Putting Your Mouth Where Your Money Is:
How US Companies’ Fear of Chinese Retaliation Influences US Trade Policy

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Prepared for the Chinese Trade Policy workshop at the University of California, San Diego, August 17, 2006

Draft: please do not quote or cite without written permission of the author. Comments welcome!
You have multinational companies in China – I used to work for one, so I know – who are afraid of retaliation against their businesses so they often praise the Chinese government. When President Hu visited Microsoft several weeks ago, Chairman Bill Gates thanked him for the improvements in their protection of intellectual property... These companies are being politically correct in the most politically incorrect country in the world.


Introduction

Throughout China’s extended negotiations with the United States over intellectual property rights (IPR) from 1991 through 1996, Beijing’s strategy during the formal talks relied on consistently defensive posturing, surrendering as little as possible until the last possible moment, as well as demonstrating an apparent unwillingness or inability to exact concessions not directly related to the initial catalog of US demands. This interpretation holds that after sufficient hemming and hawing, the Chinese side accepted most of the US demands – which focused overwhelmingly on copyright issues – even though it did not implement many of them. If we ignore the implementation problem for a moment and concentrate solely on the negotiations, we would conclude that the Chinese “lost” at the negotiating table.

But such a conclusion is wrong. China “lost” what it could afford to lose at the negotiations because it was extremely successful at ensuring that the most troublesome issues facing US IPR holders, and the most embarrassing and intractable issue facing Chinese authorities at the time – trademark counterfeiting at the local level in China – remained off the trade agenda altogether. In other words, China was able to shape US talking points so that they concentrated almost exclusively on copyright, not trademark, protection. China was able to accomplish this by what I call here “transnational trade deterrence,” or the explicit or implicit threat of sanctions by local Chinese governments to deter foreign firms operating within their borders from making their dissatisfaction with local government performance widely known.

The term, “transnational trade deterrence” (TTD), although somewhat unwieldy, is deliberate. It exists as a counterpart to the notion of “transnational alliances” derived by John Odell in his work on two-level games. Using the notion of transnational alliances, Odell was able to explain trade outcomes that were in the interests of neither of the negotiating parties (the governments of the US and Brazil), but were very much in the interests of the domestic constituencies of

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1 Interviews with Chinese trade official, Beijing, March and August, 1999.
both countries (IBM US and IBM Brazil). These outcomes were possible because of the linkages established between these two domestic (Level 2) constituencies.\(^2\)

In the case of transnational trade deterrence (I have inserted the term “trade” because deterrence in the traditional strategic studies context is almost always *transnational*), the relationship between the two domestic constituencies is a conflictual one. Rather than see eye to eye on a particular trade issue – in this case, intellectual property protection – these two constituencies have very different goals and priorities. The power and informational asymmetries between these two parties, which I explain later in this chapter, have the effect of influencing the negotiations between their two respective governments in ways that are impossible to explain by focusing solely on the negotiators themselves.

**A Primer on IPR Trade Policy: Special 301**

The Office of the United States Trade Representative is the key US Government agency charged with pursuing US trade policy. Section 301 of the *1974 Trade Act* requires the USTR to identify and investigate countries that engage in trade practices deemed unfair to US interests and to impose sanctions where appropriate. Section 301 granted the United States unilateral power to punish countries that were considered a threat to US trading interests and to enforce US rights under existing bilateral and multilateral trade agreements.\(^3\)

The *1988 Omnibus Trade and Competitiveness Act* established statutory mandates for investigations of (and the leveling of trade sanctions against) countries deemed to be violating US intellectual property. It institutionalized government-business intellectual property relations by requiring the USTR to post notices in the *Federal Register*, soliciting comments on the issue of IPR infringement of US products abroad, including specific evidence of IPR violations and recommendations for action.

Because of its small staff size and high turnover rate, the USTR relies on US firms and associations to provide much of the data on unfair trade practices (including IPR violations) abroad to ensure the accuracy and bolster the credibility of the charges leveled by the USTR at the target country. Thus, USTR action depends upon the provision of clear, concise, and compel-

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ling information by the various business interests hurt by these practices. As one former negotia-
tor put it, “informing, explaining become persuading.”

Moreover, Special 301 institutionalizes this informational requirement: it compels the
USTR to act in response to the information – and more importantly, to the recommendations – it
receives from interested actors within the business community. The establishment of Special 301
was an exceptionally successful strategy by the IPR associations. They were able to institute a set
of statutory constraints on the conduct of the US trade policy that enhanced the position and the
power of the individual firms and the IPR associations vis-à-vis the USTR. Thus, access to the
USTR was institutionalized, and the USTR was compelled to respond. Finally, simply having
one’s intellectual property violated abroad provided the requisite “standing” to participate in the
Special 301 process.

Given the ease of entry into the trade agenda setting process, why did (and do) so many
companies whose losses were in the millions, even hundreds of millions of dollars in China ow-
ing to poor IPR protection so unwilling to take part in the Special 301 process when they had
every incentive to do so? The answer has to do with the behavior of local government officials
half a world away from USTR headquarters.

The Transnational Trade Deterrent Threat

“Deterrence,” stated simply, is the attempt to influence another actor to refrain from en-
gaging in a particular action. Rational deterrence is based upon a cost-benefit calculation: weigh-
ing the costs of conflict together with the benefits of cooperation. All things being equal, if the
costs of conflict (and/or the benefits of cooperation) are sufficiently low, deterrence will fail; if
the costs of conflict (and/or the benefits of cooperation) are sufficiently high, deterrence is more
likely to succeed. The focus of deterrence theory has been primarily, although not exclusively, on
the role of the “defender” or the “issuing” country (the defender of the status quo; the country
issuing the deterrent threat, in this case, China). The analysis below looks at both the defender
and at the “initiator” (the USTR on behalf of US industry).

The actual behavior that the Chinese TTD threat is designed to prevent is foreign firms’
bringing unwanted attention to China’s shortcomings vis-à-vis implementation and enforcement
of trade policy (including, but far from limited to, intellectual property). A representative from a
US beverage company summarized the transnational deterrent threat in this way:

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4 Interview with former USTR official, December 1998.

5 Ibid.
[We do] not get too directly involved with the Chinese government in complaining about the trademark issue. First of all, [we need] to maintain good relations with the Chinese government. The rules are always changing and the government can announce an “audit” if [we rub] them the wrong way. [We] also [have] expansion plans and will certainly need the Chinese government to be on [our] side in undertaking such a plan. There are also tax issues. In short, [we do] not want to put [ourselves] on any Chinese governmental “black list.”

And this is by no means a new phenomenon, as Jim Mann wrote almost twenty years ago about the early reform period:

Why were the foreign companies so unwilling to complain? Each company feared Chinese retaliation. China had successfully created a climate in which favoritism was expected. If Coca-Cola complained that it was being unfairly restricted, Chinese authorities might counter by making life tougher for Coke (or better for Pepsi)…Foreign correspondents doing stories on business conditions in China regularly found that unhappy local representatives were willing to voice bitter complaints, but only in private. They might talk to the press, but only on background or off the record…Few news articles were written about difficult business conditions in China, and the ones that appeared had a remote, abstract feel to them. They contained few names or concrete examples.

Moreover, even in the post-China WTO era, this sentiment continues to inform US business strategy:

In reaction to the explosion of counterfeiting and other theft of intellectual property rights, [multi-national enterprises] doing business in China have adopted a non-confrontational strategy of long term cooperation and informal lobbying. …MNEs that approach the United States government have been careful in the past not to ask the U.S. government to initiate any formal action under U.S. federal trade law. Many MNEs have adopted a strategy of publicly praising the PRC government for improving its IP enforcement regime, while privately these same MNEs lament that the piracy problem is worse than ever…MNEs pursue a non-confrontational strategy because MNEs are afraid of doing anything that might offend the Chinese government and that might lead to re-

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6 Interview with US beverage executive, Shanghai, April 5, 1999. This source mentioned that as far as investigative work is concerned, he outsources to private investigation firms in order to guarantee the safety of his staff, noting that in several instances investigators hired by his company were threatened and even physically assaulted.

taliation against their businesses in China. For this reason, MNEs avoid any actions that might be interpreted as hostile or threatening, but instead take every opportunity to praise the Chinese government for any improvements in IP enforcement.  

Where does this fear of retaliation come from? Whether arising from a firm’s own actual experience, from that of a competitor or an associate, or whether it simply exists “out there” as a thinly-disguised threat, the specter of such retaliation has become an unremitting fact of life that contributes to a chronic sense of insecurity for foreign commercial actors operating in China. This threat of retaliation has become internalized by these foreign actors and shapes their behavior to a great extent. The size of the Chinese market, the substitutability of most foreign firms and their products, and the power asymmetries at the local level between Chinese government officials and foreign company representatives, all underscore the high stakes and the ease of execution that underlie this threat. However, although this threat is taken as a fact of life in doing business in China, its impact beyond China’s borders is less well understood.

Much of deterrence theory revolves around “strategic deterrence,” which states that “if you do x I shall do y to you.” If the opponent expects the costs of y to be greater then the benefits of x, he will refrain from doing [x]; he is deterred.” However, once the application of strategic deterrence theory extends to increasingly complex situations – such as the trade negotiations examined here – it begins to run out of explanatory power. It is thus necessary to revisit some of the basic assumptions of traditional deterrence theory, specifically, the degree of anticipated retaliatory damage following a deterrence breakdown, and the specificity of the deterrent threat. By examining these concepts, we are able to explain analytically and theoretically the empirical phenomenon that very few are willing to acknowledge even exists, at least in public.

The Degree of Retaliatory Damage

George and Smoke place the crystallization of traditional deterrence into strategic deterrence theory as resulting from the ability of states to inflict greater degrees of pain on the target state’s general population without first destroying the state itself. In other words, it is the ability to inflict a substantial degree of “pain” that makes deterrence possible. But as we move from a

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military context to that of international trade, they concepts need to be revisited and perhaps “weighted” somewhat differently.

The “degree of retaliatory damage” is important for the defender’s (China’s) deterrent strategy. In order to make his deterrent threat credible, the defender must demonstrate both the capability and the will to carry out the threat. However, this raises questions about how to think about credibility when the deterrent threat that may not, in the end, be sufficiently “painful.” On the one hand, the fact that the stakes are lower increases the likelihood that the issuing country will carry out the threat. On the other hand, if the stakes are lower than in the case of military action, they are arguably easier to absorb. Insofar as credibility involves both the capability and the will to carry out the threat, if a critical dimension of credibility (“capability”) is deemed absorbable, the “will,” and, by extension, the defender’s overall threat may be seen by the target country as far more credible, but somewhat less threatening than in a military context. As a result, the defender must develop a strategy that compensate for this. In the present context, the most important of these is the manipulation of information to make it ambiguous, or to deliberately render it “incomplete.”

The Specificity of the Deterrent Threat: “Strategic Ambiguity”

Traditional deterrence theory stipulates that the deterrent threat must be clearly stated for deterrence to hold. However, transnational trade deterrence is more likely to be successful in situations of incomplete information, in which the defending country’s intentions, and to a lesser extent, its capabilities, are sufficiently opaque. In other words, the TTD threat may be even more effective when it is not clearly stated. How does “strategic ambiguity” contribute to TTD success?

First, when the ability to inflict substantive pain is curtailed, it becomes increasingly important for the defender to strategically manipulate information and maximize ambiguity and thus minimize accurate information about its retaliatory capabilities, including the limits of the damage that could be brought about by such retaliation. Limits on the knowledge about an actor’s weakness can contribute to, and even drive, other actors’ inflated assumptions about its strength. Under conditions of “perfect information,” it is easier to gauge an opponent’s likely moves, as well as to analyze and break down the threat (and make arrangements to absorb it), thus mitigat-


11 This is somewhat different from Betts’ argument that uncertainty is conducive to deterrence “when butressed by the threat of awesome punishment” because, as I argue here, even the threat of punishment is left deliberately vague. Richard Betts, “Conventional Deterrence: Predictive Uncertainty and Policy Confidence,” *World Politics* 37 (January 1985): 154.
ing its impact. Under conditions of “imperfect information,” it is far more difficult, if not impossible, to establish *ex ante* defenses against the transnational deterrent threat.

Second, the notion of strategic ambiguity captures the empirical reality of conflicting messages between Beijing and local government units in China that are picked up by, if not always aimed directly at, the potential target for retaliation, the foreign firm. TTD has never been articulated as national policy in China precisely because it originates within the domain of local political officials, and leaders in Beijing may not support such threats – for domestic political reasons – even as they help Beijing’s negotiating posture. TTD represents the degree to which Beijing is unable to rein in local government defection from national policy. In fact, locally articulated threats may actually be more potent the more they depart from national policy: the fact that these threats can be made in the first place implies Beijing’s inability to guarantee the “safety” of a foreign firm operating outside of Beijing’s immediate jurisdiction even if national policy pledges to do so.\(^\text{12}\) The diffuseness of these threats also contributes to the effectiveness of their strategic ambiguity. The threats cannot be isolated or systematically identified and aggregated; this feeds foreign firms’ perception that they are omnipresent, and, therefore, it is easy for these firms to exaggerate their range and power.

Third, ambiguity can also contribute to an effective strategy of transnational trade deterrence with regard to signaling. The decision to bluff, or to refrain from doing so, can have a significant impact on a country’s reputation. Such a mixed-strategy equilibrium is captured by Barry Nalebuff:

> If it was thought that a weak country would never attempt to bluff or act tough, then seeing a country act tough would indicate true strength. This would improve its reputation immensely, possibly enough even to motivate a weak country to act tough (which would not be in equilibrium). As bluffing becomes increasingly likely, the enhancement of a reputation following tough behavior is diminished. At some point, the probability of bluffing is sufficiently high (and the improvement of reputation is sufficiently small) that the cost of the weak country acting tough is exactly offset by the gain in reputation.\(^\text{13}\)

Nalebuff raises the notion that acting tough (i.e., through an explicit demonstration of an actor’s ability and/or will to carry out a deterrent threat) reach a point of diminishing returns.

\(^{12}\) Local officials are often fond of saying “above has its policies, below has its countermeasures” (*shang you zhengce, xia you duice*), much to the chagrin of national-level officials in Beijing. This dimension of state capacity was a frequent lament among national-level government Interviewees.

\(^{13}\) Barry Nalebuff, “Rational Deterrence in an Imperfect World,” *World Politics* 43 (April 1991): 319. Although he is less than certain about this formulation’s ability to withstand the rigors of perfect sequential equilibrium standard, it does describe the empirical phenomenon of strategic ambiguity.
One can similarly argue that the decision not to act tough may actually be an equilibrium strategy. In other words, an optimal strategy for a country to demonstrate its capability and will to exercise retaliation, under certain conditions (such as “strategic ambiguity”), may be to simply do nothing.

Fourth, the TTD threat need not pose a direct threat to the US, or to a particular commercial sector, to be capable of inflicting a tremendous amount of damage on a single firm, or even a small group of firms. Therefore, to the individual foreign firm operating in China, the diffusion and the ambiguity of the TTD threat combined with local Chinese governments’ ability to inflict pain to create an environment that provides a substantial disincentive to rock the boat regarding IPR and other trade-related issues.

Credibility of Transnational Trade Deterrence

Successful deterrence must be credible. For a deterrent threat to be credible, the defender must demonstrate the capacity and the will to carry out its threat. The “targets” of such deterrence, in the context of this chapter are the actors within the US IPR trade lobby that set the US trade through Special 301. Is an objective TTD threat credible to this set of targets?

The issue of capability is relatively straightforward. “Capability,” in this context, means the ability to severely undermine continued or future penetration of the domestic Chinese market, or utilization of its inexpensive labor force. Local Chinese officials have the ability to carry out a deterrent threat. The absence of an effective, autonomous legal system throughout most of China and the lack of transparency within the political process provides few checks and balances on arbitrary local power. More so, the national government lacks the requisite power to substantially rein in local officials, and therefore is unable to reduce local manifestations of this deterrent threat even if it sought to do so.

Retaliatory action would also inflict a considerable degree of pain on the individual foreign firm (as opposed to US interests writ large). The lure of the vast Chinese consumer market as well as China’s equally large (and low-cost) manufacturing capacity is sufficiently compelling

14 Of course, one can argue that by issuing a deterrent threat, local leaders will simply force foreign firms to move their operations to a location in which local officials are less inclined to make such threats. However, this involves significant transaction costs on the part of the foreign firm. Moreover, when combined with the uncertainty regarding the new government hosts’ propensity to level such a threat once the relocation is consolidated, the benefits of such a move – when viewed against the associated transaction costs – are may not be able to overcome the prohibitive costs. To a considerable degree, the foreign firm is at the mercy of the local host government, and not the other way around.

to inhibit foreign firms from risking their ability to capture such a lucrative consumer market and manufacturing base.

I think basically companies have decided that it’s better to be in China and get your technology stolen than to not be in China. That’s basically what people have decided. Companies go into China with their eyes wide open. They’re willing to put up with things in China they would never put up with in any other country of [sic] the world. Why? Because the dream, ever since the British started this whole thing several hundred years ago with thinking...if we could only sell a shirt to every person in China...everybody is afraid not to be a part of that dream.16

In some cases, this might mean the closure of a foreign firm’s operations on some pretext. It may also take a more basic form of “flexing local governmental muscle” to force a foreign firm to go along with the wishes of its Chinese host. Or it may involve both. In either case, the power asymmetries between local governments and foreign firms are pronounced, and although it is impossible to be systematic in presenting such examples, the following instance of this second type is as representative as it is illustrative.

In the latter half of the 1990s, a foreign firm had signed a contract with local authorities in a town in Northwest China to build a high-tech factory (the “interior factory”), capable of producing two “families” of sophisticated industrial generators. This arrangement was undertaken as a joint venture between the foreign company and a local manufacturer, the Zhonghua Motor Factory. While this interior factory was being built, another factory was under construction in a commercial area (the “coastal factory”) along China’s eastern seaboard. This second factory was literally a “carbon copy” of the interior factory, all the way down to the minute details in the material specifications. Moreover, the coastal factory had actually begun operations while the interior factory was still under construction. Representatives from the coastal factory approached the foreign firm and said that they had established a “similar” facility and that they would like to establish a partnership with the foreign firm. If the latter refused, the coastal factory threatened to “dump” its generators on the domestic market at a third of the projected interior factory price and crowd the interior factory (and its foreign joint-venture partner) out of the market. As a result, the

foreign firm had little choice but to abandon its nine million dollar investment in the interior factory, and entered into a forced partnership with the coastal factory.\textsuperscript{17}

In addition to illustrating the power asymmetries between foreign firm and local government (both the “coastal” and “interior” factories enjoyed varying degrees of local governmental involvement), this example underscores the financial resources and the coordination abilities across broad geographic areas that some local governments have at their disposal.

It is somewhat more difficult to generalize about the notion of “will.” It should be noted that while such “strong arm” tactics, as in the example above, characterized national-level contracting to foreign firms during the 1980s and early 1990s, they are far less the case today.\textsuperscript{18} However, at the local level (the provincial level and below), such tactics remain the norm. It is therefore necessary to look at the incentives facing local leaders in China.

At the grass roots level, cadres are generalists, and must often choose from competing (and often conflicting) policy objectives to implement with the limited resources at their disposal. This decision is greatly simplified by the prioritization of these tasks by their administrative superiors. These priorities vary somewhat from region to region, but the most important of these almost invariably include economic development, tax extraction, the “alleviation of poverty,” and the implementation of the “one-child policy” birth control program. They are institutionalized within performance indicators under the “cadre responsibility system” (\textit{ganbu gangwei mubiao guanli zerenzhi}) and reinforced by the “one-level down management” supervision system (\textit{xia-guan yiji}).\textsuperscript{19} At higher levels, performance appraisals are far more complex, although it is ultimately the generalist officials in the government and Party organs that make the final decisions on local priorities and these overall priorities are largely the same as at the grass-roots level. Moreover, in the absence of a concerted national campaign (with the corresponding extrabudgetary outlays) to shift these priorities in an alternate direction, they are unlikely to change.

\textsuperscript{17} It later came to light that the foreign firm’s joint venture partner in building the interior factory, the government-owned Zhonghua Motor Company, was responsible for giving the original (and highly confidential) factory plans to the coastal factory because it was unable to pay for its technology transfer payments at the time, and the coastal factory offered Zhonghua generous partnership terms in return. The foreign firm had very little choice but to go along with the Chinese. Although the foreign firm had been advised that it could take the case to court, by the time any settlement could be reached, they would have already been pushed out of the local markets in both the coast and the interior (Interview with IPR lawyer, Shanghai, May 27, 1998; and Interview with US company executive, August 17, 1998). Both sources insisted that, for their own protection, place and company names must be changed; I have honored their requests.

\textsuperscript{18} Interview with US auto parts executive, Beijing, July 9, 1998.

“Intellectual property rights enforcement” is generally far too specific to make it onto local performance indicators. However, several of the most important of these indicators can be in direct conflict with intellectual property protection. The first three indicators listed above, generally deemed the most important, and which encompass the “general principles” of the top leadership, are often inconsistent in practice with effective intellectual property protection. Insofar as IPR-infringing activities on the part of local factories, middlemen, or retailers contribute to economic development, the alleviation of poverty, and the supply of tax revenue, a disincentive for intellectual property enforcement is institutionalized into the priorities on which local officials’ performance is appraised. As one Party Vice-Secretary of Chongqing put it, “I believe that intellectual property and economic development are both important, but I consider economic development to be the more important of the two.”

When local priorities dovetail with those of foreign firms operating in those areas, these firms are unlikely to articulate dissatisfaction with local governments. When the goals of a foreign firm do come into conflict with the priorities of local officials, the former (in the absence of a TTD threat) are far more likely to raise the issue with higher-level governmental units in China, or directly through the Special 301 process. Because local governments have a strong preference to stay out of Beijing’s crosshairs, and because of the possibility that Beijing could make an example of the local government in question, there is an extremely strong incentive for the latter to prevent such behavior on the part of the foreign firm. Implicit or explicit deterrent threats are almost always far less costly then the alternative. Therefore, it is reasonable to claim that local Chinese leaders do, indeed, have the will – whether overt or latent – to deter foreign firms operating within their jurisdictions.

Transnational Trade Deterrence: Probability of Success

20 Interview with private investigator, Shanghai, June 16, 1998.

21 The Xichang VCD wholesale market in Kunming is an important source of revenue for the Wuhua District Administration for Industry and Commerce (AIC) through the management fees (guanli fei). The Wuhua District AIC was, until recently, firmly under the control of the Wuhua District Government, and provided a considerable source of revenue (Interview with provincial official, Kunming, June 22, 1999). As a result, it was able to engage in the widespread and open sales of pirated VCDs, with only cursory and largely ritualized raids twice a week (Interview with vendors, Kunming, June 23, 1999).

22 As a result, some local authorities choreograph raids to demonstrate that they are doing something, often ensuring that the actual punishments are relatively benign. Another tactic is to delay the investigation until all (or most) of the product is moved out of the factory (Interview with Chinese scholar, Shanghai, June 15, 1998).

23 Meeting with Chongqing Municipal Party Vice-Secretary, Chongqing, March 12, 1998.

24 Even when foreign and local official interests converge, it may be useful to maintain some sort of deterrent signaling to forestall any potential future change in the status quo.
Given the power and the will of the local Chinese governments to retaliate, combined with the expected utility of engaging in the trade agenda-setting process, the foreign firm can theoretically make its calculations based on a very simple deterrence model.\(^{25}\) In the face of an explicit deterrent threat, a potential target, \((T)\) – in this case an actor within the IPR lobby (i.e., a foreign firm operating in China) – can choose from aggressively pressing ahead, or it may abstain or offer a non-confrontational petition to the United States Trade Representative, or USTR (represented by NC or “non-confrontational behavior,” and the utility \(u_T(\text{NC})\) for backing down or not engaging in such behavior in the first place). If the target presses ahead with a more aggressive form of lobbying, the chance that China will carry out its deterrent threat would be represented as \((p)\). The costs of the ensuing Chinese retaliation \((R)\) are represented in the target’s utility for this outcome, \(u_T(R)\) – the more painful the threatened retaliation, the lower the value of \(u_T(R)\). There is a chance \((1 - p)\) that China will not follow through on its threat, in which case there are no barriers to confrontational behavior on the part of the US firm, which can thus be judged a “success” \((S)\). The target’s utility function for this outcome is \(u_T(S)\).

If we assume that the target prefers “success” to “non-confrontational behavior,” and prefers “non-confrontational behavior” to Chinese retaliation, we can draw up the preference rankings in the following way: \(u_T(S) > u_T(\text{NC}) > u_T(R)\). Deterrence works when the target prefers to engage in “non-confrontational” behavior \((\text{NC})\) rather than in pressing ahead with its aggressive 301 action \((S)\), or, when:

\[
u_T(\text{NC}) > p[u_T(R)] + (1 - p)[u_T(S)]
\]

Using this, the probability of China’s carrying out the TTD threat can be calculated as:

\[
p > \frac{u_T(S) - u_T(\text{NC})}{u_T(S) - u_T(R)}
\]

In which the right hand side of the inequality is the “critical risk” and which must be smaller than the probability of China’s carrying out the deterrent threat for the threat to succeed. The larger the value of the denominator and/or the smaller value of the numerator\(^{26}\) – as a result of the dif-


\(^{26}\) Because, given the preference rankings above, \(u_T(\text{NC})\) is greater than \(u_T(R)\), the value of the right-hand side of the inequality will always be less than 1.
ference in the values in $u_T (NC)$ and $u_T (R)$, respectively – and thus smaller the overall value of the right-hand side of the inequality, the greater the likelihood that the critical risk will be less than $p$, and the greater the likelihood of deterrence success. Conversely, the smaller the value of the denominator and/or the greater the value of the numerator (and thus the greater the overall value of the right-hand side of the inequality), the greater the likelihood that the critical risk will be greater than $p$, and the greater the likelihood of deterrence failure.

In other words, as the value of $u_T (R)$ decreases – or the value of $u_T (NC)$ increases – the denominator grows, and the critical risk goes down, and deterrence is more likely to succeed. As the value of $u_T (R)$ increases – or the value of $u_T (NC)$ decreases – the numerator grows, and deterrence is more likely to fail. If the value of $u_T (S)$ rises, both the numerator and the denominator will increase and the overall critical risk will rise with it. As the utility of taking the risk of aggressively exploiting the Special 301 process rises, the less likely that deterrence will succeed.

**Figure 1: Multiple Nash Equilibria under Salient and Non-Salient Deterrent Effects**

<table>
<thead>
<tr>
<th>Nature</th>
<th>Salient Deterrent Effect</th>
<th>Non-Salient Deterrent Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Aggressive Lobbying</td>
<td>Non-Aggressive Lobbying</td>
</tr>
<tr>
<td>B</td>
<td>Retaliate</td>
<td>Not Retaliate</td>
</tr>
<tr>
<td></td>
<td>(d, b)</td>
<td>(a, c)</td>
</tr>
<tr>
<td></td>
<td>(a, c)</td>
<td>(b, c)</td>
</tr>
</tbody>
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For example, if a foreign firm operating in China is experiencing losses due to piracy, it will weigh current (and future) piracy-related losses against threats of retaliation leveled by its local host government, which has demonstrated its capability and will to back up its explicit threat. If these losses are calculated to be less than those associated with being shut out from the China market (or manufacturing setting) altogether – the value of $u_T (R)$ decreases and/or the

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27 Values in parentheses correspond to “IPR lobby” and “China,” respectively.
value of $u_T (NC)$ increases – the foreign firm will most likely avoid antagonizing its Chinese hosts. Its equilibrium strategy, as indicated in Figure 1, is to maintain the status quo.

If, on the other hand, current or anticipated future losses are calculated to be greater than the costs associated with retaliation – the value of $u_T (R)$ increases and/or the value of $u_T (NC)$ decreases – the foreign firm is more likely to engage in aggressive lobbying (i.e., call attention to the suboptimal performance of its Chinese hosts). Its equilibrium strategy is to engage in aggressive lobbying, as indicated in Figure 1. Moreover, in this case China would not retaliate, as doing so would have a demonstrably negligible impact on the sales of legitimate copyright-intensive products in China (as a result of market access restrictions) while at the same time resulting in trade sanctions leveled by the US. Thus, in an environment in which there is complete information, behavior of the foreign firm can be predicted with some degree of certainty by a simple cost-benefit analysis.

The TTD Effect: Impact on Trade Policy Then and Now

If the empirical puzzle of this chapter is to explain why the US copyright lobby was so aggressive (during the early 1990s – far less so now) while the trademark associations were so feeble in bringing their case to the USTR, how can TTD explain such variation? Much of the answer has to do with the fact that during the Sino-US negotiations over intellectual property, which spanned the period from 1991 through 1996, trademark-intensive firms had a physical presence on the ground while copyright-intensive did not. As a result, throughout the Special 301 process, trademark demands were muted and vague while copyright-related demands were aggressive and specific. The USTR had no alternative than to move forward on those issues for which it had credible information and to shelve (or at least focus less on) those for which it could not make a credible case. After all, insofar as the USTR relies on US firms to provide it which information the basis of which it makes its international case against China (or any other country), its credibility is inextricably linked with the credibility of those firms that provide it with the data to make its case. If the firm fails to provide adequate information because it is deterred from doing so, the USTR has no political choice but to table those demands until such information is available. The result was that the negotiations focused almost completely on the less problematic issue (at the time) of copyright protection than on the rampant counterfeiting that was draining US companies of hundreds of millions of dollars.

This is supported by the fact that that the copyright-intensive firms have become far less confrontational vis-à-vis their Chinese hosts, as evidenced by the quote that began this chapter. This has led to a far less confrontational strategy by the US today than that which framed US
trade policy throughout the 1990s. Indeed, one can point to the fact that the US has been quite skittish in bringing an IPR case against China under the WTO. Although many in the government (and in business circles) are chomping at the bit to undertake such action, the US has been reluctant to do so for one important reason: it cannot bring a case for the WTO mediation if no company wants to go on record as being that case. Remarked former congressman Dave McCurdy, now the head of the Electronics Industry Alliance (EIA):

It’s not the failure of the WTO as an instrument…The question is, do you have evidence to bring a case that’s credible so that you don’t lose all of your international credibility in using this mechanism? It cannot be a political tool based on anecdotal information or a kind of broad-based sociological and general economic information. There has to be a clear case of failure to comply with these rules. I will tell you that when we went through the process of building this document, we had a hard time. We had a lot of examples, but there was not one single company prepared to put their [sic] name on that document. Now, we gave this to the Chinese government, we’re distributing this. Because there is the real potential for retaliation or retribution. It may not be direct; it may not be today. It may not be six months from now, but there is this long term fear.28

And the impact on the US negotiating position is no less dramatic:

When I worked for a multinational company, we also went to the US government and we said we would like you to bring this issue up with China, but please don’t use our name. And that’s what is going on here. Because the companies are screaming at the US government, but there’s only so much in my opinion that can be done is the companies are not willing to take this, are not willing to do anything to offend the Chinese government. If the US government tries to negotiate with China and says to China you cannot retaliate against these companies, nothing is going to happen. China is not going to agree to that.29

In other words, the US is not going to have a tenable bargaining position vis-à-vis Beijing without such credibility. Rather than show its empty hand under the spotlight of international scrutiny, the rational choice for the USTR is simply to jettison non credible demands from its ne-


gotiation agenda (as it did throughout the 1991-1996 period) or to refrain from (or at least to demonstrate extreme reluctance in) bringing about a case against China in the first place (as is currently the case regarding the WTO action against China).

**Conclusion**

I have argued that China has been able to manipulate the substance of the agenda setting process through transnational trade deterrence. Variation within the agenda setting and ratification processes can be explained by the degree to which a given company or member of a trade association was in the direct line of fire of the TTD threat. Companies and trade associations that had credible information – names, places, dates, times, etc. of IPR violations they faced – were able to mobilize the USTR on their behalf as a result of the information they provided under Special 301. Those firms that were unable to provide such credible data were not taken seriously by the USTR and certainly not by Beijing. As a result, they were unable to mobilize the USTR on their behalf.

The irony is that those firms and associations that were losing the most and who could make the most credible cases, were precisely those who were sidelined by the process. I have endeavored to account for this anomaly by arguing that these companies were deterred from taking effective action against China as a result of a threat that emanated not from Beijing as a coherent, concrete policy, but rather which arose from the political context of the physical in which these firms were operating in China. The result was that this transnational trade deterrence was able to shape the US trade policy agenda by preventing those issues that were most troublesome for China to appear in the first place.

The problem is always, how do you explain a *non*event? How do you explain something that did *not* occur? How do you account for the *lack of* items on a trade negotiating agenda? The off-the-record and rare public expressions of frustration are not enough to explain such an outcome, only to articulate the perception that something is going on behind the scenes. It is the purpose of this chapter to account for this nonevent by making the case that this behind-the-scenes activity is very real, very potent, and can be explained by an analytical framework – transnational trade deterrence – that may be all but invisible, but which keeps many US CEOs and government officials awake at night, and which has shaped and continues to shape US trade policy in ways that are as substantial as they are imperceptible.