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It's Time to Dump Nonmarket Economy Treatment

by K. William Watson

Trade officials in the United States and Europe use what is called "nonmarket economy methodology" in antidumping cases against imports from China. That practice ignores the actual prices used by Chinese producers and results in unpredictable and unrealistically high antidumping duties.

The use of nonmarket economy methodology is quite rightly prohibited by global trade rules at the World Trade Organization (WTO). But, when China joined the WTO in 2001, it agreed to a 15-year transitional period during which other members would be allowed to use the methodology. The transitional period ends on December 11, 2016.

As that deadline approaches, it is not clear whether the United States and the European Union will honor their new WTO obligation. Some industry representatives and trade lawyers have argued that even after the deadline passes, WTO members will not actually be required to end nonmarket economy treatment until China's government reduces its current level of control over the economy. They claim that China is still a nonmarket economy and warn that granting it market economy status will leave domestic industries defenseless against "unfair" trade practices.

These arguments rely on faulty legal reasoning and a mischaracterization of domestic trade remedy laws. The use of nonmarket economy methodology harms domestic import-using businesses and consumers by increasing the unpredictable and protectionist nature of antidumping measures. The purpose of this bulletin is to debunk the myths surrounding nonmarket economy treatment and the 2016 deadline in the hopes of preventing the U.S. and EU governments from maintaining this economically harmful policy while needlessly provoking trade conflict with China.

What Do Global Trade Rules Really Say?

According to Deputy U.S. Trade Representative Michael Punke, "The issue of China's status is not automatic. . . . The mere change of date at the end of the year does not automatically result in a change of status for China." He then noted that the U.S. government was "still considering what our decision will be."[1] The existence of a legal argument to support continued nonmarket economy treatment gives the U.S. government a convenient excuse to maintain protectionist policies it already agreed to end. The U.S. Trade Representative will likely employ the argument in dispute settlement at the WTO once China inevitably brings a challenge in 2017.

This statement about China's status under WTO rules, however, is wrong, and any continued use of nonmarket economy methodology will almost certainly lead to WTO-authorized retaliation.

For nearly 15 years, there has been a clear understanding among all parties that China's protocol of accession to the WTO only permits the use of nonmarket economy methodology until December 11, 2016, after which time other WTO members will no longer be able to discriminate against Chinese goods in antidumping cases.

Paragraph 15 of China's accession protocol allows other WTO members to "use a methodology that is not based on a strict comparison with domestic prices or costs in China."[2] That is, it exempts WTO members, including the United States and the European Union, from having to follow the rule that prohibits the use of nonmarket economy methodology.

That permission, however, is subject to certain limitations, and WTO members must also employ what is known in U.S. law as the market-oriented industry test. Under that test, if a Chinese exporter can show that market conditions prevail in its industry, the use of nonmarket economy methodology is no longer permitted. Similarly, the Chinese government must be given the opportunity to establish that its economy as a whole meets the criteria for market economy treatment under a member's domestic law.

These tests were created long before China joined the WTO. Paragraph 15 simply requires countries to use the tests and abide by the results. Also, any positive determina-

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tions under these tests must be permanent, meaning that once nonmarket economy treatment is rescinded, it cannot be reapplied.

The basic purpose of Paragraph 15 is to establish a transition period—not for China but for other WTO members that apply antidumping measures against Chinese imports. During that period, existing WTO members can maintain WTO-inconsistent antidumping practices when dealing with China. China's WTO accession protocol states that those practices must end either when China meets the (otherwise WTO-inconsistent) criteria under domestic law for market economy treatment or, "in any event," by December 11, 2016.

Recently, however, some enterprising trade lawyers have developed an argument to justify continued discrimination even after the 15-year transition period has elapsed.[3] They point out that only one part of Paragraph 15 technically expires after 15 years, leaving other provisions intact after December 11, 2016. One of the remaining provisions says that members must use Chinese prices or costs if producers pass the market-oriented industry test.

The theory is that the continued existence of this provision demonstrates intent by the drafters of the protocol that some discriminatory treatment for China should still be available after 2016 if particular industries have not yet completed their transition away from state control.

A comprehensive defense of this argument was made by American trade lawyer Jorge Miranda. He has interpreted the partial expiration of Paragraph 15 to mean that the 2016 deadline merely requires a shift in the burden of proof regarding market conditions in China.

> Through 11 December 2016, Chinese respondents bear the burden of proof to demonstrate that the individual industries or sectors have reached the stage where they operate under [market economy] conditions. Conversely, after 11 December 2016 the burden of proof shifts and petitioners are tasked with demonstrating that the individual industries or sectors remain under [nonmarket economy] conditions.[4]

The biggest problem with this argument is that the provision that does expire is the only one that allows WTO members to use nonmarket economy methodology in the first place. The remaining provision simply restates, in conditional language, what WTO members are already required to do under the WTO Antidumping Agreement.

The purpose of that remaining provision was to limit the special rights granted under the expiring provision. The expiration of the latter cannot somehow transform the former into a grant of rights.

After the provision allowing members to "use a methodology that is not based on a strict comparison with domestic prices or costs in China" expires, nothing in China's accession protocol exempts WTO members from having to follow the regular rules of the WTO Antidumping Agreement.[5] The use of nonmarket economy methodology is inconsistent with those rules, so WTO members will be in violation of their international obligations if they continue treating China as a nonmarket economy after the deadline.

The Myth of Market Economy Status

The modern justification for nonmarket economy treatment relies on a presumption that excessive state interference in the economy renders domestic prices so out of sync with supply and demand that they cannot serve as a legitimate benchmark for export prices.

Advocates for the use of nonmarket economy methodology against imports from China argue that China's economy is so controlled by the central government as to make regular antidumping methodology inappropriate. They want to continue to use nonmarket economy methodology until China can prove that it has met the qualifications necessary for market economy status.

The contention may sound reasonable on its face, but it assumes that nonmarket economy treatment makes good sense in the first place and that the test for granting market economy status is reasonable. Neither is true.

The United States began using a special methodology to deal with imports from state-controlled economies in the Soviet Bloc during the Cold War. The regular methodology of comparing home market prices and export prices didn't make any sense in those situations, because home market prices were set by central planners and export prices were determined by state-trading companies. There was no relationship at all between those prices.

Rather than acknowledge that antidumping was simply not an appropriate mechanism to regulate trade with Communist countries, U.S. officials chose instead to develop a convoluted formula that fabricated home market prices based on the investigated producer's factors of production and another, unrelated producer's costs for inputs in a third country.

The methodology allows for an incredible amount of bureaucratic discretion, as trade officials have to determine what manufacturers in what countries will provide cost data for dozens—or even hundreds—of surrogate values.[6] While the stated goal of nonmarket economy methodology is to estimate what prices would be in a market economy country, the actual result is an antidumping duty based on "differences between an exporter's price in the U.S. market and a fictitious hodgepodge of estimated components serving as a proxy for his home market price."[7]

Most nonmarket economies didn't really trade with the West and were not parties to the General Agreement on Tariffs and Trade (GATT), a precursor agreement to the WTO that included basic rules to discipline antidumping practices. Nevertheless, the GATT did include an explicit exception to those general rules in cases where a country "has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State."[8]

While China's economy certainly suffers from a great amount of government interference, it doesn't come close to meeting that strict definition.

Not only does China not meet the definition of nonmarket economy under international rules, it doesn't meet the definition under domestic law, either. After the Soviet

Union collapsed, the U.S. government developed criteria to determine whether former Communist countries should no longer be treated as nonmarket economies. The European Union has a similar test.

When people argue that China doesn't meet the criteria for market economy status, this is the test they are talking about. The test is actually a series of vague factors officials are supposed to consider and base their decision on. In the United States, the test has six factors:

1. the extent to which the country's currency is convertible,
2. the extent to which wage rates are determined by free bargaining between labor and management,
3. the extent to which foreign investment is permitted,
4. the extent of government control of the means of production,
5. the extent of government control over pricing and output decisions, and
6. any other factors considered appropriate.[9]

As you can see, the test doesn't tell us how much government control in each area is indicative of a nonmarket economy or how to weigh the different factors. Only one of the factors even considers the price comparability problem originally posed by Soviet economies. The sixth factor expressly permits authorities to consider whatever they want to justify their decision.

What's more, federal statute expressly prohibits judicial review of any decision to impose or revoke nonmarket economy status.[10] The reality is that the question of nonmarket economy status is purely political. The way the test has been used in the past only highlights its absurdity.

The last time U.S. officials considered changing China's nonmarket economy status was in 2006. In justifying the decision to maintain China's nonmarket economy status, the official report stated, "China has a dynamic (but constrained) private sector, but . . . the state retains for itself considerable levers of control over the economy."[11]

The most interesting thing about that decision is that only seven months later, the same agency decided—based on the same factors—that China's economy was indeed sufficiently market-driven to allow for the imposition of duties to countervail government subsidies. The analysis was largely the same, but the conclusion was worded very differently:

> "Private industry now dominates many sectors of the Chinese economy, and entrepreneurship is flourishing. . . . Many business entities in present-day China are generally free to direct most aspects of their operations, and to respond to (albeit limited) market forces. The role of central planners is vastly smaller."[12]

The lesson here is that China is either a market economy or a nonmarket economy depending on which designation will enable trade officials to impose higher tariffs.[13] The test is overly strict, has been inconsistently applied to China in the past, and is immune from judicial scrutiny.

There's Always Regular Antidumping Abuse

The antidumping lobby has urged governments to continue using nonmarket economy treatment by claiming that otherwise there will be no way to protect domestic industries from low-priced Chinese imports. One European steel industry representative went so far as to say "Granting China [market economy status] is giving it an unlimited license to dump." [14] Hillary Clinton claims that abiding by our obligation to abandon nonmarket economy methodology would "defang our anti-dumping laws and let cheap products flood into our markets."[15]

Although nonmarket economy treatment is one of the most egregious forms of antidumping abuse, the unfortunate truth is that even if governments stop using nonmarket economy methodology, there are still plenty of ways, consistent with the WTO Antidumping Agreement, to impose excessively high antidumping duties. Cato scholars have thoroughly documented the myriad ways antidumping authorities have found to abuse their discretion under domestic and international antidumping rules.

The most likely outcome after the end of nonmarket economy treatment is for antidumping authorities to rely heavily on a methodology known as constructed value.[16] Under certain circumstances, domestic prices can be approximated, or "constructed," by adding together a producer's costs of production plus estimated profit.[17]

The WTO rules allow for the use of constructed value when a high portion of domestic sales are not made "in the ordinary course of trade" or when "a particular market situation in the exporting country does not permit a proper comparison with the export price."[18]

Antidumping authorities will enjoy the latitude to claim that Chinese prices are unreliable because of government interference in the market. This would enable them to resort to constructed value, which (while not nearly as unpredictable and unrealistic as nonmarket economy methodology) tends to produce unrealistically high estimates of domestic prices and so inflates the values of the antidumping duties ultimately imposed.

There is also the option of imposing countervailing duties that directly target Chinese subsidies. Protectionists often conflate antidumping, which deals with private pricing practices, and countervailing duties, which directly address the price distortions of foreign subsidies. They are, in fact, two totally separate remedies. In 2015, every U.S. antidumping duty order against Chinese goods was accompanied by a countervailing duty order. The average countervailing duty in those cases was approximately 103 percent.[19] Far from defenseless in the face of Chinese market intervention, protection-seeking U.S. companies have numerous weapons in their arsenals.

Conclusion

Advocates for maintaining the status quo discrimination in antidumping treatment of Chinese imports are trying to frame the question of China's nonmarket economy designation in ways that misdirect the debate. There is no real question about what WTO rules require. China does not still need to show that it meets the criteria for market economy status. And, ending nonmarket economy treatment will not leave other countries defenseless against “unfair” trade practices.

The United States and European Union have already agreed to end nonmarket economy treatment of Chinese goods by no later than December 11, 2016. Refusing to honor that agreement will serve to frustrate important economic and political relationships with China and harm U.S. and European businesses and consumers.

Notes

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3. Bernard O’Connor, “Market-economy Status for China Is Not Automatic,” *Vox*, November 2011, http://www.voxeu.org/article/china-market-economy; and Jorge Miranda, “Interpreting Paragraph 15 of China’s Protocol of Accession,” *Global Trade and Customs Journal* 9, no. 3 (2014): 94–103.
4. Miranda, “Interpreting Paragraph 15 of China’s Protocol of Accession.”
5. World Trade Organization, “Protocol on the Accession of the People’s Republic of China,” ¶15.
6. Daniel J. Ikenson, “Abuse of Discretion: Time to Fix the Administration of the U.S. Antidumping Law,” Cato Trade Policy Analysis no. 31, October 6, 2005, p. 6.
7. Daniel J. Ikenson, “Nonmarket Nonsense: U.S. Antidumping Policy toward China,” Cato Trade Briefing Paper no. 22, March 7, 2005, p. 3.
8. General Agreement on Tariffs and Trade, annex I, Ad Article VI.
9. 19 U.S.C. §1677(18).
10. 19 U.S.C. §1677(18)(D).
11. International Trade Administration, “Antidumping Duty Investigation of Certain Lined Paper Products from the People’s Republic of China—China’s Status as a Non-market Economy,” memorandum, August 30, 2006, p. 80.
12. International Trade Administration, “Countervailing Duty Investigation of Coated Free Sheet Paper from the People’s Republic of China: Whether the Analytical Elements of the *Georgetown Steel* Opinion Are Applicable to China’s Present-Day Economy,” memorandum, March 29, 2007, http://enforcement.trade.gov/download/prc-cfsp/CFSChina.Georgetown applicability.pdf.
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16. K. William Watson, “Will Nonmarket Economy Methodology Go Quietly into the Night? U.S. Antidumping Policy toward China after 2016,” Cato Policy Analysis no. 763, October 28, 2014.
17. Brink Lindsey and Daniel J. Ikenson, “Reforming the Antidumping Agreement: A Road Map for WTO Negotiations,” Cato Trade Policy Analysis no. 21, December 11, 2002, p. 17.
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19. See U.S. International Trade Commission, “Antidumping and Countervailing Duty Orders in Place,” January 14, 2016, https://www.usitc.gov/sites/default/files/trade_remedy/documents/orders.xls.