau of Industry and Security, “The Effect of Imports of Steel on the National Security: An Investigation Conducted under Section 232 of the Trade Expansion Act of 1962, as Amended,” Department of Commerce, January 11, 2018.

³ Alex Durante, “[How the Section 232 Tariffs on Steel and Aluminum Harmed the Economy](#),” Tax Foundation, September 20, 2022.

⁴ Clark Packard, “[China's Economic Headwinds](#),” Cato Institute Defending Globalization: Foreign Affairs, October 10, 2023,

In the absence of U.S. re-engagement in TPP (since renamed the Comprehensive and Progressive Agreement for Trans-Pacific Partnership), the U.S. should build on its successful bilateral agreement with South Korea known as KOR-US. Given the thawing in relations between Seoul and Tokyo, adding Japan and other allied countries to the KOR-US agreement presents a next-best option.

Likewise, policymakers should adopt the House's Select Committee on the Chinese Communist Party wise recommendation to expedite CFIUS review of FDI from trusted allies like Japan and South Korea.

The U.S.-China relationship is increasingly complex and is a top geopolitical issue facing the world. How the two countries manage this relationship will greatly affect global peace, prosperity, and stability in the 21st century. The guiding principle of our economic policy vis-à-vis China should focus on affirming market incentives that boost the performance and competitiveness of American firms and those of our allies.⁵

I look forward to answering any questions the Committee may have.

⁵ Note: Attached are two relevant, longer form pieces

Course Correction

Charting a More Effective Approach to U.S.-China Trade

BY CLARK PACKARD AND SCOTT LINCICOME

EXECUTIVE SUMMARY

Over the past several years the U.S.-China economic relationship has soured and become subordinated to broader concerns about national security and geopolitics. After a decades-long reform agenda in China that lifted hundreds of millions out of grinding poverty, Chinese president Xi Jinping has increasingly turned inward—reembracing Maoist socialism and heavy-handed central planning. Washington's response to these worrisome developments has been reflexively hawkish economically, scattershot, and woefully inadequate for the economic challenge that China presents.

Fearing that China is inexorably poised to become the world's leading economy, policymakers in the United States have embraced tariffs, investment restrictions, export controls, and massive domestic subsidies to favored industries such as semiconductor manufacturing. These moves have failed to change Beijing's behavior, but they have

counterproductively weakened the U.S. economy and alienated allies that Washington needs to rally in defense of market-based democracy against 21st-century mercantilism.

This analysis explains that instead of mimicking China's increasingly interventionist economic policies, the United States should focus on promoting the competitiveness of the American economy and the economies of our allies. Policymakers should rely on the market-oriented policies that propelled the United States to unprecedented wealth and power, including openness to international trade and investment; liberalized immigration; lighter-touch regulation, particularly in the burgeoning technology industry that sits at the epicenter of the economic competition with China; and smarter tax policies. These policies are not a panacea with respect to all that ails the U.S.-China economic relationship, but they would be much more successful than the failed status quo.



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INTRODUCTION

The U.S.-China relationship is increasingly complex and is the top geopolitical issue facing the world today. How the two countries manage this relationship will greatly affect global peace, prosperity, and stability in the 21st century. Concerning economic and trade policy specifically, the United States should focus on affirming the market incentives that boost the performance and competitiveness of American companies and those of our allies. Unfortunately, Washington policymakers have instead embraced economically hawkish rhetoric and policies that are at best superficial and at worst counterproductive. As former treasury secretary Henry Paulson astutely observed, “We have a China attitude, not a China policy.”¹

“China faces a significant brain drain among technology workers and other entrepreneurs, most of whom prefer the freedom offered by the United States and other Western countries.”

The bipartisan consensus in policymaking circles around Washington today is that China is an economic juggernaut, inexorably poised to overtake the United States as the world’s leading economy. To many policymakers, Beijing’s increasingly interventionist and mercantilist policies have supercharged its economy and promise to displace the United States at the top of the global order unless Washington matches China’s economic interventionism.

This consensus is rife with problems. For starters, China’s economic rise has a lot more to do with its brief abandonment of heavy central planning decades ago than it does with today’s reembrace of industrial policy and Maoist socialism. Indeed, the Chinese economy today is not the powerhouse many believe it to be. Short-term issues and longer-term systemic trends will further constrain future economic growth and dynamism in China—obstacles created in no small part by China’s relatively recent shift away from economic liberalization.

Beijing’s draconian “zero-COVID” policy shuttered large portions of the Chinese economy in 2022. President

Xi Jinping’s embrace of heavy intervention in the tech industry has paralyzed a once dynamic and growing sector of the economy.² The country’s real estate sector is overinflated and has led to a debt default by giant property developer Evergrande.³ And China’s ever-expanding bureaucracy has been paralyzed by the inevitable conflict between eradicating COVID-19 and hitting Beijing’s pre-determined growth targets.⁴

These forecasts are notoriously difficult, especially given the uncertainties caused by the pandemic and China’s recent reopening.⁵ However, China’s longer-term headwinds are more certain and daunting. Productivity is slowing and has been for quite some time.⁶ China also has an enormous demographic problem, exacerbated by its cruel, now abandoned One Child Policy, that will both slow growth and strain government social spending.⁷ China faces a significant brain drain among technology workers and other entrepreneurs, most of whom prefer the freedom offered by the United States and other Western countries.⁸ Likewise, China has seen its international standing erode in recent years for myriad reasons, including human rights abuses such as forced labor in the Xinjiang region; effectively annexing Hong Kong in 2020 with the passage of the national security law meant to quash dissent and criticism of Beijing; an aggressive foreign policy posture in the region, including threatening Taiwan’s sovereignty; and its misinformation about the origins of COVID-19. This analysis will focus almost exclusively on the U.S.-China economic relationship. China engages in several repressive practices, which deserve a straightforward U.S. response, but those are beyond the scope of this analysis.

That is not to say that the United States should do nothing about China’s economic practices. There are legitimate concerns about numerous international trade and investment policies pursued by Beijing, its increasingly brutal human rights practices, and its geopolitical bellicosity and coziness with Russia and rogue regimes, which all demand attention. Yet concerning the challenges that China poses economically, U.S. policymakers seem intent on rejecting the very policies that have propelled the United States to enormous wealth and global influence and instead are mimicking Beijing’s heavy-handed industrial policies and interventionism. That would be a mistake. There is a better way: one that relies on America’s traditional strengths.

CHINA'S TROUBLING INTERNATIONAL ECONOMIC PRACTICES

There is an emerging awareness in Washington and other Western market-oriented democracies that China's international trade and investment practices pose significant challenges to the United States and the rules-based trading system.

In 2017, then president Donald Trump directed his United States Trade Representative (USTR) to begin an investigation into Chinese commercial practices pursuant to Section 301 of the Trade Act of 1974.⁹ Over the next seven months, USTR compiled a 301 Report that served as an indictment of China's international trade and investment practices. The overarching theme of the report is that China uses a number of unfair and malicious methods to acquire U.S. technology in service of Beijing's high-tech indigenous innovation policies known as "Made in China 2025."¹⁰ According to USTR, these policies inhibit U.S. exports; undermine American innovation, manufacturing, and services; and bolster jobs in China at the expense of American workers.

The list of complaints is long, and it encompasses both major problems as well as smaller irritants. First, China engages in widespread and unauthorized state-sponsored cyber espionage into U.S. commercial networks in order to steal trade secrets and abuse intellectual property. These stolen materials include "trade secrets, technical data, negotiating positions, and sensitive and proprietary information internal communications." Many of these cyber intrusions target American firms that operate in markets and industries deemed strategic by Beijing, including those with a national security nexus.¹¹

Next, China uses hidden industrial policy and foreign discrimination, including via its numerous state-owned enterprises (SOEs), that hurt American competitors. This is done on a massive scale and in a completely nontransparent way. It is worth noting that the International Monetary Fund (IMF) estimates that Chinese SOEs are about 20 percent less productive than private sector competitors in the same market.¹² Beijing's increasing reliance on SOEs will slow growth in China over the long run, but it hurts U.S. firms in the short run and erodes business confidence in foreign trade.

Next, China uses foreign ownership restrictions "to require or pressure technology transfer from U.S. companies

to Chinese companies" as a condition of accessing the Chinese market. This is done, for example, through requirements that U.S. companies establish a China-based joint venture partner. Pressure is then exerted on the foreign manufacturers to turn over cutting-edge and core technologies to their Chinese joint venture partners.¹³

"Despite identifying many of the problems with China's international trade and investment practices, the U.S. approach to addressing these challenges has been woefully inadequate across the last two presidential administrations."

Beijing also uses opaque and unevenly applied licensing restrictions to discriminate against American firms that are seeking to operate in China and reach consumers in its market. The 301 Report describes how the Chinese government often requires firms to turn over sensitive technical information to secure approval to operate in the country but does not require the same of domestic Chinese firms.¹⁴

Likewise, there is a "pervasive" state-sponsored effort to direct and facilitate investment in, and acquisition of, U.S. companies and assets by Chinese companies. Such investments and acquisitions have strategic and military goals. These transactions are often undertaken by China's numerous SOEs and state-supported banks and investment funds, which are not subject to market disciplines.¹⁵

In total, the 301 Report casts doubt on Chinese international economic practices—essentially 21st-century high-tech industrial policy on a massive scale—and demonstrates how such policies undermine the U.S. economy, both workers and firms. These are real challenges and require a concerted response, one that has thus far failed to materialize.

THE FAILING APPROACH

Despite identifying many of the problems with China's international trade and investment practices, the U.S. approach to addressing these challenges has been woefully inadequate

across the past two presidential administrations. First, the United States levied a series of tariffs, which triggered predictable retaliation from Beijing, in the past few years. Then, in 2022, policymakers decided to copy Beijing’s inefficient industrial policy by establishing our own subsidies for favored industries. Neither tariffs nor domestic subsidies are up to the serious task of outcompeting China in the 21st century.

In total, tariffs now cover about 70 percent of all imports from China and the average rate is nearly 20 percent, which is more than six times higher than before the trade wars began. Meanwhile, retaliatory tariffs cover about 60 percent of American products and services sent to China, at an average rate above 21 percent, which is up from about 7 percent before the trade wars.¹⁶ Together, the tariffs and reprisals constitute an even larger share of GDP than the infamous Smoot-Hawley tariffs, which exacerbated and prolonged the Great Depression according to recent research by Pablo Fajgelbaum of Princeton University and Amit Khandelwal of Columbia University.¹⁷

In January 2020, Washington and Beijing signed a truce informally known as the Phase One Agreement. The two sides agreed to forgo additional tariffs, but the existing tariffs remain in place. China agreed to purchase large quantities of American exports over a two-year period and promised to make certain structural changes to its economic practices. Now, after more than two years, the status quo—tariffs and the Phase One Agreement—has failed on multiple levels.

First, despite Trump’s repeated statements to the contrary, countless academic studies have found that Americans, not the Chinese, paid the tariffs (and continue to do so).¹⁸ As a result, the tariffs’ economic harms to the U.S. economy were significant. The New York Federal Reserve, for example, estimates that the tariffs increased costs for average American households by about \$830 per year, accounting for direct costs and efficiency losses, and resulted in approximately \$1.7 trillion in lost

Table 1

Selected estimates of the cost of Section 301 and other tariffs

Study	Tariffs covered	Costs considered	Average annual cost per household
American Action Forum (2022)	Section 301 tariffs (25 percent on \$250 billion of imports and 7.5 percent on \$112 billion of imports)	Higher tax burden	\$379 (gross)
Amiti, Redding, and Weinstein (2019)	Tariffs imposed from February 2018 to May 2019	Higher tax burden and deadweight (efficiency) losses	\$831 (gross)
Congressional Budget Office (2020)	Tariffs imposed between January 2018 and January 2020	Loss in output and higher consumer prices	\$1,277 (net)
Fajgelbaum et al. (2021)	Tariffs imposed from February 2018 to September 2019, plus foreign retaliation	Gross: higher tax burden and deadweight (efficiency) losses Net: loss in output	\$894 (gross) \$194 (net)
Tariffs Hurt the Heartland (2022)	Tariffs imposed from February 2018 to April 2021	Higher tax burden	\$737 (gross)
Tax Foundation	Section 301 tariffs (25 percent on \$250 billion of imports and 7.5 percent on \$112 billion of imports)	Loss in output	\$405 (net)
Trade Partnership (2019)	Tariffs imposed or announced as of November 2018, plus foreign retaliation	Loss in national income	\$574 (net)

Sources: Tom Lee and Jacqueline Varas, “The Total Cost of U.S. Tariffs,” American Action Forum, May 10, 2022; Mary Amiti, Stephen J. Redding, and David E. Weinstein, “New China Tariffs Increase Costs to U.S. Households,” *Liberty Street Economics* (blog), Federal Reserve Bank of New York, May 23, 2019; Congressional Budget Office, “The Budget and Economic Outlook: 2020 to 2030,” January 28, 2020, p. 33; Pablo D. Fajgelbaum et al., “Updates to Fajgelbaum et al. (2020) with 2019 Tariff Waves,” January 21, 2020; “New Data Shows Trade War Has Cost Americans Nearly \$94 Billion, Including Close to \$14 Billion in First Four Months of 2021,” press release, Tariffs Hurt the Heartland, June 18, 2021; Erica York, “Tracking the Economic Impact of U.S. Tariffs and Retaliatory Actions,” Tax Foundation, April 1, 2022; and “Estimated Impacts of Tariffs on the U.S. Economy and Workers,” Trade Partnership Worldwide, LLC, February 2019, p. 10.

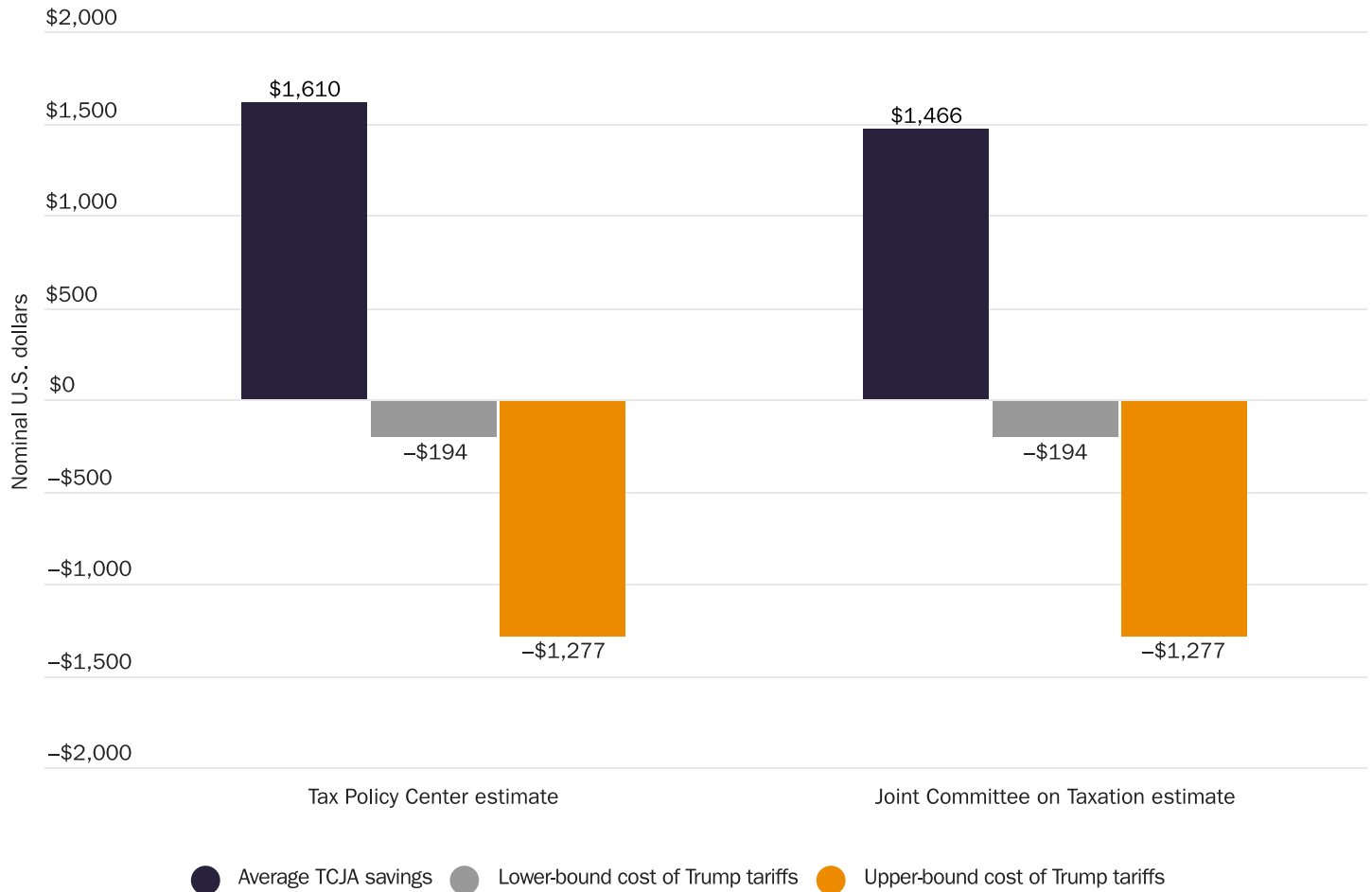
Notes: The average annual cost per household was obtained by dividing the total cost of the tariffs reported by each study by the number of households in the United States in 2018 (127.6 million). For the Congressional Budget Office (2020), the average annual cost per household was obtained directly from the report. “Gross” refers to costs considering higher tax burden and deadweight (efficiency) losses resulting from the tariffs, while “net” refers to costs that also contemplate offsetting factors (i.e., producer gains and tariff revenues).

market capitalization for firms through investment slowdowns.¹⁹ Meanwhile, Moody’s Analytics estimates that the trade wars cost about 300,000 jobs.²⁰ Table 1 summarizes academic research on the tariff’s economic costs. Figure 1 shows that these costs erased up to half of the average household’s savings from the tax cuts enacted by the Tax Cuts and Jobs Act of 2017.

Second, in a Sisyphean attempt to close the bilateral trade deficit, the United States spent considerable political capital to get the Chinese to agree to specific purchase requirements over a two-year period. This distorted markets, angered allies, and empowered Chinese SOEs, which were used to make the purchases. Moreover, by the end of the two-year period, China was well short of the level of

Figure 1

Annual savings from Tax Cuts and Jobs Act of 2017 minus annual costs of Trump tariffs in 2018, averaged by household*



Sources: The lower-bound estimate for the impact of Trump tariffs is from Pablo D. Fajgelbaum et al., “Updates to Fajgelbaum et al. (2020) with 2019 Tariff Waves,” January 21, 2020. The upper-bound estimate for the impact of Trump tariffs is from “The Budget and Economic Outlook: 2020 to 2030,” Congressional Budget Office, January 28, 2020, p. 33. For alternative estimates on the impact of Trump tariffs, see Table 1 in this paper. Estimates for the impact of the Tax Cuts and Jobs Act of 2017 are from “Distributional Analysis of the Conference Agreement for the Tax Cuts and Jobs Act,” Tax Policy Center, December 18, 2017; and “Distributional Effects of Public Law 115-97,” JCX-10-19, Joint Committee on Taxation, Congress of the United States. Author’s calculations are described in the note below.

Note: Estimates of the impact of Section 301 tariffs also include the effects of other tariffs imposed by the Trump administration from January 2018, but the Section 301 tariffs account for the largest share of the observed effect. The aggregate impact of Trump tariffs is divided by the number of U.S. households in 2018 (approximately 127.6 million). The Tax Policy Center divides the aggregate impact of the Tax Cuts and Jobs Act of 2017 by “tax units,” which is defined as an “individual, or a married couple, that files a tax return or would file a tax return if their income were high enough, along with all dependents of that individual or married couple.” The Tax Policy Center estimates that the amount of tax units in a given year exceeds the number of households reported by other sources. The Joint Committee on Taxation reports the aggregate change in federal taxes and a distinct number of taxpayer units. Thus, aggregate savings from the Tax Cuts and Jobs Act of 2017, according to the Joint Committee on Taxation’s estimates, are divided by the committee’s number of taxpayer units (177 million) to obtain the average.

American products it had promised to buy. As Chad Bown of the Peterson Institute for International Economics noted, “In the end, China purchased only 57 percent of the total US goods and services exports over 2020–2021 that it had committed to” under the Phase One Agreement.²¹

Third, and perhaps most importantly, Beijing has done little to overhaul its troubling economic and trade practices, as U.S. Trade Representative Katherine Tai herself admitted before Congress.²² Instead, as the U.S.-China Economic and Security Review Commission’s 2021 report to Congress highlighted, Beijing’s pursuit of industrial policy continues apace.²³ The *Wall Street Journal* recently reported, in fact, that “China has *doubled down* on the state-led economic model the Trump administration had set out to change. Chinese authorities increased their use of subsidies—including cash infusions, discounted loans and cheap land—to dominate high-technology industries.” And the U.S. approach may have hardened attitudes in Beijing and among the Chinese public. As former U.S. trade representative Charlene Barshefsky noted, Chinese leaders “did not change their economic model one iota, reinforcing to Xi Jinping that their economic model can withstand even aggression by the United States.”²⁴ Recent research also found that the trade war reduced Chinese citizens’ support for both trade with the United States and international trade in general.²⁵

“Mimicking Beijing’s 21st-century industrial policy is simply not a panacea in the economic competition between the United States and China.”

Likewise, Congress recently passed the Chips and Science Act of 2022 on a bipartisan basis. At the center of the legislation is about \$80 billion in federal grants and tax credits for semiconductor production. The supposed purpose of the trade-distorting subsidies is to induce firms to produce more semiconductors and related technologies domestically. Policymakers argued that such subsidies are necessary because China heavily subsidizes its own industrial production of semiconductors and it could invade Taiwan, a U.S. ally and a major supplier of chips to the U.S. and global markets.

Yet there are compelling reasons to be circumspect about the transformative power of these subsidies. If history is any guide, this bout of industrial policy will be no more successful than previous iterations.²⁶ Indeed, it is likely that inefficient semiconductor subsidies will dampen innovation, enrich rent seekers, and trigger trade tensions with the very allies the United States needs to rally to exert pressure on Beijing to curtail its predatory commercial practices.

Mimicking Beijing’s 21st-century industrial policy is simply not a panacea in the economic competition between the United States and China. Likewise, the U.S.-China trade war—easily the most aggressive bout of unilateral, tit-for-tat protectionism in decades—is imposing enormous costs on innocent bystanders in a misguided effort to fundamentally change Beijing’s mercantilism and nationalism. Indeed, it most likely has made things *worse*.

SMARTER POLICY RESPONSES

There is a far better approach to China than ineffective bellicosity and sclerotic protectionism. This approach focuses less on trying to change Chinese government behavior, which seems unlikely, and more on using time-tested policy tools to supercharge the U.S. economy and reassert America’s global leadership.

International Trade Tools

First, policymakers should lift the Section 301 tariffs, which are doing significantly more harm than good to the United States. They have utterly failed to discipline China’s mercantilism and instead have imposed significant costs on the American economy, especially American manufacturers. Other tariffs should also be liberalized, particularly those on industrial inputs. More than half of all imports in the United States are capital goods, raw materials, or intermediate inputs used by American firms to make products here. Tariffs on these goods raise manufacturers’ production costs and instantly make them less globally competitive than foreign competitors who have freer access to the same inputs. Policymakers should unilaterally eliminate existing duties on such capital goods, raw materials, and intermediate inputs, which would strongly enhance America’s global competitiveness.

The most obvious place to start in this regard is the Trump administration’s tariffs on imported steel and aluminum, which were implemented on bogus “national security” grounds and have harmed both metal-consuming American manufacturers and relations with key trading partners.²⁷ The tariffs also triggered predictable retaliation, ensnaring unrelated industries like agriculture into the morass. The tariffs’ big winners have been a handful of politically connected U.S. companies and unions and American manufacturers’ *global competitors* who pay far less for these critical industrial inputs.²⁸ The United States should also reform its trade remedy system, which has resulted in duties on hundreds of imported products—primarily industrial inputs—that are imposed with no regard to their potential harms to downstream consuming industries.²⁹

“The tariffs’ big winners have been a handful of politically connected U.S. companies and unions and American manufacturers’ global competitors who pay far less for these critical industrial inputs.”

Removing these tariffs would not only make American manufacturers more competitive vis-à-vis their Chinese competitors, but also provide some relief for inflation-weary American families. While today’s historic inflation has been primarily caused by loose fiscal and monetary policy and various supply-side bottlenecks, recent research from the Peterson Institute finds that eliminating the Trump administration’s trade war tariffs (both on China and metals) could save American families hundreds of dollars per year.³⁰ Eliminating tariffs will not completely solve inflation or fix U.S.-Sino commercial relations, but it is a good and obvious place to start.

Second, the United States should end its blockade of new appointments to the World Trade Organization’s (WTO) Appellate Body, the highest court of international trade. As a result of U.S. intransigence, the WTO’s dispute settlement system is paralyzed.³¹ Where there are legitimate grievances about Chinese protectionism in violation of Beijing’s commitments under the World

Trade Organization Agreements, the United States and its like-minded allies should pursue dispute settlement in the Geneva-based tribunal. Many of the practices highlighted by the United States in the 301 Report are prohibited by WTO rules, including forced technology transfer, while there is an affirmative—and enforceable—obligation to protect intellectual property.³² Research from the Cato Institute finds that China has an imperfect but decent record of complying with adverse decisions by the WTO.³³

Third, the United States should rejoin the Trans-Pacific Partnership (TPP), which was subsequently renamed the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) after the Trump administration’s ill-advised withdrawal from the partnership at the beginning of Trump’s term in office. The TPP was a U.S.-led effort to create a major trading bloc in the Asia-Pacific region, which was launched in the waning days of the George W. Bush administration and finalized in October 2015. It was signed by the 12 Pacific Rim countries in February 2016. The agreement’s objectives were threefold:

- **Economics:** the TPP/CPTPP reduced a number of trade barriers between the parties to the agreement. This would lead to increased efficiency, productivity, and economic growth for the members. The Peterson Institute found that, if implemented, the TPP would have raised real incomes in the United States by \$131 billion annually by 2030 and increased U.S. exports by nearly \$360 billion over that span, more than 9 percent above the 2014 baseline used by the authors of the study.³⁴ The U.S. International Trade Commission found that by 2032, the TPP would have raised real incomes by \$57.3 billion, increased gross domestic product by \$42.7 billion, and created 128,000 jobs, while exports to new trading partners would have grown by nearly 20 percent.³⁵ These are small but significant gains for the United States.
- **New Trade Rules:** the TPP/CPTPP also included new rules covering various aspects of the modern economy that were not captured by previous trade agreements, including the North American Free Trade Agreement (NAFTA) and the WTO Agreements. Such disciplines included digital trade, industrial subsidies, and SOEs. Even though it was not a member of TPP,

China loomed large in the agreement's negotiations: these rules targeted a lot of Beijing's "state capitalist" trade and investment practices. The goal was to write new rules and eventually "multilateralize" them at the WTO. The TPP thus established a high bar for any eventual Chinese accession to TPP and helps WTO members to pressure China into accepting the new rules on a multilateral level.

- **Geopolitics:** although the TPP made economic sense, foreign policy benefits drove the agreement. At its core, TPP was designed to counter China's growing influence in the Asia-Pacific region. First, TPP members would have an alternative market to China: the United States. Countries tend to trade with large nearby countries under what's known as a "gravity model." The TPP's elimination of trade barriers was intended to offset China's massive gravitational pull in the region. This could help reorient supply chains out of China and into neighboring TPP member countries as well as the United States. The TPP also provided a forum to promote regional cooperation, consultation, and dispute settlement, similar to the WTO, albeit in a nimbler form. Finally, TPP was intended to be an ever-growing platform for new members to join, especially close allies in the region like South Korea and Thailand. (Seoul recently applied to join CPTPP.) Adding members would give the agreement extra heft and increase the leverage of the United States while bolstering the "TPP supply chain." China would be faced with a choice: raise its commercial standards to join the ever-growing TPP bloc or face competitive disadvantages in its own backyard.

But the TPP was far from perfect: it contained a fair amount of special-interest protectionism (e.g., on intellectual property and textiles), while certain laudable provisions (e.g., constraining subsidies and state-owned enterprises) were diluted to appease certain signatories. But, as the Cato Institute's chapter-by-chapter analysis of the agreement concluded in 2016, it was on-net liberalizing—by a significant margin—and deserved support.³⁶ This conclusion has since been bolstered because CPTPP signatories have removed some of the most offending provisions.

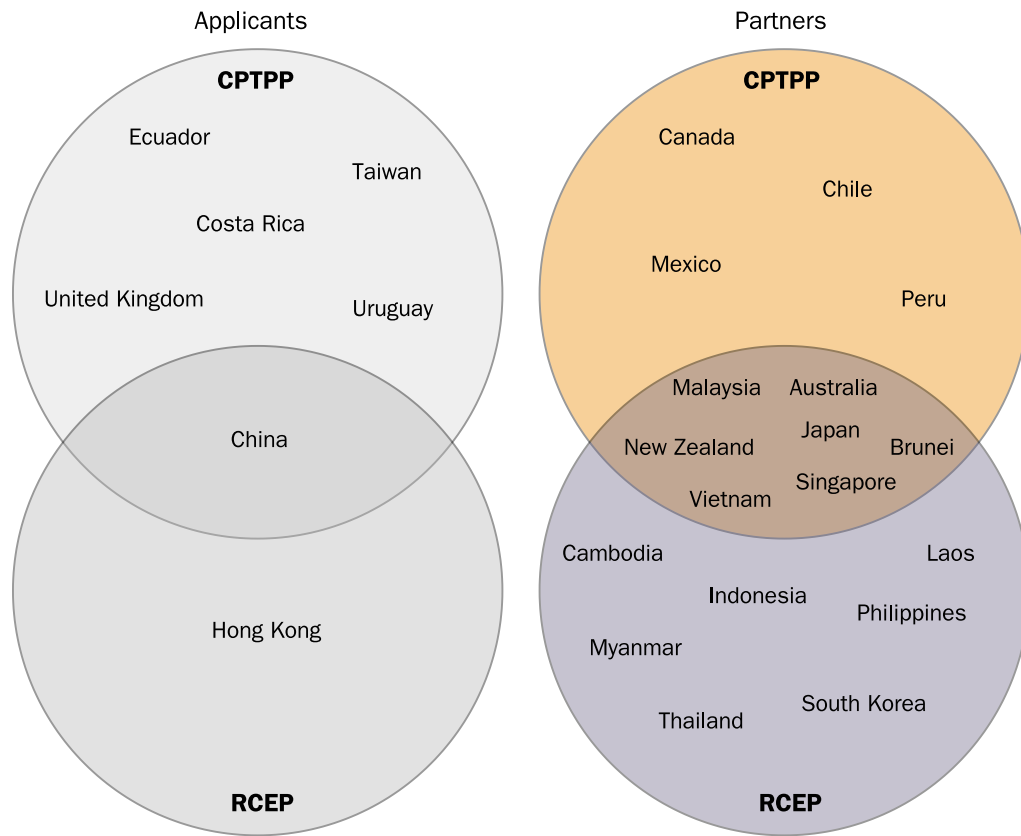
The TPP's original motivations, moreover, have since proven sound. Unfortunately, American exporters are on the outside of the agreement looking in: they face significantly higher trade barriers than their competitors within the TPP bloc. Lost market access is an especially acute problem for American farmers and ranchers attempting to reach notoriously closed Asian agriculture markets, which were pried open in TPP negotiations. Likewise, American consumers face higher tariffs and other trade barriers than consumers in TPP countries—relief that would have been welcome during a period of high inflation and supply chain chaos. And perhaps most tragically, the United States forfeited its economic leadership role in the Asia-Pacific region, ceding the ground to China. Beijing is working hard to fill that void. At the beginning of 2022, the China-led Regional Comprehensive Economic Partnership (RCEP)—a large, albeit lower-quality trade agreement than TPP—went into effect. The imperative to rejoin CPTPP grows every day as China's influence and assertiveness in the region grows. Figure 2 shows the parties to the CPTPP and the RCEP, as well as countries currently applying to join the former agreement.

“The Indo-Pacific Economic Framework is simply no substitute for rejoining the CPTPP and expanding its membership to include longtime allies like South Korea, Taiwan, and the post-Brexit United Kingdom.”

The Biden administration is now seeking to reassert American international economic leadership in the Asia-Pacific region with its Indo-Pacific Economic Framework (IPEF) initiative. The IPEF negotiations recently began, but the administration's refusal to put market access issues on the table means the impact of the agreement will be extremely limited.³⁷ The IPEF is simply no substitute for rejoining the CPTPP and expanding its membership to include longtime allies like South Korea, Taiwan (a high-tech manufacturing hub), and the post-Brexit United Kingdom, all of whom have expressed an interest in joining the pact.

Figure 2

Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and Regional Comprehensive Economic Partnership Countries (RCEP)



Sources: Jeffrey J. Schott, “Which Countries Are in the CPTPP and RCEP Trade Agreements and Which Want In?,” Peterson Institute for International Economics, March 2, 2023; “CPTPP Accession,” New Zealand Ministry of Foreign Affairs and Trade; and “Hong Kong Applies to Join RCEP Trade Agreement,” Nikkei Asia, February 23, 2022.

Notes: South Korea and Thailand have publicly indicated their interest in applying to join CPTPP, but they have not initiated the process yet. Bangladesh is reportedly considering applying to join RCEP.

Fourth, the United States should pursue more trade-liberalizing agreements with other partners, either through the CPTPP or outside of it. It has now been more than 10 years since the United States entered into a new trade agreement (the last bilateral agreements were with South Korea, Panama, and Colombia, respectively). The rest of the world has moved on while the United States has dithered. As mentioned, RCEP went into effect in early 2023 and the African Continental Free Trade Agreement is now in place. Over the long term, a stagnant U.S. trade agenda will lead to a less dynamic and slower-growing U.S. economy, not to mention a decline in American prestige and influence over foreign policy decisions made around the globe.

The most obvious place to start is the Transatlantic Trade and Investment Partnership (T-TIP) with the European Union, which stalled during the Trump administration but

has received newfound attention following Russia’s invasion of Ukraine.³⁸ The T-TIP has the potential to be a high-quality, comprehensive modern trade agreement between economic superpowers. Cutting trade and investment barriers and streamlining regulatory recognition would be a boon on both sides of the Atlantic. (Just imagine, for example, if the FDA had accepted European regulatory practices *before* the U.S. infant formula crisis.) Like TPP, T-TIP would strengthen important geostrategic ties in the face of an increasingly aggressive Russia and reaffirm the United States’ commitment to the transatlantic relationship. It would also provide the United States with another trading bloc committed to high-quality commercial rules that could be leveraged to help discipline Beijing’s trade and investment transgressions.

Another trade tool available to policymakers concerned about U.S.-China trade and investment is the Generalized

System of Preferences (GSP), the authorization for which lapsed at the end of 2020. The GSP cuts tariffs on certain products coming to the United States from about 120 developing countries, including several of China’s competitors, including Thailand, the Philippines, Cambodia, and Indonesia. As the *Wall Street Journal* recently documented, after the Trump administration’s tariffs, many companies relocated manufacturing out of China and into GSP-beneficiary countries to take advantage of the tariff disparity.³⁹ Now that GSP has lapsed and tariffs have increased on products from GSP countries, however, several of those companies are moving production back into China—at the same time a bipartisan chorus of policymakers is urging producers to exit the Chinese market. As Dan Anthony, the executive director of the Coalition for GSP, and Steve Lamar, the president and CEO of the American Apparel and Footwear Association, wrote in the *Wall Street Journal* in late 2022 urging renewal of GSP, “Companies are looking to Congress for a signal. So far Congress is telling them to go to China.”⁴⁰ Thus, Congress should quickly reauthorize and expand the GSP.

“The United States should employ other tools of economic statecraft, but in a far more narrowly tailored way than has been recently proposed.”

Finally, the United States should repeal the Jones Act (i.e., Section 27 of the Merchant Marine Act of 1920), which restricts domestic shipping services to vessels that are built in the United States, owned by Americans, U.S.-flagged, and U.S.-crewed. As a result of this act, our shipping laws are some of the most protectionist in the world. The Jones Act was once justified as necessary to ensure adequate domestic shipbuilding capacity and a supply of merchant mariners in times of war or other national emergency, but over the last 100-plus years it has become apparent that the act fails to bolster national security, while it serves as a drag on the economy.⁴¹ The Jones Act inflates shipping costs because the transport of cargo between U.S. ports and inland waterways is off-limits to foreign competition. These higher shipping costs have ripple effects throughout the economy: they

increase demand for alternative forms of transportation, including trucking, rail, and pipeline services, which raises those modes’ rates and increases business costs throughout the supply chain, especially in manufacturing. Likewise, the Jones Act is a source of constant irritation to several trading partners, thus discouraging U.S. exports in those markets.

Sanctions, Investment Screening, and Export Controls

The United States should employ other tools of economic statecraft, but in a far more narrowly tailored way than has been recently proposed. For example, lawmakers recently bolstered the government’s ability to monitor and restrict potentially malicious foreign investment in domestic firms through the Committee on Foreign Investment in the United States (CFIUS). But CFIUS reviews should be scrutinized because they often lack transparency and could be (and arguably have been) used as a protectionist cudgel in industries with a tenuous national security nexus. Nevertheless, limited restrictions on Chinese investment (especially by SOEs) applied in a transparent and consistent manner can ensure that American trade secrets and sensitive technologies are not controlled by or transmitted to the Chinese government.

Narrow sanctions on specific bad actors—individuals or firms—can also be a legitimate policy tool. Sanctioning SOEs controlled by the Chinese Communist Party or targeting Chinese firms that engage in cyber espionage to steal American trade secrets may be justified in certain cases. These measures would be dramatically better than the blanket tariff regime currently in place, but—as with CFIUS actions—they must be narrowly tailored, thoroughly documented and supported, and fully transparent.

Likewise, export controls can be a useful tool to protect and advance American foreign policy and technological interests, but they can also be misapplied to the detriment of important U.S. companies and national interests. It is reasonable, for example, to restrict the export of materials used exclusively to make nuclear weapons. However, it is a muddier calculus when the product in question has both civilian and military applications, such as semiconductors. Policymakers considering deploying export controls should implement some basic guardrails to ensure a proper balance

between protecting national security and ensuring the relative free flow of goods across borders, which is instrumental to American prosperity and security. In particular:

- Policymakers should clearly define national security concerns tied closely to defense and defense-related goods and services. The Trump administration’s flagrant abuse of tariffs on imported steel and aluminum shows the dangers in loosely defining “national security.”
- Policymakers should also be required to balance the security and economic ramifications of export controls. Like import tariffs, export restrictions can harm domestic exporters, who lose foreign sales, or harm importing firms that are denied access to inputs by foreign retaliatory “copycat” export control measures. An overly restrictive export control regime could dissuade foreign firms from even opening operations in the United States.
- When there is a legitimate national security product or service involved and the threat outweighs the potential economic costs of the export restriction, unilateral sanctions should be avoided in all but the rarest of circumstances. In a globalized world with various suppliers of virtually every product, unilateral controls can lose their effectiveness and simply deny sales to a U.S. firm by diverting trade to a less-efficient producer while doing nothing to enhance national security.
- Policymakers should establish transparent procedures before and after export controls are implemented to ensure they are not unduly burdensome. The executive branch should work with the private sector to determine if there are ways to mitigate potential national security risks associated with the export of a product or service in question and to understand the full economic effect of the proposed control. Likewise, there should be a robust and timely judicial review process that allows appeals to be heard quickly. A time-limited sunset for proposed export controls also makes sense.
- Finally, export controls should be tailored as narrowly as possible. There is a high potential for sanctions to hurt people without achieving the desired policy aims. Serious scholars have questioned the efficacy of various sanctions, including export controls, when they remain in place for long periods of time.⁴²

As an example of the danger of these policies, overbroad export controls caused certain Chinese firms to hoard semiconductors in recent years. That exacerbated a growing global shortage in semiconductors that became acute during the pandemic.⁴³

Liberalize Immigration

If the United States is going to outcompete China in the 21st century, particularly in the fields that are likely to drive future growth, Washington needs to welcome far more immigrants into the country. Unique among the most powerful nations of the world, the United States is a nation of immigrants, and they are one of our greatest assets. Yet in recent years policymakers have unwisely restricted immigration. For example, it is estimated that legal immigration fell by about 50 percent between fiscal years 2016 and 2021, spurred by the false belief that immigrants somehow reduce Americans’ living standards.⁴⁴ Such zero-sum thinking is antithetical to American values and conflicts with both historical evidence and economic research. It risks undercutting an asymmetric advantage the United States has over China: the ability to attract and retain talented foreigners. Although immigration levels have returned to their pre-pandemic levels during the last two years, given the aging population in the United States, more needs to be done to increase immigration.⁴⁵ Indeed, immigration levels remain millions behind where we should be today.

“If the United States is going to outcompete China in the 21st century, particularly in the fields that are likely to drive future growth, Washington needs to welcome far more immigrants into the country.”

First, the academic literature is clear that immigrants are net job creators because they tend to be more entrepreneurial than nonimmigrants.⁴⁶ Some of America’s most innovative and globally competitive firms were founded by immigrants, including Google, Uber, Qualcomm, Tesla, eBay, Yahoo, and Pfizer.⁴⁷

Immigration is crucial if the United States is to continue leading the technology sector, which is at the nexus of the geopolitical competition with China. As economist Kimberly Clausing notes in her recent book, *Open: The Progressive Case for Free Trade, Immigration, and Global Capital*, “As of 2014, 46 percent of Silicon Valley’s workforce was foreign-born. The share is even larger for workers between the ages of 25 and 44, and it rises to a whopping 74 percent of workers hired for their math and computer expertise in that age bracket.”⁴⁸

Figure 3 depicts the increase in the U.S. foreign-born STEM [science, technology, engineering, and mathematics] workforce from 2000 to 2019. Research shows that immigrants are particularly prevalent in, and essential for, important technology industries such as semiconductors and artificial intelligence.⁴⁹ Openness to immigration is therefore essential to keeping R&D-intensive multinationals *in* the United States and *out* of China, which has long struggled to retain or attract skilled human capital.⁵⁰

Furthermore, it is estimated that between 1990 and 2010, the “inflows of foreign STEM workers explain between

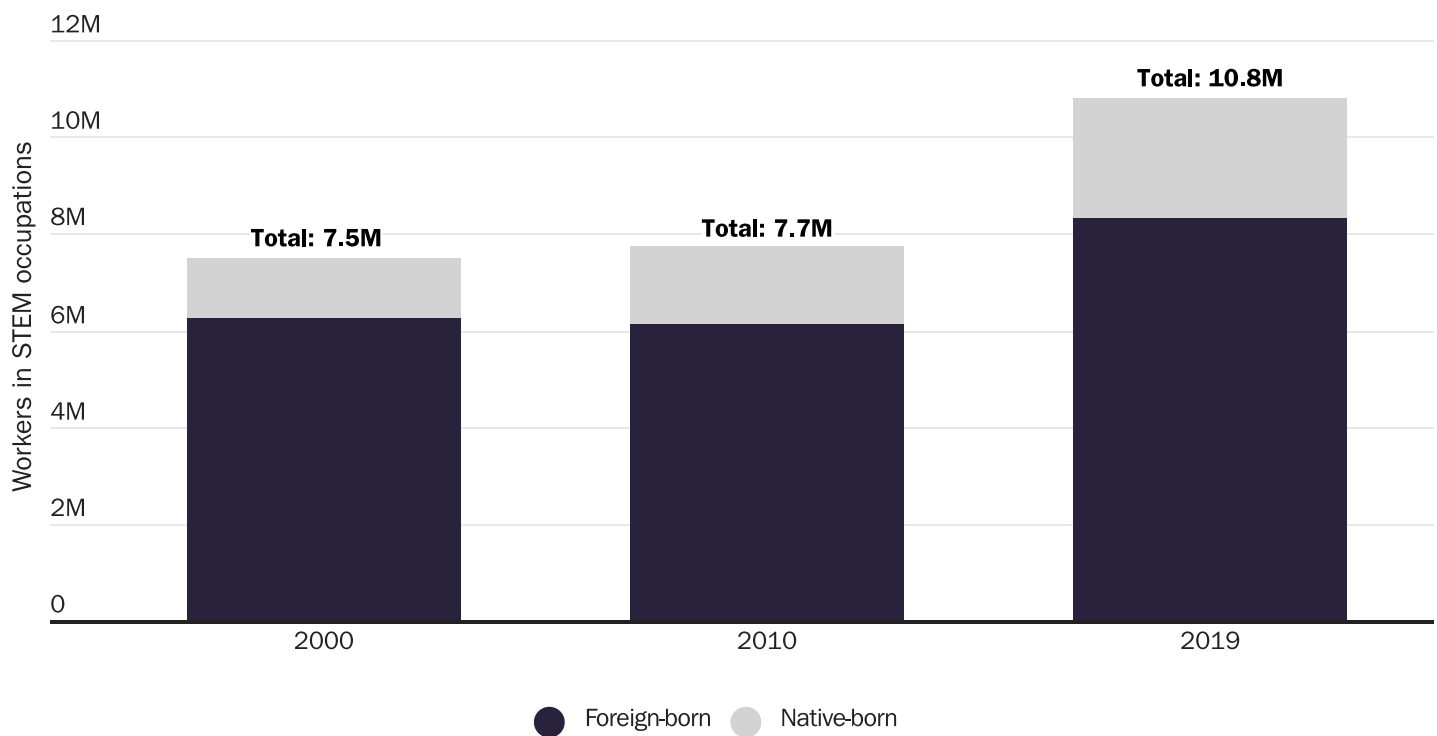
30% and 50% of the aggregate productivity growth” in the United States.⁵¹ Immigrants are about twice as likely to be granted patents as nonimmigrants because they disproportionately have degrees in science and engineering. The same study found positive spillover effects from skilled immigration: “A 1 percentage point rise in the share of immigrant college graduates in the population increases patents per capita by 9–18 percent.”⁵² In other words, skilled immigrants provide a direct benefit to the United States, but they also spur innovation among nonimmigrants.

America’s colleges and universities have long been breeding grounds of innovative research and technology. Students who hold visas make up a disproportionate number of graduate-degree-seeking students in science, computer science, and engineering.⁵³ Yet research by David Bier of the Cato Institute found that the Trump administration oversaw an enrollment decline of about 700,000 students in U.S. colleges and universities.⁵⁴

At the same time, the United States remains a far more attractive spot than China for international scientists and engineers.⁵⁵ Yet instead of capitalizing on China’s woes in

Figure 3

U.S. Science, Technology, Engineering, and Mathematics (STEM) workforce by nativity, selected years 2000–2019



Source: “Foreign-born STEM Workers in the United States,” American Immigration Council, June 14, 2022.

Notes: STEM = Science, technology, engineering, and mathematics. STEM occupations are defined by the American Immigration Council according to the list of STEM occupations from the U.S. Census Bureau. The American Immigration Council report is based on data from the American Community Survey.

attracting and retaining top scientists, Washington’s hostility toward Beijing is driving some of the top talent out of the United States.⁵⁶ Recent research found that nearly 1,500 U.S.-trained Chinese engineers and scientists dropped their U.S. academic or corporate affiliations and exchanged them for Chinese affiliations in 2021, which represents a more than 20 percent increase from the prior year.⁵⁷ This trend accelerated due to the Trump administration’s so-called “China Initiative,” which the Justice Department intended to use to counter espionage and national security threats from China.⁵⁸ Yet it became apparent that many of the cases were weak and those were quickly dismissed. Additionally, there were charges of racial profiling, which led the Biden administration to drop the program in 2022.⁵⁹ Indeed, there is recent evidence that Washington’s hostility toward China is pushing scientists away from the United States and toward China.⁶⁰ If this trend continues it risks undermining the asymmetrical advantage the United States has over China: the ability to attract and retain talented foreigners.

Policymakers should reverse course and liberalize immigration, particularly for high-skilled immigrants. Specific ideas to attract and retain top-notch foreign talent include exempting STEM graduates from green card caps, providing Chinese nationals who hold college degrees with work permits or green cards without numerical caps,

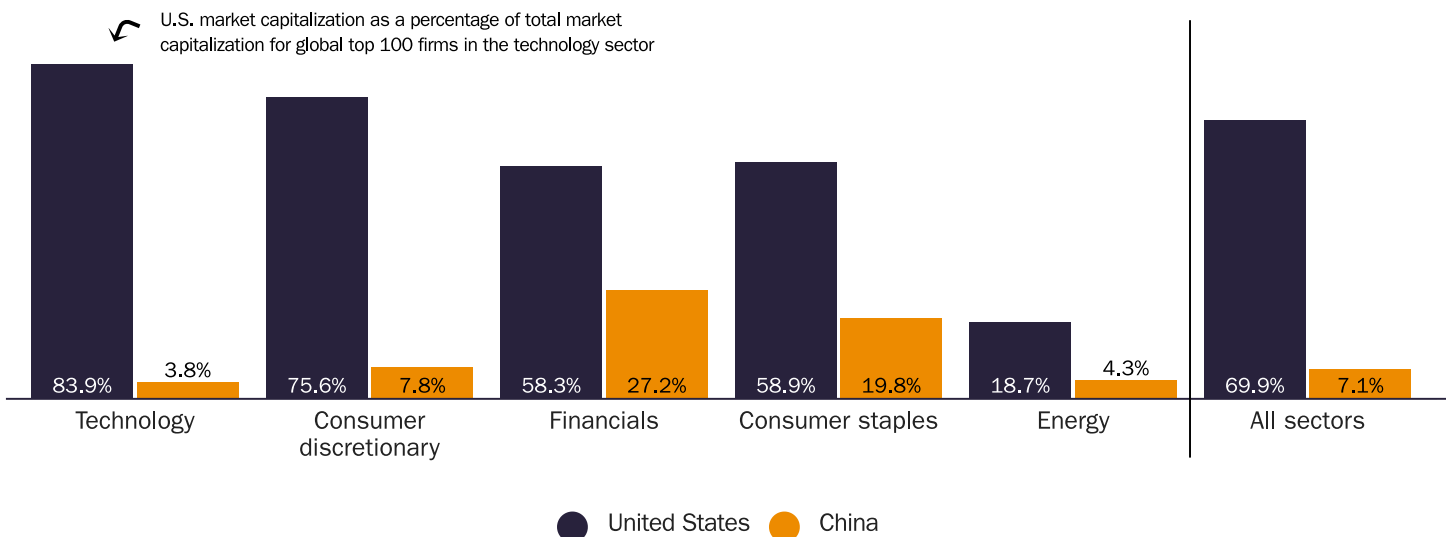
creating a start-up entrepreneur visa, and prioritizing visa applications in high-tech sectors.⁶¹

Over the long term, immigration restrictionism would lead to a less dynamic and innovative economy and undercut the United States vis-à-vis China. A recognition of the positive-sum results of liberalizing immigration would spur innovation from nonimmigrants, bolster our technology sector, and reduce the number of talented workers and innovators in China. It is a no-brainer.

Tech Optimism and Light-Touch Regulation

A primary goal for both Washington and Beijing is to set standards and dominate the commanding heights of technology. As noted, U.S. policymakers’ concerns about China’s embrace of industrial policies—focused on alternative energy vehicles, information technology, telecommunications, robotics, and artificial intelligence—are understandable. Yet U.S. trade and immigration policy have become increasingly hostile to the very American firms that are pushing the envelope in terms of research and development (R&D) and high-tech products. Simply put, populist outrage toward superstar technology firms may be smart politics, but it is no way to “outcompete China.”

Figure 4
When measuring the percent of total market capitalization for the top 100 global firms, the United States outcompetes China in every sector, especially technology



Source: “Global Top 100 Companies by Market Capitalisation,” PricewaterhouseCoopers, November 18, 2022.

Specifically, lawmakers in Congress and lawyers at the Department of Justice are increasingly skeptical of major U.S. technology firms simply because of their size and not for any anti-consumer concerns. They are looking at using antitrust tools to crack down on them, including by upending a century of predictable rules that center on consumer welfare. Antitrust is beyond the scope of this analysis, but it is worth considering the geopolitical and economic implications of severely cracking down on America's leading technology firms given the ongoing struggle with China over technological supremacy.

“Kneecapping America’s most influential and successful technology companies will not only dim their R&D intensity but will also benefit Chinese competitors like Tencent and Alibaba.”

With its historically more-liberal regulatory policy, dedication to the rule of law, and embrace of openness, the United States has led the way in creating the type of environment necessary to cultivate technological innovation. In 2022, four of the top five global firms based on market capitalization were American technology firms (Apple, Microsoft, Amazon, and Alphabet [the parent company of Google]). Further, 63 of the top 100 global firms based on market capitalization were American firms. Of the total market capitalization of the top 100 firms, 70 percent is U.S.-based. In 2021, China was second, with 11 of the top 100 firms based on market capitalization, including tech giants Tencent and Alibaba. As Figure 4 shows, U.S. firms hold a higher share of total market capitalization than Chinese firms across all sectors, especially technology.⁶²

A recent report from the Progressive Policy Institute (PPI) highlights how six of the largest American tech firms—Amazon, Alphabet, Intel, Facebook, Microsoft, and Apple—are driving large-scale investments in research and technology. The Progressive Policy Institute estimates that these six firms made nearly \$90 billion in private investment in 2020, which was up about 6 percent over 2019.⁶³ That is remarkable given that the economy in 2020 was lagging because of the outbreak

of COVID-19. Cracking down on U.S. tech firms will mean less investment in R&D in cutting-edge technologies.

The American tech giants already face heavily subsidized foreign competition and discriminatory treatment abroad, particularly from China. Despite this, the American technology industry pushes the envelope on exactly the types of R&D that policymakers should welcome: those current and next-generation technologies the United States will need to outcompete Beijing. Kneecapping America's most influential and successful technology companies will not only dim their R&D intensity but will also benefit Chinese competitors like Tencent and Alibaba.

The U.S. technology industry is the envy of the world. That is why China, the European Union, and others are trying to mimic it through subsidies and discrimination. Yet those policies are simply no match for a relatively free and dynamic economy fostered by economic openness and light-touch competition policies. Making the United States less efficient and less dynamic through misguided efforts at targeting high-performing American tech companies is a nonsensical way to counter China's economic rise.

Smarter Tax Policies

Finally, policymakers should bolster U.S. competitiveness by improving the tax treatment of R&D investment and capital-intensive manufacturing in the United States. As part of the Tax Cut and Jobs Act (TCJA), which passed in 2017, domestic firms making investments in R&D are currently allowed to deduct those costs from their tax liability for the year in which the investments occur instead of amortizing those deductions over many years. This is a potent incentive for economic growth.

Unfortunately, that provision began to be phased out at the end of 2022 and it phases out entirely by 2026, returning firms to amortizing over a period of years. Likewise, the tax code requires firms to amortize deductions for nonresidential buildings, such as manufacturing facilities, over a 39-year period. Because of inflation and the time value of money, a dollar today is worth a lot more than a dollar in 5—or 39—years from now. Over time, this will raise the cost of R&D, resulting in less innovation and fewer new technologies. This is a recipe for slower growth, lower productivity, and lower wages—and a less competitive

economy vis-à-vis China. Instead, policymakers should make the immediate expensing of R&D permanent and expand it to include structures in order to ensure that the United States remains the best place in the world to innovate and create.

CONCLUSION

Policymakers are rightly concerned about Chinese policies that distort international trade and investment. But copying these policies won't ensure that American companies

outcompete their Chinese counterparts in the years to come. The policies laid out in this analysis will.

Policymakers need to understand that many of Beijing's decisions are beyond Washington's control and, moreover, will be self-defeating for China in the long run. Rather than mimicking Chinese interventionism, policymakers should trust America's traditional strengths: openness to international trade and immigration and a devotion to dynamic market-based innovation. A reembrace of these policies will ensure that America's next 50 years are as prosperous and harmonious as the last.

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China's Economic Headwinds

Overestimating China's economic strength and future growth prospects leads to overreaction and poor policymaking.

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By **Clark Packard**

- ◆ Beginning in the late 1970s, China's experimentation with market liberalization helped supercharge China's economy. It is estimated that this change in policy lifted approximately 800 million people out of grinding poverty.
- ◆ In recent years, China has abandoned its commitment to market liberalization and instead embraced a return to Maoist command and control of its economy.
- ◆ Beijing faces several short-term and long-term headwinds that will almost certainly limit its economic potential—and the supposed threat it poses to the United States.

The bipartisan consensus emerging in policymaking circles around Washington, DC, is that China is an economic juggernaut, inexorably poised to overtake the United States as the world's leading economy. To many policymakers, Beijing's increasingly interventionist and mercantilist policies—high-tech, 21st-century industrial policy—have supercharged its economy and that unless Washington matches China's interventionism, the United States' days as a global economic superpower are numbered.

Proponents of this consensus about China's economic rise argue that the United States naively welcomed Beijing into the rules-based trading system to pad the profits of multinational corporations at the expense of average American workers—all on a Panglossian belief about the ability of freer markets to facilitate democracy and peace. This development, critics allege, allowed China to dramatically increase its wealth, which it is leveraging to strengthen its military and adopt a revisionist foreign policy.

This consensus is rife with problems. First, China's rise has a lot more to do with its abandonment of central planning decades ago than it does with today's re-embrace of protectionism, industrial policy, and **Maoist socialism**. Second, China faces several headwinds that will constrain future growth. Indeed, overestimating China's economic strength and future growth prospects leads to overreaction and poor policymaking. To be clear, many of China's commercial practices are legitimately concerning and do pose significant challenges to the United States and the rules-based trading system. To meet these challenges, however, policymakers need a sober assessment of China's economy and prospects for future growth.

Chinese Reforms Boost the Economy

Between the establishment of the People's Republic of China in 1949 and the early 1970s, China's economy was centrally planned, and it had little foreign trade. Beginning in the late 1970s, **China began to liberalize** its economy and experiment with private markets under the leadership of

Deng Xiaoping. Among the policies enacted, “agricultural collectives were phased out, and private farming was introduced; the state monopoly on foreign trade was abolished; foreign investment was gradually permitted; and trade barriers were reduced in stages,” says Douglas Irwin in *Clashing over Commerce: A History of US Trade Policy*. Indeed, as part of the process that granted China a spot in the World Trade Organization (WTO), Beijing cut tariffs substantially—from an average of 25 percent to 9 percent—phased out import quotas, eliminated several nontariff barriers, and made a commitment to respect and enforce intellectual property rights.

China’s economic liberalization dramatically improved the lives of average citizens. Between 1980 and 2016, China’s national poverty rate, as judged by the World Bank’s poverty line, fell from about 90 percent to 4 percent, which implies 800 million fewer Chinese **living in poverty**. Global trade played a critical role in this advancement. Even according to David Autor, David Dorn, and Gordon Hanson, authors of the famous **China Shock** papers, Beijing’s own domestic internal reforms—especially tariff liberalization (and thus access to imports)—were responsible for much of its gains in global export competitiveness in the late 1990s and 2000s.

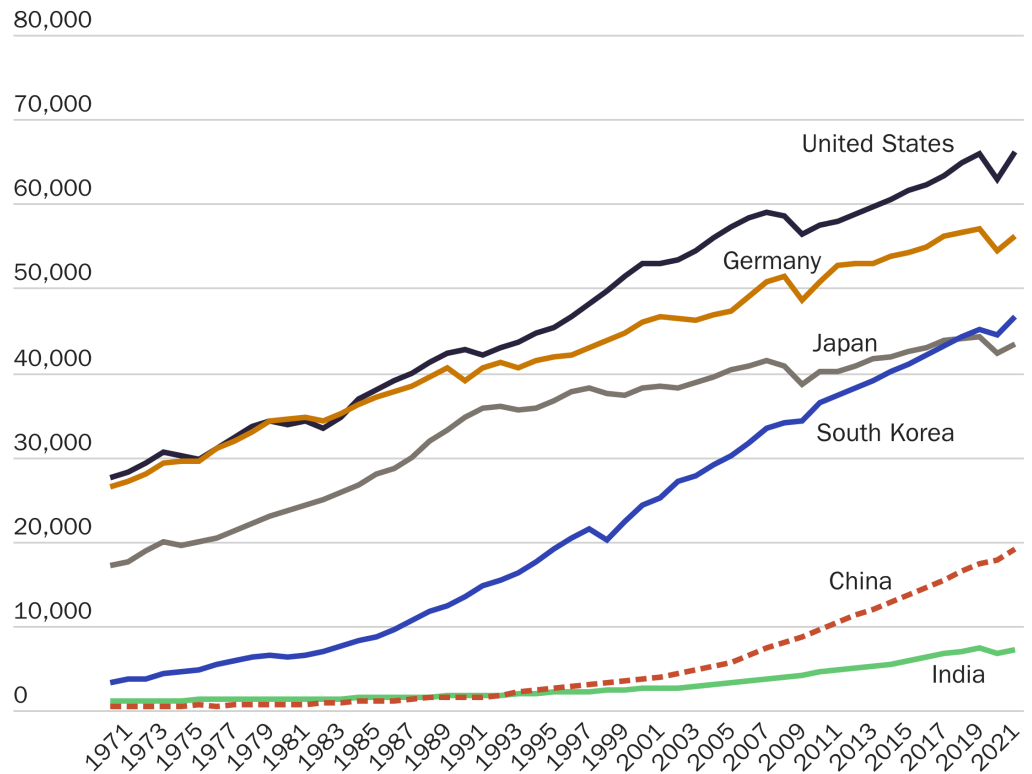
The Chinese People Are Still Relatively Poor

Despite the rapid growth following China’s market-oriented economic reforms, the average Chinese citizen remains poor relative to the individuals in the developed world because its economic growth began from a very low, communism-induced baseline. Figure 1 shows per capita gross domestic product (GDP) based on purchasing power parity (PPP) among the major economies in the world. As the chart shows, per capita GDP adjusted for PPP in the United States was about \$66,000 in 2021 compared to just over \$19,000 in China.

Figure 1

Despite making much progress since the 1970s, China remains a relatively poor country

GDP per capita, constant 2020 international dollars, PPP



Source: The Conference Board, "GDP per Capita, 2020 International Dollars, PPP, 1950–2021," Human Progress.

Notes: GDP = gross domestic product; PPP = purchasing power parity; the international dollar is an artificial currency used to eliminate differences in purchasing power when comparing countries. Data adjusted for PPP.

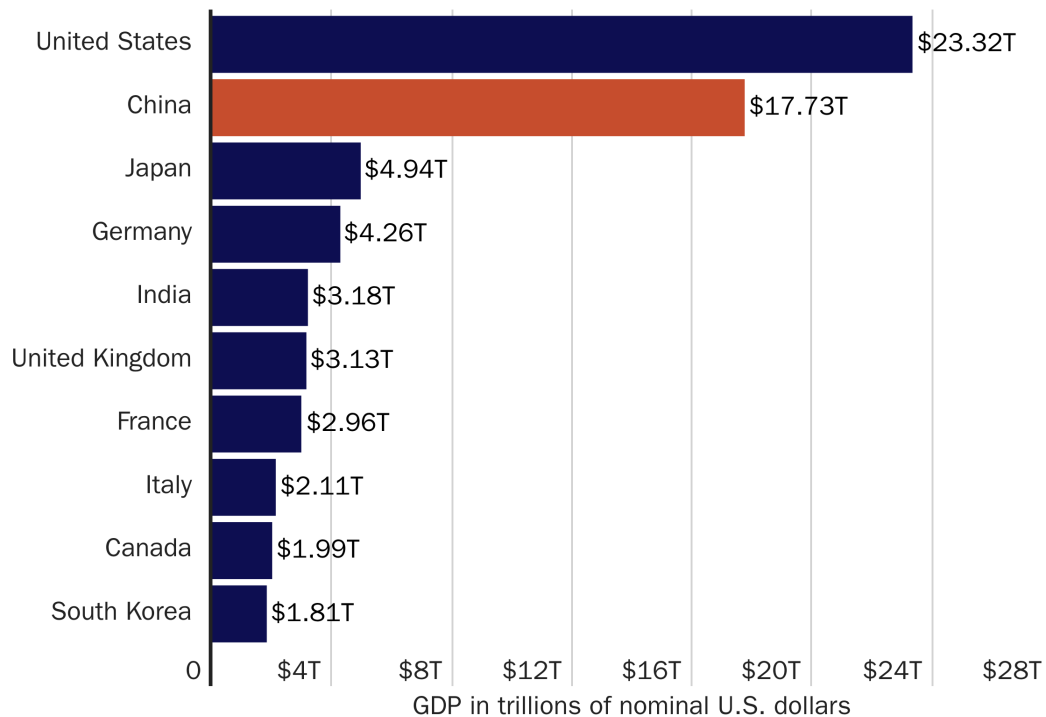
China's influence in the global economy thus comes more from its massive population than from Chinese individuals' productivity and wealth.

China's Growing Clout in the Global Economy

Nevertheless, China is the second-largest economy in the world—trailing only the United States. In 2021, its **GDP** was about \$17.7 trillion compared to about \$23.3 trillion for the United States. In fact, both countries dwarf their closest competitors economically as Figure 2 demonstrates. Japan is the third-largest economy in the world, but its **GDP in 2021** was only about \$5 trillion, **while Germany**, the fourth-largest economy, was about \$4.3 trillion.

Figure 2

China is the second-largest economy in the world, trailing only the United States



Source: "GDP (Current US\$)," The World Bank.

And, with about 1.4 billion people (about 18 percent of the world's total population), China has a massive consumer market that most multinational corporations want to access. On top of that, the country is a major trading nation and central to many supply chains, especially in Asia. Indeed, China's share of **world goods exports** was negligible in 1980, but it rose to 14.68 percent in 2020.

Thus, even if several American-allied countries in the region share U.S. concerns about Beijing's commercial practices, the reality is that China's market size, trade relationships, and geographical positioning are such that many foreign governments and multinational corporations will desire to maintain ties to the Chinese market, even amid growing geopolitical risk.

Nevertheless, China's influence and economic strength now and in the future should not be oversold—especially to justify radical shifts in Western governments' domestic and international economic policy. Indeed, China faces both short-term problems and long-term headwinds that will at best diminish the country's once-bullish economic and investment prospects and at worst severely weaken China's economy and government in the decades ahead.

Short-Term Problems

Despite some undeniable economic successes, policymakers in Beijing, particularly under the leadership of Xi Jinping, have moved in an illiberal direction. As a result, China faces several short-term concerns that will likely weigh on growth in the coming years.

The tech sector, once a dynamic and thriving industry, has been paralyzed by Xi's re-embrace of Maoist socialism. Likewise, Beijing's crackdown on education platforms and its general antipathy toward private-sector firms continues to fuel youth unemployment in China. *The Economist* recently noted that China's **urban youth unemployment rate** is above 20 percent.

Likewise, China's open embrace of industrial policy in the late 2000s generated backlash in the global business community and developed country governments, heightening geopolitical tensions and fomenting trade conflicts (or, at the very least, giving Western politicians an excuse to favor their own national industries). Thus, for example, the United States imposed expansive export controls on semiconductors and semiconductor manufacturing equipment to China in late 2022, followed by Japan and the Netherlands, two major players in the semiconductor production supply chain, shortly thereafter. Given the ubiquity of semiconductors in virtually everything produced today, these efforts will hurt China's technology and manufacturing capacities in the short and intermediate term.

The real estate sector is increasingly overinflated while property developers fail to deliver on promised residential units leading to a large middle-class **boycott of mortgage payments** in 2022. Evergrande, a major Chinese property developer, **defaulted on its debt** in late 2021. Investment in property development fell by **nearly 6 percent** in the first quarter of 2023. As a result of real estate struggles, local government coffers, largely reliant on land sales to fund public services, are drying up. A *Wall Street Journal* story about the **Guizhou province** is illustrative of this problem. For a while, the southwestern province was one of the fastest-growing regions in China owing to debt-fueled infrastructure development that was financed by local banks that lent heavily to local governments. As the *Wall Street Journal* notes, "Chinese authorities largely stood aside over the past two years as the country's largest property developers slid into financial distress, causing losses for investors and many businesses and depressing the land sales that were a big source of revenue for many local governments," including Guizhou. As Tianlei Huang, a research fellow at

the Peterson Institute for International Economics told the newspaper, “It is challenging the problems in the real economy to the financial sector and eventually could pose a threat to financial stability.” Indeed, two-thirds of local governments in China are “now in danger of breaching unofficial debt thresholds set by Beijing to signify severe funding stress.”

It’s not just economic policies that increasingly make China a less desirable country in which to invest and with which to trade. Beijing’s handling of COVID-19 and its disastrous Zero-COVID strategy is giving multinational corporations second thoughts about investments in China. The country also recently began **cracking down** on economic consulting firms, which is drawing criticism. Moreover, China is increasingly relying on forced labor and repression toward Uyghur Muslims in the Xinjiang region. Likewise, Beijing has turned its back on the “One Country, Two Systems”—meaning a great deal of autonomy and self-governance—promise to Hong Kong, which was effectively annexed with the passage of the national security law in 2020. Beijing’s hostility to inquiries into the origins of COVID-19 has increasingly alienated countries in the Indo-Pacific region, such as Australia, which led to a **simmering trade war** between the two countries.

In other words, Beijing’s belligerence is adding to growing geopolitical risk and uncertainty. Foreign direct investment into China fell by nearly 50 percent in 2022 compared to 2021 as foreign firms are increasingly wary of China’s deteriorating relations with other countries and firms. All told, **growth is suffering** and will continue to suffer unless these policies are reversed or at least mitigated.

Long-Term Headwinds

China’s short-term problems may be surmountable, but its long-term headwinds pose a much bigger challenge for Chinese economic growth and global influence.

China’s Demographic Problems

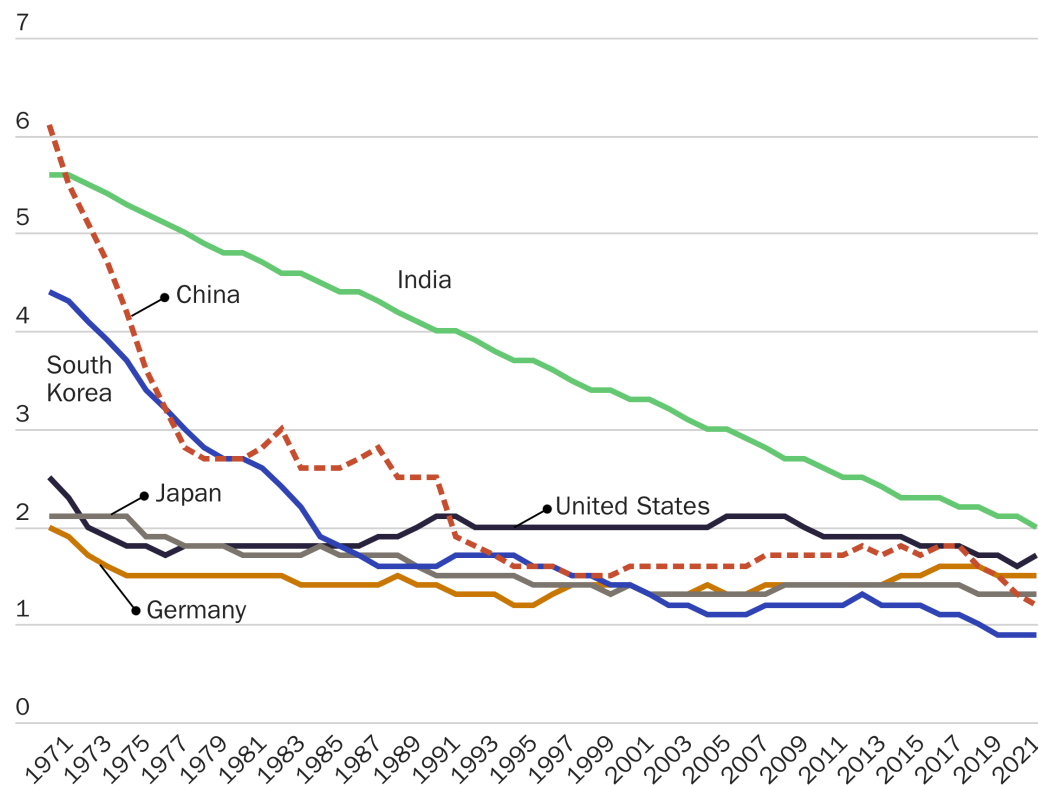
First, China’s rapidly aging population and a shrinking workforce will weigh on economic output, suppress innovation, and stress government services. The United Nations recently announced that **India will overtake China** as the world’s largest population in 2023. An essay in *Foreign Affairs* noted,

“In 1978, the median age of a Chinese citizen was 21.5 years. By 2021, it had risen to 38.4, surpassing that of the United States.” In the 30-year period between 1949 and 1979, China’s population grew from 540 million to nearly 970 million. Beginning in the 1970s, however, China began a series of policies aimed at curbing population growth, and fertility rates began to drop precipitously—“from 5.8 births per woman in 1970 to 2.7 in 1978.” Today, China’s fertility continues to fall; in 2020, for example, the fertility rate of **1.3 births per woman** is below the replacement rate of 2.1 births per woman. Data from China’s National Bureau of Statistics in 2021 show that the birth rate in the country **fell for the fifth consecutive year** with a fertility rate of 1.15 births per woman, one of the lowest percentages in the world (Figure 3).

Figure 3

The decline in China’s fertility rate has outpaced that of other major economies since 2017

Fertility rate (children per woman)*



Source: United Nations, “Fertility Rate: Children per Woman,” Our World in Data.

Note: Total fertility rate defined as “the number of children that would be born to a woman if she were to live to the end of her childbearing years and give birth to children at the current age-specific fertility rates.”

In 2016, Beijing reversed course and lifted its brutal One Child Policy. As of May 2021, the limit is three children. Despite this about-face, what explains China’s demographic headwinds? For starters, women have seen increased educational and employment opportunities, which **has been**

linked to lower birth rates in other countries, including the United States. Likewise, China has a severe imbalance in the ratio of men to women owing to the One Child Policy that favored males. In most of the world, the sex at birth ratio is 1.06 males for every 1 girl, but in China, it is **1.2 males for every 1 female**, and in some provinces, the ratio is 1.3 males for every 1 female. Other possible drivers include the fact that the population has gotten used to having smaller families, rising costs associated with having a child, and a decrease in marriage rates.

Given the significant downturn in the Chinese economy in 2022, early indications are that the **birth rate will drop again**. Indeed, marriages in 2021 were down to their lowest levels since the mid-1980s, when Beijing began keeping records of annual registrations, and initial data suggest a further decline in 2022. Yi Fuxian, a scientist in obstetrics and gynecology at the University of Wisconsin-Madison and author of *Big Country with an Empty Nest*, a book on China's demographic troubles, projected that China's Zero-COVID policies would lead to a significant drop in marriages in 2020 and 2021 and would lead to a drop of about a million births in 2021 and 2022. Though there are legitimate questions about the veracity of Chinese demographic data, government officials are now acknowledging publicly that the country faces serious challenges. In August 2022, China's National Health Commission wrote in an essay for the Communist Party's journal, "Low births and aging amid negative population will become the norm."

Low birth rates, a rapidly aging population, and a shrinking workforce will almost certainly inhibit China's future GDP growth, but it will also inhibit productivity, dynamism, innovation and risk-taking, all leading to a weaker social safety net. Yet China's long-term structural problems do not end there.

Talent Is Fleeing China

In theory, China should be leading the way in the high growth sectors of the global economy. Yet on top of low birth rates and a rapidly aging population, China also faces a serious exodus of young, talented, highly educated citizens.

The Organisation for Economic Co-operation and Development's (OECD's) Programme for International Student Assessment (PISA) measures international educational outcomes by administering a cross-national exam

every three years to 15-year-old students in about 80 high- and middle-income countries. Each participating country selects a representative sample of between 4,000 and 8,000 students and administers the exam. Due to the outbreak of COVID-19, 2018 was the last time the OECD administered the **PISA exam**. Based on those results, China ranked first in reading, science, and mathematics. Meanwhile, the United States ranked 13th in reading, 37th in mathematics, and 18th in science.

China's success extends to undergraduate education as well. The country awards “more science and engineering undergraduate degrees than the U.S., Britain, France, Germany, Japan and South Korea combined.” Between 2000 and 2015, “the number of science and engineering undergraduate degrees granted **per year in China** more than quadrupled”—from about 360,000 annually to more than 1.7 million.

These smart, talented individuals, however, aren't staying in China. Take artificial intelligence (AI). Of the top-tier **AI researchers globally**, nearly one-third received their undergraduate degree from a university in China, yet the overwhelming majority do not stay in China. In fact, 56 percent come to the United States, and about one-third stay in China. As Macropolo, a project of the Paulson Institute at the University of Chicago, notes, “After completing graduate studies in the United States, a full 88% of those Chinese researchers chose to stay and work in the country, while only 10% headed back to China. (This sample includes a combination of recent graduates, mid-career researchers, and veteran researchers to reflect average stay-rates across all these groups.)”

Generally, about 70 percent of international science, technology, engineering, and math (STEM) graduates from **U.S. Ph.D. programs** stay in the country, but among Chinese graduates, the rate is significantly higher—about 85 percent stay here.

Not only is China failing to keep a large quantity of its highly talented AI researchers, but it also struggles to attract foreign advanced STEM talent. An October 2021 study from the **Center on Strategic and International Studies** notes, “Only about 10 percent of international scientists and engineers seemed open to moving to China, compared to nearly 60 percent for the United States.” This is despite China's decades-long global recruitment efforts.

So why does China struggle to retain and attract talent? As a February 2022 report from **Peking University Institute of International and Strategic**

Studies argues, this is largely due to the “relatively relaxed and innovative scientific research environment” in the United States compared to China. **Other reasons include** China’s “authoritarian political system and restricted freedom” and “language barriers, pervasive internet censorship, and environmental quality.”

Yet instead of capitalizing on China’s woes in attracting and retaining top scientists, Washington’s hostility toward Beijing is driving some top talent **out of the United States**. Recent research found that nearly 1,500 U.S.-trained **Chinese engineers and scientists** dropped their U.S. academic or corporate affiliations for Chinese affiliations in 2021, which represents a more than 20 percent increase from the prior year. This trend accelerated due to the Trump administration’s so-called China Initiative, which the U.S. Justice Department intended to use to counter espionage and national security threats from China. Yet it became apparent that many of the cases were weak and were quickly dismissed, and there were **charges of racial profiling**, which led the Biden administration to **drop the program in 2022**. Indeed, there is recent evidence that if the trend of Washington pushing scientists away from the United States and **toward China** continues, it risks undermining the asymmetrical advantage the United States has over China: the ability to attract and retain talented foreigners.

China’s Declining Business Dynamism and Slowing Productivity

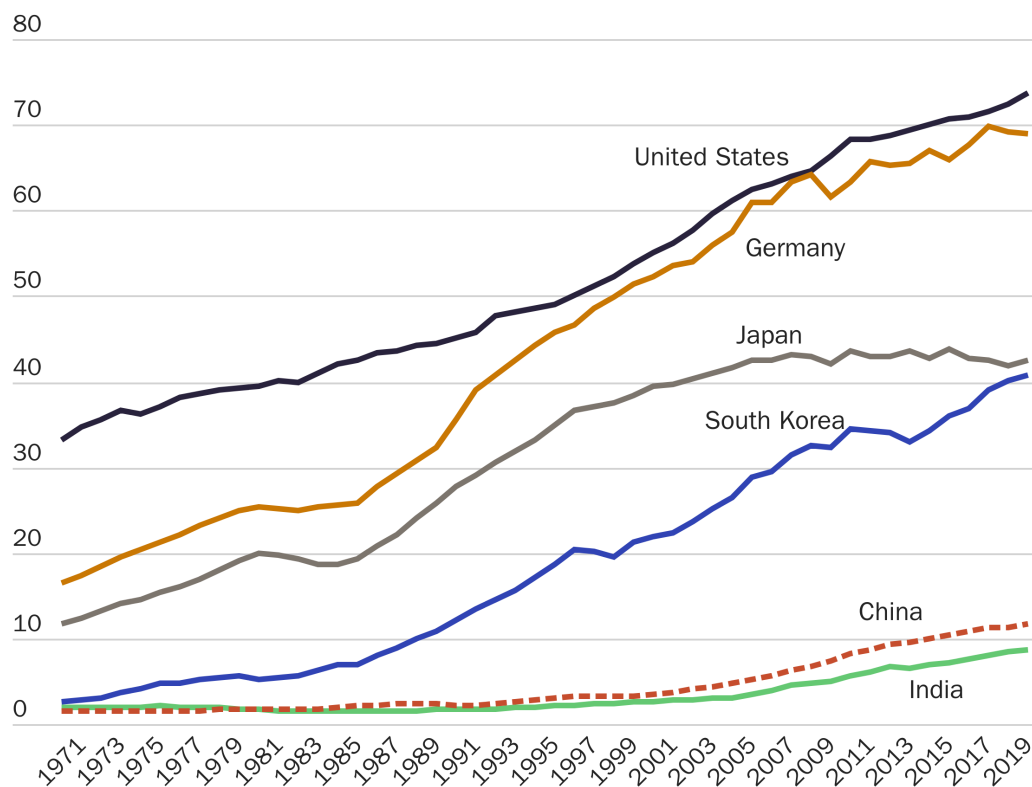
A nation’s **economic growth and global influence** generally stems from two things: the size of its population and the productivity of its workforce. China could thus increase global power by, theoretically, offsetting a declining population with strong productivity growth. In reality, however, productivity is a significant challenge for China’s economy that will increasingly hamper growth unless policies are radically transformed.

Beginning in the late 1970s and early 1980s—shortly after Deng’s market-oriented reforms—China experienced a rapid increase in productivity growth, but much of this was due to **catch-up growth** given that the country had a very low starting point. Indeed, China’s annual productivity growth averaged about 4 percent during this period. Today, however, there is mounting evidence that **productivity growth** is slowing in China—an even sharper decline than worldwide productivity trends (Figure 4).

Figure 4

After decades of growth, China's productivity appears to be stalling

Real GDP per hour worked, in constant 2017 international dollars, PPP



Source: Penn World Table, "Productivity: Output per Hour Worked," Our World in Data.

Notes: GDP = gross domestic product; PPP = purchasing power parity.

What are the primary causes of China's productivity slowdown?

Demographic challenges and brain drain as documented above are certainly contributors. In addition, China's increasing reliance on top-down economic planning (industrial policy) and **state-owned enterprises** (SOEs) is a major contributing factor. It is estimated that China's SOEs are about **20 percent less productive** than private firms operating in the same sector.

This is a relatively new phenomenon. Between 1998 and 2005, the International Monetary Fund (IMF) estimates that the **share of SOEs** in industrial output fell from about 50 percent to about 30 percent and that this "transition coincided with rapid aggregate productivity growth, which came in part from the growth of the private sector at the expense of less productive SOEs." Yet the role of SOEs in China's economy is growing. As the **IMF noted** in early 2023 in its review of China's economy in 2022, "SOEs are being tasked to make advances in strategically important sectors and technologies affected by growing geoeconomic fragmentation, further burdening them with responsibilities." Indeed, the IMF noted in 2022 that "the decline in business dynamism is particularly pronounced in sectors and regions with large SOE presence."

China's shift from economic liberalization toward central planning has also taken a toll on Chinese innovation and productivity. It is estimated that about 70 percent of China's subsidies flow to less productive SOEs, and the **government increasingly subsidizes** non-SOEs—to their detriment. A December 2022 paper found, for example, that between 2007 and 2018, direct government subsidies to companies listed on China's stock exchange increased by about seven-fold—from about \$4 billion to \$29 billion. Examining firm-level data about the relationship between firm productivity and **government subsidies**, authors of the study found that the latter tended to *undermine* the former:

We find little evidence that the Chinese government picks winners—if anything, the evidence suggests that direct subsidies tend to flow to less productive firms rather than more productive firms. In addition, we find that, overall, the receipt of direct government subsidies is negatively correlated with subsequent firm productivity growth over the course of our data window, 2007 to 2018. Even subsidies given out by the government in the name of R&D and innovation promotion or industrial and equipment upgrading do not show any statistically significant evidence of positive effects on subsequent firm productivity growth.

Likewise, a November 2022 National Bureau of Economic Research (NBER) paper found “little statistical evidence of productivity improvement or increases in R&D expenditure, patenting and profitability” of China's major industrial policy program known as “**Made in China 2025**,” which is the crown jewel for Beijing's goal of indigenous innovation and technological supremacy as a bulwark for future economic and military strength. Finally, another NBER paper found that beginning in 2008, China's industrial policy began heavily subsidizing local firms with many patents. As a result, more patents were awarded, but the **quality declined** and led to less innovative firms buying patents to receive subsidies. In total, it was a large welfare loss once accounting for the subsidy cost.

Debt continues to plague both the corporate and government sectors, which hurts growth. As the IMF noted, “Government and household debt-to-GDP ratios are estimated to have increased to new highs of 108 and 62 percent in the second quarter of 2022, respectively, while corporate debt is hovering around a very elevated 125 percent.” The *Wall Street Journal* reported that by June 2022, **debt in China reached** about \$52 trillion, “dwarfing outstanding debt in all other emerging markets combined.” The same story reported that between 2012 and 2022, debt in China grew by \$37 trillion—nearly one and a half times the amount in the United States, a

larger economy. Much of this debt is the result of the massive subsidies China provides on industrial policy projects, the overwhelming majority of which did not create leading-edge companies. In short, Chinese “state capitalism” may have generated a few notable successes in industries like electric vehicles. But as long as Beijing pursues its economic goals through government-influenced SOEs and costly industrial policy, surging debt and sagging productivity will combine with demographic decline to severely hamstring the country’s economic growth—and its global influence.

Conclusion

China’s experiment with market-oriented reforms between about 1980 and 2012 propelled the country to increasing wealth and rising living standards for average citizens. In recent years, Chinese leaders have unfortunately turned back toward illiberalism through heavy-handed state intervention in the economy and repressive human rights practices. These policies are starting to show signs in the data. Since 2011—the last year before Xi Jinping became president—China has seen foreign direct investment drop precipitously as tensions mount between Beijing and the West. In 2011, foreign direct investment was about 4 percent of China’s GDP; today, it’s 1 percent. As economist **Noah Smith** recently noted, foreign direct investment in China from G7 countries declined from \$35.4 billion in 2014 to \$16.3 billion in 2020.

Policies emanating from Beijing are the primary culprit for this decline and will generate more of it in the future—an outcome that would be tremendously unfortunate for not only the hundreds of millions of Chinese people who have yet to escape relative poverty but also for the global economy overall.

But China’s future is not yet written, and Beijing should reverse course again in the years ahead and re-embrace the types of reforms that drove the country’s rapid economic growth in the past. This might not be the most likely future, but it’s the one we should all hope for.

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