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June 28, 2004

Via e-mail: webmaster-support@ita.doc.gov

Ronald Lorentzen
Acting Director, Office of Policy
Import Administration, Room 3713
U.S. Department of Commerce
14th Street and Constitution Ave., NW.
Washington, DC 20230

PUBLIC DOCUMENT

Re: Comments of Stewart and Stewart in Response to the Federal Register Notice of May 27, 2004 regarding the Unfair Trade Practices Task Force

Dear Mr. Lorentzen:

Stewart and Stewart is a law firm located in Washington D.C. focusing on international trade issues. On behalf of Stewart and Stewart, we hereby respond to the request of the Department of Commerce for public comment on the work of the newly established Unfair Trade Practices Task Force. *See Request for Public Comment--Unfair Trade Practices Task Force*, 69 Fed. Reg. 30285 (May 27, 2004). These comments are submitted on Stewart and Stewart's own behalf and do not necessarily reflect the views of clients, present or past.

The Department of Commerce recently established the Unfair Trade Practices Task Force "to pursue the elimination of foreign unfair trade practices that prejudice or adversely affect U.S. commercial interests." 69 Fed. Reg. at 30286. To help the Task Force establish its initial priorities, the Department has asked for assistance in identifying unfair trade practices of greatest concern and impact that are deserving of the Task Force's attention. *Id.* The Department has indicated that it seeks comments "on all types of foreign unfair trade practices, including those practices which currently may not be subject to specific or adequate trade disciplines, as well as comments on the underlying market distortions that may have contributed to or resulted from the practice in question." *Id.* In response to the Department's request, the following comments identify unfair trade practices and underlying market distortions that adversely affect US commercial interest and that the Task Force should examine.

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(1) Border Tax Adjustments

Differences in tax systems, in particular, differences in how countries make border tax adjustments for internal taxes, have caused disadvantages to US companies involved in international trade. In exporting, one primary example of a border tax adjustment is the refund or remission of internal taxes paid on goods that are exported rather than domestically consumed. Typically, such refunded internal taxes are indirect taxes (such as sales taxes and value added taxes) but do not include direct taxes (such as income taxes paid by a company). The GATT 1994 (Articles VI and XVI) permits border adjustments for indirect taxes but not for direct taxes. Because the US government's tax system, in contrast to many other countries' systems, relies primarily on direct taxes rather than indirect taxes, US companies that export have not received the advantage of border tax adjustments that exporters from other countries receive. This disparity prejudices and disadvantages US companies that export. The US has attempted to remedy this disparity but has not succeeded to date.

In the Omnibus Trade and Competitiveness Act of 1988, Section 1101(a)(16), the United States Congress identified "border taxes" as one of the US principal negotiation objectives, stating:

> The principal negotiating objective of the United States regarding border taxes is to obtain a revision of the GATT with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily for revenue on direct taxes rather than indirect taxes.[1]

Although a negotiating objective in the Uruguay Round, the US did not achieve a revision of the GATT regarding border taxes in that round. The problems and disadvantages caused by "border taxes" remain one of the primary obstacles to more balanced trade relations between the US and its major trading partners are our exports are subject to the imposition of border taxes (usually double digit) and face import competition where foreign producers have been refunded their internal indirect taxes. Thus, in the Trade Act of 2002, Congress again identified "border taxes" as a key focus for reform through trade negotiations.

> The principal negotiating objective of the United States regarding border taxes is to obtain a revision of the WTO rules with respect to the treatment of border adjustments for internal taxes to redress the disadvantage to countries relying primarily on direct taxes for revenue rather than indirect taxes.[2]

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[1] Omnibus Trade and Competitiveness Act of 1988, Pub. L. 100-418, Title I, Sec. 1101, Aug. 23, 1988, 102 Stat. 1121; 19 U.S.C. § 2901(b)(16).

[2] Trade Act of 2002, Pub. L. 107-210, Div. B, Title XXI, Sec. 2102, Aug. 6, 2002, 116 Stat. 994; 19 U.S.C. § 3802(b)(15).

In the legislative history to the Trade Act of 2002, Congress explained the problems and disadvantages that US companies experience because of the disparities of tax systems imposed by different countries and consequent border tax adjustments:

> The principal negotiating objective regarding border taxes directs negotiators to seek a revision of WTO rules that will eliminate the current disadvantage to countries, such as the United States, that rely primarily on direct taxes (such as income taxes), rather than indirect taxes (such as sales and value-added taxes), and that tax income on a worldwide rather than a territorial basis. Rulings adopted by the WTO Dispute Settlement Body have found that the WTO Agreement on Subsidies and Countervailing Measures prohibits provisions in the United States Internal Revenue Code that exempt from taxation certain income from export transactions. By contrast, provisions under the laws of other countries that exempt export sales income from indirect taxes or remit to exporters taxes previously imposed might not be prohibited even though they provide similar relief to that afforded by the Internal Revenue Code.
>
> In the matter of United States--Tax Treatment for `Foreign Sales Corporations,' the WTO Appellate Body recognized the sovereign right of every country to set its own taxation rules. At the same time, the Appellate Body reached decisions concerning the Foreign Sales Corporation provisions of the Internal Revenue Code (and, more recently, the Extraterritorial Income Exclusion Act of 2000 provisions) that severely constrain the sovereign right of the United States to set its own rules of taxation for foreign source income earned in export transactions. Under the Appellate Body's interpretations, it would be difficult for the United States, consistent with WTO rules, to maintain its `worldwide' approach to international taxation while ensuring that U.S. producers are not at a competitive disadvantage compared with producers in jurisdictions that take a `territorial' approach to international taxation.
>
> In short, WTO subsidy rules as interpreted by dispute settlement panels and the Appellate Body give rise to a disparity that favors territorial tax jurisdictions over worldwide tax jurisdictions. The view of the Committee is that this disparity must be corrected, in order to preserve the sovereign right of every country to choose its own rules of taxation. Accordingly, the objective on border taxes directs the President to pursue this correction in the recently launched round of WTO negotiations. It is the Committee's expectation that in eliminating the existing disparity, the President will avoid a result that would place U.S. workers and companies now

> benefitting from the Extraterritorial Income Exclusion Act of 2000 at a competitive disadvantage.[3]

In the FSC case referenced by the Senate Report, the WTO Appellate Body found that the US tax exemption provided to US firms on economic activities performed abroad was a prohibited export subsidy. The effect of this decision is to create a systematic bias against US exports in comparison to countries that use indirect taxes which are not collected on exports. Thus, not only is the discrimination in how direct and indirect taxes are adjusted built into the GATT/WTO but the attempt of the US to address this discrimination has been declared a prohibit export subsidy.

Although this issue is not a specific item on the agenda of the Doha Round negotiations, the US has raised the issue in the context of the rules negotiations and discussions about subsidy disciplines. In one paper, the US pointed out that different tax systems have a distorting effect and create unfair disadvantages:

> The Subsidies Agreement disciplines direct and indirect taxes differently. Under the existing Agreement, it is more likely that direct tax concessions related to export activity will be found to be export subsidies, and therefore inconsistent with the Agreement, than would export-related concessions on the payment of indirect taxes. The United States recognizes that this distinction has existed in the GATT/WTO subsidy rules for some time. Nonetheless, the United States believes that an essential part of the work of the Rules Group should be to work toward greater equalization in the treatment of various tax systems that, at least with regard to their subsidy-like effects, have only superficial differences. The current distinction risks ignoring the potential trade-distorting effect that certain practices involving indirect taxes may have on trade, and may unfairly disadvantage competitors operating under a direct taxation system.[4]

Moreover, in its recent report, *Manufacturing in America,* the Department of Commerce said that, in future negotiations, the US "should pursue the elimination of the border adjustability of indirect taxes to address the disadvantages to countries relying primarily on direct taxes."[5]

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3 Senate Report 107-139, 107th Cong., 2d Sess. 35-36 (2002) (emphasis added).

4 *Subsidies Disciplines Requiring Clarification and Improvement*, Communication from the United States, TN/RL/W/78 (19 March 2003) at 4.

5 U.S. Dept. of Commerce, *Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers* (January 2004) at 76.

In order to correct the evident disadvantages to US exporters, the US should (1) support amending Article 3.1(a) of the SCM Agreement or Annex I to the SCM Agreement under item (e) of the Illustrative List of Export Subsidies to clarify that the rebate or exemption of direct taxes on foreign-source or extraterritorial income (as defined under US law) is not an export subsidy, and (2) support a revision of the GATT 1994 with respect to the treatment of border adjustments for internal taxes so as to equalize the treatment accorded direct and indirect taxes.

(2) Currency Manipulation

The practice of currency manipulation is a serious market distortion that the Task Force should examine. Indeed, in the report, *Manufacturing in America*, the Department observes that, in roundtables conducted with US manufacturers:

> participants raised the issue of exchange rates, in particular China's peg of its currency, the yuan, to the dollar. Many manufacturers expressed concern that exchange rates with a number of trading partners are set by government intervention rather than market forces, leading to lower U.S. exports and stronger import competition. American manufacturers pressed for the market to set the terms of competition, not governments.[6]

The setting of exchange rates by governments by pegging their rate to the US dollar and the intervention of foreign governments in the currency market to maintain their exchange rates at a set level is a cause of significant trade problems for US manufacturers and exporters. Currency misalignment creates trade distortions because it results in misallocation of economic resources and undermines stability. Undervalued currencies, in particular, produce false market signals -- making it appear that industries in the country with an undervalued currency are more competitive than they actually are, leading to overexpansion of production and export flooding in particular products. For instance, since 1994, China has pegged its currency exchange rate at 8.28 yuan to the dollar. As has been detailed by various economists and by the Fair Currency Alliance, the current valuation of the yuan is significantly undervalued. As a result, Chinese goods compete domestically and internationally at prices that are artificially low hurting US producers in the US market, in the Chinese market and in third country markets.

While, at present, China has been particularly singled out as a country with an undervalued currency that has had substantial negative effects on trade, other countries have also engaged in similar behavior (for example, Japan, South Korea, and Taiwan). In recent years, China, as well as Japan, South Korea and Taiwan, have made massive purchases of US dollars to maintain their exchange rates or minimize the appreciation of their currencies.[7] Together, these

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[6] U.S. Dept. of Commerce, *Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers* (January 2004) at 52.

[7] China more than doubled its purchases of US dollars from $165.6 billion in 2002 to $356.5 billion in July 2003 with at least 30 percent (or $70.1 billion) of that increase occurring in 2003. To compete with the low yuan,

four countries account for about 60% of the US trade deficit, and hold $1.2 trillion of official reserves, with at least a $188.4 billion increase since 2002.[8]

The effects of currency manipulation on the US economy have been staggering. Shipments of manufactured goods fell by $270 billion from 2000, and 2.8 million factory jobs have been lost.[9] Economists have estimated that the Chinese currency is undervalued by as much as 40% or more[10] and that the effect of undervaluation by the four countries is that the US trade deficit is about $100 billion larger than it would otherwise be.[11]

The current concern about China's undervalued currency and its effects on US manufacturing and increased imports has led to a number of proposals in Congress to address this problem. One bill, for example, introduced by Senator Schumer, would impose a 27.5% additional rate of duty on Chinese imports.

Currency manipulation is not defined in the International Monetary Fund Agreement or under IMF or US law. Clarification by the US in its existing laws and by the IMF would be helpful to move trading partners more quickly to sustainable currency policies. As the Administration is aware, there are potential WTO and IMF remedies available to address the problem. While the US is engaged bilaterally with China to obtain a floating currency in China, the needs of many sectors of the US economy for a restoration of economic rationality in the value of the Chinese currency cannot await the likely years of internal reforms needed for a float to be achieved. A revaluation of the yuan by 40% is needed now. The Task Force should ensure that this acknowledged problem is tackled with the urgency the ballooning trade deficit with

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Japan, Taiwan, and Korea have likewise intervened in the currency market by increasing their purchases in 2001 and 2002.

Treasury reported that Japan's intervention in the currency market the first half of 2003 totaled $59 billion with an additional $22.7 billion in July and August. *See* US Dept. of Treasury, *Report to Congress on International Economic and Exchange Rate Policies* (JS-954) at 9 (October 30, 2003).

With respect to Taiwan, in 2002 Treasury concluded: "Taiwan's monetary authorities exert a strong influence on the foreign exchange market through heavy and frequent intervention, the use of various capital controls and close monitoring of trading." *See* US Dept. of Treasury, *Report to Congress on International Economic and Exchange Rate Policies, Reporting Period: July 1, 2000 through December 31, 2000.*

8 *See* Testimony of Franklin J. Vargo, National Association of Manufacturers, before the Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of the House Committee on Financial Services, *Hearing on China's Exchange Rate Regime and Its Effects on the U.S. Economy* at 2, 5 (October 1, 2003).

9 *See* Testimony of Franklin J. Vargo, National Association of Manufacturers, before the House Committee on International Relations*, Hearing on U.S.-China Ties: Reassessing the Economic Relationship* at 2 (October 21, 2003).

10 *See* Testimony of Franklin J. Vargo, National Association of Manufacturers, before the House Committee on International Relations*, Hearing on U.S.-China Ties: Reassessing the Economic Relationship* at 4 (October 21, 2003).

11 *See Chinese Currency Manipulation and the U.S. Trade Deficit*, Statement Before the U.S.-China Economic and Security Review Commission by Ernest H. Preeg, Senior Fellow in Trade and Productivity, Manufacturers Alliance/MAPI (September 25, 2003).

China indicates is warranted.[12] It is also important that the US work with other trading partners, including Japan, Korea and Taiwan to ensure a restoration of exchange rate equilibrium for their currencies vis-à-vis the US. dollar.

(3) Government Procurement

Government procurement is an area where US commercial interests often face disadvantages as the result of unfair practices. These can occur with countries that are signatories to the WTO Government Procurement Agreement as well as with countries that are not signatories. Only a limited number of countries have signed on to the WTO Government Procurement Agreement.[13] At present, thirteen countries (counting the EU as one) are signatories, nine are currently negotiating their accession and nineteen are observers.[14] Those numbers indicate that there is potentially a large amount of government procurement trade that is not subject to the GPA and thus potentially results in trade distortions. Given the multitude of countries that are not members of the GPA, but are considered US trading partners, government procurement is an area that warrants the Task Force's attention.

Among the members and observers of the GPA, an unfair trade practice can result when a country fails to meet its GPA obligations. For example, according to the USTR's 2004 NTE report, "Canada has not yet opened 'sub-central' government procurement markets (i.e., procurement by provincial governments), despite commitments in the GPA to do so no later than July 1997. Some Canadian provinces maintain 'Buy Canada' price preferences and other discriminatory procurement policies that favor Canadian suppliers over US and other foreign suppliers."[15] Obviously, major trading partners should comply with the GPA commitments already made to the US.

Other examples of unfair practices in the government procurement area are illustrated by Brazil and India, neither of whom is a signatory to the GPA. USTR has noted respecting Brazil

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[12] The Fair Currency Alliance, a group of trade associations and unions representing manufacturing, agriculture and labor, prepared a "Section 301 Petition" to address the problem of Chinese currency manipulation but has not filed the petition with USTR. *See Fair Currency Alliance Says China Understating Global Trade Surplus*, INSIDE US-CHINA TRADE (June 16, 2004) ("Zoellick and other cabinet officials said in late April that they would reject a Section 301 petition on China's currency policies if it were filed. However, the Alliance has said it might still file the petition, and will monitor the Bush Administration's progress on the issue over the summer before deciding how to proceed.").

[13] The following countries are parties to the WTO Agreement on Government Procurement (GPA): Canada, European Communities (including its 25 member States: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxemburg, Malta, Netherlands, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, United Kingdom), Hong Kong China, Iceland, Israel, Japan, Korea, Liechtenstein, Netherlands with respect to Aruba, Norway, Singapore, Switzerland, and the United States. *See* World Trade Organization, *Committee on Government Procurement*, *available at* http://www.wto.org/english/tratop_e/gproc_e/memobs_e.htm.

[14] World Trade Organization, *Committee on Government Procurement; available at* http://www.wto.org/english/tratop_e/gproc_e/memobs_e.htm.

[15] USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at 47.

that it has retained limitations on foreign capital participation in procurement bids that reportedly can "impair access for potential service providers in the energy and construction sectors."[16] The USTR's 2004 NTE report further noted the following regarding public procurement regulations in Brazil:

> Although Law 8666 of 1993, which covers most government procurement other than informatics and telecommunications, requires nondiscriminatory treatment for all bidders regardless of the nationality or origin of product or service, the law's implementing regulations allow consideration of non-price factors giving preferences to certain goods produced in Brazil and stipulating local content requirements for eligibility for fiscal benefits. Decree 1070 of March 1994, which regulates the procurement of information technology goods and services, requires federal agencies and parastatal entities to give preference to locally produced computer products based on a complicated and nontransparent price/technology matrix.[17]

India presents another example where government procurement practices are disadvantageous to US commercial interests. India is not a signatory to the GPA and has no bilateral government procurement agreements with the United States. According to the 2004 NTE report, "Indian government procurement practices and procedures are neither transparent nor standardized. Foreign firms do not generally win Indian government contracts."[18]

(4) Investment Restrictions/Requirements

Unfair trade practices can often take the form of investment restrictions and investment requirements by foreign countries. Barriers to investment may include unfair requirements concerning local content and trade balancing requirements (both prohibited by the WTO Agreement on Trade Related Investment Measures {TRIMS}), inconsistently enforced laws, inaccessibility to global markets for foreign invested enterprises, corruption, and strict guidelines or even prohibitions regarding foreign investment, particularly with respect to forced technology transfers. The Task Force should be aware of, monitor, and address these types of practices as necessary. Examples of investment restrictions include:

- *Local Content Requirements*

A recent report regarding Russia's barriers to investment indicates that local content requirements in the automobile industry have been problematic, as investment incentives are only provided for large investments that meet local content requirements. This practice has

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16 *Id.* at 21.

17 *Id.* at 21.

18 *Id.* at 217.

been found to negatively impact US investors who have consequently faced "difficulty in obtaining relief promised by the Russian Government from local content requirements and for special customs treatment."[19] Hopefully, these issues will be addressed as part of the Russian Federation's WTO accession process. However, as the Administration is aware, WTO accession is not a guarantee that TRIMs violations will be eliminated. For example, despite China's commitment to eliminate local content restrictions pursuant to its obligations under TRIMS, US companies reported that some Chinese officials in 2003 continued to base their decisions on this factor.[20]

- *Unfair Investment Laws and Regulations*

Another serious barrier to investment is foreign countries' inconsistent application and enforcement of investment laws that disadvantage US investors. For example, the investment licensing process in Vietnam has been "characterized by stringent and time consuming requirements that are frequently used to protect domestic interests, limit competition, and allocate foreign investment rights among various countries."[21] Moreover, Vietnam imposes a number of restrictions on foreign investment such as limiting the ratio of foreign shareholding in Vietnamese companies.[22] Similarly, India maintains several investment laws, *e.g.*, local shareholding regulations, which vary across different industries, are "frequently changed," and are not always transparent.[23] And, China entirely prohibits investment in certain sectors, such as the news media, television, films, the production of arms and the mining and processing of certain minerals.[24]

- *Inaccessibility to Capital Markets*

In China, foreign-invested enterprises are prohibited from accessing domestic or international stock markets, selling corporate bonds, accepting venture capital investment, or selling equity.[25] To this end, it is reported that China "maintains strict controls over the inward and outward flows of capital accounts – money used for investment."[26]

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[19] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 415 (Russia).

[20] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 87 (China).

[21] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 500 (Vietnam).

[22] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 500 (Vietnam).

[23] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 224 (India).

[24] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 88 (China).

[25] *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 88 (China).

[26] *See U.S. and China Take Small Steps on Trade*, NEW YORK TIMES (June 25, 2004).

- *Technology Transfer*

In some instances, the ability of US companies to conduct business in countries such as China or Vietnam is conditioned on the transfer of technology.[27] For example, the June 2004 U.S.-China Commission ("Commission") Report submitted to Congress highlighted forced technology transfer as an "enduring US security concern as well as a violation of China's WTO agreement."[28] The Commission recommended that the USTR and the Department of Commerce "undertake immediately a comprehensive investigation" of, *inter alia,* investment conditions in China requiring technology transfers, and that when this practice occurs, a complaint should be filed with the WTO.[29]

(5) Subsidies and State-owned/State-invested Enterprises

It is well-recognized that the "use of trade-distorting subsidies by foreign governments can seriously threaten the interests of American workers and industries."[30] Accordingly, the US Government has stated that it "is committed to eliminating or neutralizing the unfair trade practices which harm U.S. interests."[31] The Task Force should therefore address how subsidies and the operation of state-owned or state-invested enterprises distort the market and cause unfair disadvantages to US commercial interests.

A prime user of subsidies to support its manufacturers is China. In particular, China often provides subsidies to state-owned enterprises (SOEs) that grossly distort market competition and put US manufacturers at a distinct disadvantageous position.

In China, heavy subsidization persists despite China's commitment to phase out a number of subsidy programs as part of its WTO accession agreement, including subsidies provided to SOEs running at a loss, giving priority in obtaining loans and foreign currencies based on export performance (to promote auto exports), and preferential tariff rates based on the localization rate of automotive production (to promote local production of autos).[32] The National Association of Manufacturers stated in testimony before Congress:

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27 *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 87 (China) and p. 500 (Vietnam).

28 *See* 2004 Report to Congress of the U.S.-China Economic and Security Review Commission at 17, 61 (June 2004).

29 *Id.* at 17, 53.

30 USTR and Dept. of Commerce, *Subsidies Enforcement Annual Report to the Congress* (February 2004) at 1.

31 *Id.*

32 *See* Protocol of Accession, WT/L/432 (23 November 2001) at Annex 5B (Subsidies to be Phased Out). China also committed to notify all of its subsidies that are included within the meaning of Article 1 of the WTO Agreement on Subsidies and Countervailing Measures (SCM), but, so far, has not complied.

> We continue to receive reports from different industries that Chinese products are being sold in the United States at prices so low that they could not even cover the cost of raw materials and shipping much less full production and marketing costs. These reports suggest the possibility of widespread use of subsidies, either direct or indirect, to help Chinese exporters gain a competitive advantage in the US market.[33]

In addition to China, the US Government has taken note of the use of potentially unfair subsidies by other countries. For example, the 2004 Subsidies Enforcement Report states that the US is monitoring the following subsidies for adverse effects to US industries:

- subsidies provided to the fertilizer industry in India[34]
- subsidies provided to the paper industry in South Korea[35]
- subsidies provided to the steel sector in Poland[36]
- subsidies provided to the aerospace industry in Canada[37]

The support of state-owned enterprises continues to be an unfair trade practice by governments, particularly China. This point was acknowledged recently when, during a teleconference concerning the work of this Task Force, a senior US trade official said that:

> an example of an unfair trade practice that cannot be clearly classified as either subsidy or dumping is the practice in China of providing state-owned companies with loans from state-owned banks, with the understanding that these loans do not necessarily need to be paid back. When the cost of capital to those companies essentially amounts to zero, U.S. manufacturers cannot compete with them on the same basis, the official said. "And this happens in a variety of different settings around the world, it's not just China," he said.[38]

Significant parts of the Chinese economy remain state-owned or state-invested, and a recent article in the Economist observed that state-owned enterprises (SOEs) in China are still dominant economic entities.

> The contrast between old and new in the state sector is at its starkest in China's north-eastern “rustbelt”, where state-owned enterprises (SOEs)

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[33] *See* Testimony of Franklin J. Vargo, National Association of Manufacturers, before the House Committee on International Relations, *Hearing on US-China Ties: Reassessing the Economic Relationship*, October 21, 2003.

[34] USTR and Dept. of Commerce, *Subsidies Enforcement Annual Report to the Congress* (February 2004) at 34.

[35] *Id.* at 43.

[36] *Id.* at 43-44.

[37] *Id.* at 44-45.

[38] Embassy of the United States, Japan, Issues Notice, *U.S. Urges Stronger Enforcement of Trade Obligations*, *available at* http://japan.usembassy.gov/e/p/tp-20040120-13.html.

> generate 70% of GDP. * * * In 2002, the state controlled half of industrial output, and SOEs still account for 35% of urban employment, despite having halved their workforce in the past 12 years. Virtually all of China's heavy industry and much of its technology is in state hands. Half of all bank loans go to SOEs. This crowds out the private sector, China's growth engine, and threatens the entire financial system, because most of those loans will never be repaid.[39]

Government support of non-performing SOEs is an unfair trade practice that disadvantages US manufacturers that must compete with these SOES. Indeed, a recent press report indicated that the China Commission for Supervision and Management of State-owned Properties had allocated 49.3 billion yuan as SOE bankruptcy subsidies and allowed state-owned banks to write off a total of 223.8 billion yuan of bad loans caused by the bankruptcies of SOEs.[40]

(6) Enforcement of Intellectual Property Rights

The area of intellectual property rights has been a fertile ground for unfair trade practices and merits the close attention of the Task Force. Protection and enforcement of intellectual property rights enforcement has been a focus of the US government's attention. In the 2004 "Special 301" annual review of intellectual property protections, the USTR examined efforts undertaken by approximately 85 countries.[41] USTR found that counterfeiting and piracy of trademarked and copyrighted products is rampant, with the report addressing "significant concerns with respect to such trading partners as Argentina, The Bahamas, Brazil, Egypt, India, Indonesia, Israel, Korea, Kuwait, Lebanon, Pakistan, Paraguay, The Philippines, Poland, Russia, Taiwan, Thailand, and Turkey."[42]

The Special 301 report emphasized that the "weak IPR protection and enforcement in China is one of the Administration's top priorities."[43] For example, counterfeiting of US pharmaceuticals and many other products has been rampant in China, causing harm to American manufacturers and putting health and safety at risk.[44] USTR has been pushing China to "price

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[39] *We are the champions*, THE ECONOMIST, March 20, 2004.

[40] *China to Bail out Last Group of Money-Losing SOEs*, CHINA DAILY (June 21, 2004). The Commission report also showed that by April 2004, China had closed 3,377 insolvent SOEs through administrative intervention and resettled 6.2 million employees. *Id.*

[41] USTR, 2004 SPECIAL 301 REPORT, at 1 (Executive Summary) (May 1, 2003); *available at* http://www.ustr.gov/reports/2004-301/fullreport.pdf.

[42] *Id.*

[43] *Id.*

[44] Testimony of Deputy U.S. Trade Representative Josette Sheeran Shiner before the Committee on Finance Subcommittees on Health Care and International Trade United States Senate (April 27, 2004); *available at* http://www.ustr.gov/speech-test/assistant/2004-04-27-shiner.pdf.

innovative drugs fairly and to add new drugs to its national formulary, which controls access to medicines for China's nearly 1.3 billion people and currently contains no medicines produced after 1998."[45] Deputy USTR Shiner reported that April 2004 discussions between US Trade Representative Robert Zoellick and China's new Commerce Minister Bo Xilai led to a number of agreements.

> ...China agreed to delay onerous new pricing decisions planned for certain innovative drugs and to update its national formulary. At a subsequent meeting of the U.S.-China Joint Commission on Commerce and Trade (JCCT), China also committed to a range of improvements to its IPR enforcement regime aimed at substantially reducing IPR infringement levels. Those commitments included: applying criminal sanctions to a greater range of IPR violations – from on-line piracy to the import, export, storage and distribution of pirated and counterfeit goods; conducting nation-wide enforcement actions against piracy and counterfeiting; launching a national campaign to educate its citizens about the importance of IPR protection; and establishing a U.S.-China IPR working to consult and cooperate on IPR matters.[46]

In the 2004 report, "USTR devotes special attention to the increasingly important issue of the need for significantly improved enforcement against counterfeiting and piracy, with particular emphasis on the ongoing campaign to reduce production of unauthorized copies of 'optical media' products such as CDs, VCDs, DVDs, and CD-ROMs. Counterfeiting of trademarked goods is an increasing problem in many countries, including Brazil, Bulgaria, India, Indonesia, Lebanon, Mexico, Pakistan, Paraguay, The Philippines, Russia, Venezuela, and Vietnam." As USTR notes, the issue in these and other countries ultimately is whether the foreign government has the political will to effectively address piracy and counterfeiting.

The issue of IPR relating to pharmaceuticals and health policy has consistently received the USTR's attention; however, serious problems with enforcement remain and have a serious impact on the US industry. As Deputy USTR Shiner reported to the Senate Finance Committee, "[d]eveloping groundbreaking medicines and other innovative products depends largely on two factors – regulatory regimes that encourage the introduction of new products, and strong and effective intellectual property rights (IPR) protections and enforcement. Innovation thrives in the United States because of our fertile economic environment – an environment that encourages the flow of capital to the most productive uses and ensures that novel ideas are granted strong

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[45] *Id.*

[46] Testimony of Deputy U.S. Trade Representative Josette Sheeran Shiner before the Committee on Finance Subcommittees on Health Care and International Trade United States Senate (April 27, 2004); *available at* http://www.ustr.gov/speech-test/assistant/2004-04-27-shiner.pdf

IPR protections."47 Those protections are not world-wide. USTR Zoellick recognized "that the trade challenges facing pharmaceuticals firms – like so many others – cut across a number of key functional and geographic areas – from tariffs and non-tariff barriers to IPR and services, and from Asia and Australia to Europe and North America" through the creation of a new Assistant USTR for Pharmaceutical Policy.48

Decreasing the violation of intellectual property rights involves engaging both developed and developing countries. Regarding the latter, the USTR's report found that during 2004, "many developing countries and newly acceding WTO Members made progress toward implementing TRIPS obligations."[49] However, certain countries have yet to fully implement the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement), "particularly with respect to the Agreement's enforcement provisions."[50]

While the commitments obtained from China and other countries are significant, it is vital that the USTR closely monitor implementation of the TRIPS Agreement. As the Department noted in its report *Manufacturing in America*, the importance of IPR enforcement to US manufacturers cannot be understated:

> For U.S. manufacturers, protection of intellectual property is not an abstract concept. America's competitive edge ensues directly from innovation and rising productivity. Intellectual property protection is the best means for ensuring that American manufacturers enjoy the benefits of their investments in research and development and of their efforts to raise productivity. It is also the means best calculated to ensure that they can enjoy the investment they make in customer service and creating a brand name that distinguishes them from other manufacturers.[51]

(7) Private Sector Cross-Subsidization

One type of unfair trade practice that is not adequately addressed by trade remedy laws is that of company cross-subsidization. Typically, cross-subsidization occurs when a company

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47 Testimony of Deputy U.S. Trade Representative Josette Sheeran Shiner before the Committee on Finance Subcommittees on Health Care and International Trade United States Senate (April 27, 2004); *available at* http://www.ustr.gov/speech-test/assistant/2004-04-27-shiner.pdf

48 Testimony of Deputy U.S. Trade Representative Josette Sheeran Shiner before the Committee on Finance Subcommittees on Health Care and International Trade United States Senate (April 27, 2004); *available at* http://www.ustr.gov/speech-test/assistant/2004-04-27-shiner.pdf

49 USTR, 2004 SPECIAL 301 REPORT, at p. 2, Executive Summary (May 2004); *available at* http://www.ustr.gov/reports/2004-301/fullreport.pdf.

50 *Id.*

51 US Dept. of Commerce, *Manufacturing in America: A Comprehensive Strategy to Address the Challenges to U.S. Manufacturers* (January 2004) at 54.

uses profits generated from one product or service to support another product or service that is not otherwise profitable. This practice distorts the market as it gives rise to false economic signals. In international trade, many US businesses face competition with foreign competitors that engage in cross-subsidization. This practice is unfair in that US companies that are economically efficient are forced to compete with foreign companies that are not economically efficient and would not be competitive but for the cross-subsidization.

Cross-subsidization also facilitates the dumping of goods, as a company or group of companies will use high prices and profits on one product to subsidize low prices on another product, which allows them to sell the uncompetitive product below cost over time. The false market signals that result from private sector cross-subsidization drive economically-efficient companies from the market for reasons other than economic efficiency.

Historically, as the Department well knows, many manufacturing industries – including steel, semiconductors, bearings, consumer electronics and many other industries -- have experienced the problems that result from competing with imported products that are sold below cost. Where selling prices are depressed below cost over time, the result is predictable -- companies, even if the most economically efficient at the commencement of increased competition, are forced to exit or lose competitiveness because of the lack of reasonable return on assets deployed.[52]

US trade laws do not provide an adequate remedy to the problem of cross-subsidization when it affects foreign markets (US dumping law does provide a remedy when imports are being sold below full cost of production). The Task Force should monitor trade data of major foreign competitor nations to identify product sectors where cross-subsidization may be a problem and work with trading partners to address these problems under domestic laws or through expanded remedies within the WTO

(8) Anticompetitive Conduct

Anti-competitive business practices that distort and restrict trade pose serious unfair trade barriers for many US exporters. Such practices can take a variety of forms, including formal and informal cartels as well as many other practices that distort global commerce.

Cartels, for example, reduce accessibility to markets and weaken competition. Consider the following description of an export cartel:

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[52] Cross-subsidization also adversely affects services industries, such as express delivery services and telecom. For example, in the telecom industry in Japan, "current interconnection policies, unless changed, may permit NTT East and West to use their market power to dominate the voice market and cross-subsidize its services in the data market." US Embassy, Tokyo, Japan, *Comments of the United States Government on the "e-Japan Strategy II (Draft)" Issued by the IT Strategic Headquarters* (June 12, 2003); *available at* http://japan.usembassy.gov/e/p/tp-20030618d2.html.

> Export cartels are generally considered to be arrangements between firms which have substituted an agreement on prices, output or related matters for independent decision-making in relation to goods or services to be exported to foreign markets. As this definition implies, not all co-operative arrangements among export firms are considered to be export cartels, but only those which seek to restrain competition through cartel-like behaviour.[53]

A number of industries have a history of international cartel practices. For example, in the steel industry in Japan, the Department of Commerce reported that cartels and cartel-like structures have served to insulate the domestic market from competition and have encouraged capacity increases.[54] Similarly, the US has raised concerns about cartels in Korea and Pakistan (cement and sugar, respectively) and their impact on global trade.[55]

Cartels do more than just restrain competitive behavior; they can also often result in dumping as cartels have the ability to lower the export price versus the price charged in the home market.[56] Further, cartels can act in a coercive manner when cartel companies boycott or threaten customers who procure imports, or participate in bid-rigging.[57]

The imposition of export controls on raw materials is another anticompetitive practice that is of growing concern. These types of restrictions have been particularly harmful to the steel industry recently, as countries like China have imposed export controls on coke in order to protect the supply available to their domestic steel producers. A May 24, 2004 Chinese press release reported that "China will scrap tax rebates for coke and coking coal starting from today to further lessen exports," which is expected to raise international prices for coke.[58]

The imposition of export controls is not limited to China, however. For example, Venezuela also recently set export controls on steel scrap, and Argentina decided to "temporarily retain 40 percent of scrap export revenue."[59] Further, South Korea, Russia, Belarus, and the

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53 *See* Organization of Economic Cooperation and Development (OECD), *Competition and Trade Policies – Their Interaction*, at 11 (1984).

54 *See Report to the President: Global Steel Trade*, International Trade Administration, U.S. Department of Commerce at 71-72 (July 2000). Although steel industry observers have found that government-sponsored cartels in Japan are virtually non-existent, more recent accounts of industry cooperation indicate that these less formal associations may work in the same manner as formal cartels. *Id.* at 72.

55 *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 330 (Korea) and p. 365 (Pakistan).

56 *See* Greg Mastel, *Keep Anti-Dumping Laws Intact,* JOURNAL OF COMMERCE (1999); *available at* http://www.newamerica.net/index.cfm?pg=article&pubID=321.

57 *See* USTR, 2004 NATIONAL TRADE ESTIMATE ON FOREIGN TRADE BARRIERS, at p. 252 (Japan).

58 *See Gov't Warns of Overheating in Coke Industry*, CHINA DAILY (May 24, 2004) (explaining that China cut its export quota on coke to 9 million tons in 2004, down from 12 million in 2003); *available at* http://www.chinadaily.com.cn/english/doc/2004-05/24/content_333142.htm.

59 *See Colombia Trade Group Lobbies for Scrap Controls*, AMERICAN METAL MARKET (Feb. 27, 2004).

Ukraine[60] maintain or are planning similar measures on raw materials for steel, and Thailand restricts its exports on agricultural exports such as rice and sugar.[61] These measures serve to restrict the flow of raw materials and artificially inflate prices outside of the exporting country. This has had a negative impact on US producers' ability to compete, particularly since the US does not maintain equivalent restrictions.

In light of the foregoing, it is critical that the Task Force address anti-competitive activity that results in the types of trade distortions and barriers discussed above through close monitoring and, where possible, in multilateral and bilateral fora.

(9) Structural Excess Global Capacity

Excess global capacity in industries such as steel and semiconductors is not only an underlying market distortion, but is also a catalyst for unfair trade practices.

Excess capacity often results from the failure to shut down inefficient facilities, and from the continued subsidization of certain industries despite weakened demand. A frequent result of overcapacity is the erosion of prices and an increase in unfair trade practices, such as dumping, where companies "dump" excess inventories in other markets in classic beggar-thy-neighbor conduct.

In the steel industry in particular, excess global capacity was a major contributor to the import surges that caused serious injury to the US steel industry from 1998 through 2002, the negative effects of which are still ongoing. In response to the steel crisis, the OECD facilitated discussions between government officials from major steel producing economies as well as industry representatives regarding the elimination of inefficient overcapacity and the restructuring of the steel sector. The Administration's efforts to address the underlying problem facing US steel producers through working with trading partners to address the massive excess capacity and increase disciplines on subsidies to the sector have been much appreciated, although efforts by trading partners to exclude themselves from solving the global problem or to maintain large subsidy sources has resulted in no meaningful breakthroughs as yet. A comprehensive set of disciplines and removal of existing excess capacity from other producing nations remains a critical objective for the US steel industry. Because similar problems exist in other important sectors (e.g., semiconductors), the Task Force should also examine whether multilateral rules are needed to address structural excess capacity problems in a comprehensive manner.[62]

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[60] *See S. Korea Plans to Restrict Steel Scrap Exports*, AMERICAN METAL MARKET (Mar. 5, 2004).

[61] *See* Department of Export Promotion: Thailand; *available at* http://www.asiatradehub.com/thailand/trade.asp.

[62] For example, in East Asia, overcapacity in the automobile and semiconductor industry has also led to global price depression and market distortions that have negatively impacted US manufacturers. *See iSuppli Updates Semiconductor Outlook: Soft Landing, Stable Market and New Growth in 2007*, Research News: Semiconductors (June 18, 2004); *available at* http://www.tekrati.com/T2/Analyst_Research/ResearchAnnouncementsDetails.asp?Newsid=2966 (noting how overcapacity resulted in the grave downturn in the semiconductor industry in 2001).

(10) <u>Trade Rules That Treat All Developing Countries the Same for Most S&D Provisions</u>

The Task Force should address the market distortions and disadvantages to US commercial interests caused by treating all developing countries similarly. Under the GATT 1994 and provisions in various WTO Agreements, developing countries are entitled to certain "special and differential" treatment. This can range from exemptions from certain obligations to lesser standards than those applied to developed countries to longer phase-in periods for implementation of obligations. The purpose of the S&D provisions is, presumably, to assist developing countries to compete as they develop their economies so that the benefits of expanded trade accrue to all WTO members. Certainly, providing special rules for the least developed countries makes economic sense and has been broadly supported. Since the WTO generally does not differentiate between developing countries (other than some special rules for least developed countries) and because classification as a developing country is a matter of self-selection, there are many distortions in global commerce that flow from S&D being provided to countries or to certain sectors in a country where there is no legitimate economic rationale for the disparate treatment. The Task Force should review ways in which countries can be graduated from S&D treatment in toto or in particular sectors.

The need for such differentiation in treatment has been recognized by the Administration. For example, in recent testimony before the Senate Finance Committee, USTR Zoellick indicated that it was unfair for competitive developing countries to benefit from S&D treatment provided to needy and non-competitive developing countries. As reported:

> U.S. Trade Representative Robert Zoellick says that more competitive developing countries such as India, China and Brazil have to open their markets in order to sustain support for open markets in the United States and elsewhere.
>
> "If countries around the world that are emerging economic powers want to get the benefit of the system, they're going to have to contribute to the system," Zoellick said in March 9 testimony before the Senate Finance Committee.
>
> * * *
>
> He added that more competitive developing countries such as Brazil and Argentina should not expect to get the same kind of special and differential treatment -- such as longer implementation schedules -- as the poorest countries get in agriculture and other sectors.

> "So that's how we're going to have to strike the balance" on special and differential treatment in the WTO, he said -- "for those that are truly in need versus those that are competitive."[63]

(11) Lack of Harmonization in Health and Safety Standards

The US and other developed countries maintain relatively high standards regarding food safety, pesticides, pharmaceuticals, worker safety, etc. in comparison to standards applied by developing countries. Harmonization is a term that describes international efforts to reconcile differences in individual countries' domestic health, safety and environmental standards and regulatory policies. While there is a need to harmonize standards among major producing countries, and some countries may need more time than others, the lack of international harmonization in areas such as health and safety standards and workplace safety should not be allowed to create artificial disadvantages to those who apply higher standards.

For example, with respect to agricultural products, many pesticides that are banned in the US are used in other countries. This difference should not be permitted to create a false economic advantage to those countries applying lower pesticide standards and the US agricultural and horticultural industries should not be disadvantaged as a result of lack of harmonization. Another example would be workplace safety standards. Countries with lower workplace standards should not benefit from the false advantage provided by lower workplace standards.

The Task Force should address how efforts can be made to bring about harmonization of health and safety standards with a recognition that some countries may need more time to adapt and improve their standards and may need technical assistance in doing so. But, shifting trade flows that result from the disparity in standards applied by developed and developing countries should not be allowed as the consequence of responsible conduct by developed countries with respect to health and safety standards.

[63] Bruce Odessey, *USTR Warns Bigger Developing Countries to Open Markets*, US Dept. of State International Information Programs, March 9, 2004; *available at* http://usinfo.state.gov/ei/Archive/2004/Mar/09-953606.html.

Stewart and Stewart appreciates the opportunity to provide the foregoing views and comments regarding foreign unfair trade practices and underlying market distortions that it believes cause major disadvantages to the commercial interests of US manufacturers and exporters.

Respectfully submitted,

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