China’s WTO Compliance
---- A Case Study of U.S.-China Semiconductor Dispute

Keywords: WTO, Compliance, International Organization, China, Semiconductor, Trade

Abstract

In March 2004 the Bush Administration filed a complaint in the WTO against China for its controversial semiconductor value-added tax (VAT) rebate policy. The case lasted 123 days and was solved at the consultation phase. This was the first WTO case filed against China by any WTO member country. Therefore it can be served as a test case to explore the distinctive pattern of commitment compliance by the non-democratic transition economy. My argument is that international regimes, particularly the WTO-plus rules designed for the transition economies, do constrain these governments’ policy choices in compliant behavior. An international legal commitment is one way that governments seek to raise the reputation costs of reneging. It is reputation costly for the transition economies because the distrust has been embedded in the international regime design. In the meantime, the preference of the domestic industry also contributes to explain the variation on transition economies’ capability and willingness to comply with international commitments.

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States reach agreement when they believe that the agreement is mutually beneficial. But these benefits cannot be achieved without active effort. Therefore, implementation of the international agreement is as important as negotiating an agreement. In some interactions, states can receive short-term unilateral benefits by defecting from agreements or delaying implementation despite the long-term desirability of the agreement. In these instances, the risks of cheating and abrogation loom large. Cooperation requires actors to demonstrate to or convince others that they have both the capability and the willingness to behave as promised. This is directly related to the concept of credibility.

Many empirical studies on international cooperation find that those characteristics typical of democratic political systems advantage states in making credible commitments in the international arena.\(^1\) Because for leaders of democracies, once a public commitment is made, a change in policy becomes undesirable.\(^2\) Leaders from democratic states experience costs from not following through on a planned course of action and find it difficult to adjust quickly to changing circumstance in the international environment. As a result, their commitments are likely to be credible, and they seek to form only secure agreements. Similarly, Lisa Martin finds that Congress plays an active and positive role in promoting international cooperation.\(^3\) The institutionalized legislative participation process of international cooperation enhances the credibility of commitments through a number of mechanisms, relying on signaling and commitment dynamics. Institutionalized legislative participation provides the executive branch and the other states with better information about legislative and societal preferences, reducing the chance of reneging. It
also creates institutional obstacles to change policies and thus improves the stability of existing policies. Enhanced credibility in turn leads to greater levels of international cooperation.

If democracies are more capable of guaranteeing their own future behavior and more cautious about forming agreement with others, then what about some transition economies who do not share the democratic political institutional features? Four questions may arise. First, would non-democratic transition economies be less credible with their commitments lacking the domestic institutional and normative constraints? Second, would the democracy be more cautious to form agreement with the non-democratic transition economy? Would the international agreement reached between the dyad composed of one democracy and one non-democracy be less secure? Third, what role the preference of the domestic industry can play in terms of commitment compliance? Fourth, does international regime alter governments’ interests and behavior?

In March 2004 the Bush Administration filed a complaint in the WTO against China for its controversial semiconductor value-added tax (VAT) rebate policy. The case lasted 123 days and was solved at the consultation phase. This was the first WTO case filed against China by any WTO member country. Therefore it can be served as a test case to explore the distinctive pattern of commitment compliance by the non-democratic transition economy. My argument is that international regimes, particularly the WTO-plus rules designed for the transition economies, do constrain these governments’ policy choices in
compliant behavior. An international legal commitment is one way that governments seek to raise the reputation costs of reneging. It is reputation costly for the transition economies because the distrust has been embedded in the international regime design. In the meantime, the preference of the domestic industry also contributes to explain the variation on transition economies’ capability and willingness to comply with international commitments.

The first section provides a brief overview of the content and implications of the WTO rules that were specifically designed for China’s accession. The second section reviews the negotiation process of this dispute case on semiconductor within the context of the interaction among WTO rules, U.S. domestic trade politics and Chinese trade politics. The final section explores the findings, provides interpretation and draws conclusions.

**WTO Rules Designed for China’s Accession**

The GATT/WTO is more than a simple club of trading partners. The GATT/WTO is a postwar institution founded to establish and promote the principle of free markets and free trade among western democracies. Its norms and rules were geared toward ensuring the maintenance of an open, nondiscriminatory market in which government intervention is minimized and tariffs and prices guide the decisions of private firms. For this reason, participation of nondemocracies or/and nonmarket economies poses an anomaly for
For nondemocracies, their commitments tend to be incredible to others since the national leaders are able to change the course of behavior easily without the effective supervision from the jurisdiction branch and general public. For nonmarket economies, tariffs and prices have little or no influence over decision making in planned economic systems in which decisions about resource allocation, imports and exports are administratively determined by the government.

The participation by East European countries for the GATT during the Cold War era did not provoke much controversy on their compatibility and credibility. The Western governments were generally not constrained by the fear that the membership of Poland, Romania, and Hungary would erode the GATT regime. On the one hand, their applications were viewed as an East-West issue and political/security consideration overwhelmed. On the other hand, the affiliation of smaller economies, even they were planned economies, was not deemed to pose a big threat to the regime. Furthermore, while Hungary requested that its tariff concessions be accepted as a legitimate entrance fee, Poland and Romania agreed to undertake quantitative import commitments in the accession negotiation. Obviously the latter is less likely to dilute or erode of the market-orientated rules of the neoliberal trade institutions. Even so, the accession agreements in all three cases included a special discriminatory safeguard clause that would provide mechanisms for blocking the possible dumping from these countries.
China’s WTO accession is very different. As one of the major trading powers in the world, China’s tariff reduction, market access and other commitments are far reaching. They exceed those made by any member that has joined the WTO since 1995. However, the scope and depth of China’s commitment was accompanied by the deep-rooted skepticism of whether China will honor the commitments it has made. Both China’s compatibility and credibility were questioned during the negotiation process. In the end, China had to bind itself to more strict and onerous rules to offset the distrust shared by WTO members, particularly in areas of antidumping, safeguards and annual review.

China began its pro-market economic reform in 1978 and has claimed itself “socialist market economy” since 1992. Today more than 96% of Chinese commodities are priced by market mechanism. Russia was granted full market economy status by both the EU and the U.S. years ago. However, in terms of its index of economic freedom, Heritage Foundation and the Fraser Institute put China 10 to 15 notches ahead of Russia. Article 15 of the Document on China's accession to the WTO conditionally defines China as a non-market economy (NME) country and this situation will last 15 years after its WTO accession. As a result, antidumping cases involving China would be resolved not on the basis of market-determined prices in the PRC but on production costs in "comparable market economies". Such treatment is highly disadvantageous to China. However, without this commitment WTO members would worry about the uncertain impacts of China’s transition economy on international trade. As put by the President of Semiconductor Industry Association, “this commitment was a vital part of China’s
overall accession package, and was central not only to industry support for accession and Permanent Normal Trade Relations (PNTR) but was also of paramount importance to lawmakers who voted in favor of the deal. In another word, Industries as well as governments turned China’s commitment to maintain its NME status to a somewhat regime constraints to control China’s future trade behaviors.

Safeguard Clauses are the most direct and useful tools to prevent the dumping from transition economy. Under certain conditions set forth in the WTO Agreement on Safeguards, a country may impose quantitative restrictions on imports. Since this is a major departure from the most basic WTO principles of eliminating all quantitative trade restrictions, the conditions that must be fulfilled before a country impose import quotas are rather rigorous. The country imposing restriction must demonstrate that increased imports have caused or threaten to cause serious injury to domestic firms producing similar or competitive products. Most importantly restrictions on imports imposed under a safeguard measure must be applied on a most favored nation basis, that is, proportionately on all suppliers. In contrast, under the terms of the transitional product-specific safeguard clause in China’s protocol of accession to the WTO, it will be fairly easy for the WTO members to impose restrictions on goods imported from China. The injury standard is low--- market interruption, rather than serious injury. Particularly they can impose a quota or other restrictive arrangement solely from China, even when imports of the same production from other countries have increased. The U.S. Trade Representative General Counsel refers to this as the “China-specific” feature of the
transitional safeguard” because it was solely designed for China. This unique and ‘WTO-unfriendly’ clause China has agreed to, according to the USTR Charlene Barshefsky, “exists for no other country in the world”.

Addressing their concern about China’s credibility, WTO members designed a China-specific transitional review mechanism, in which it will be subject to an unprecedented annual review for the first eight years of membership. A final transitional review is scheduled for the tenth year, after which China will be subject to the ordinary trade policy review. Not only is China’s transitional review far more frequent, it appears that it will be more intrusive. It will involve sixteen subsidiary bodies of the WTO. Each of these bodies will review China’s compliance with its commitments in the area of that body’s mandate. By comparison, the normal Trade Policy Review is conducted by the staff in the Trade Policy Review Division of the WTO Secretariat.

In the U.S. China’s accession to the WTO raised expectation with Congress, government and the private sector about the prospects for China to comply with the WTO rules and market access commitments it made. For example, government agencies like State Department, USTR, DOC, USCC, GAO, major think tanks and major industry associations have prepared the review of China’s WTO compliance annually since its accession in 2001. Multilaterally, annual WTO review of China’s progress, through the Transitional Review Mechanism (TRM), has also been done annually. For example, in 2003 11 out of a total of 148 WTO members participated in the TRM of China’s trade
commitment implementation. These members participated by submitting written questions to China prior to meetings of 16 WTO subsidiary bodies with a role in the TRM, or by raising issues verbally with China during these meetings, which occurred from September to December 2003. Specifically, 7 WTO members both submitted written questions and discussed issues verbally in some TRM meetings: the U.S., EU, Japan, Chinese Taipei, Australia, Canada, and Mexico. Four other members--- Brazil, Korea, Norway, and Pakistan--- only participated verbally during some meetings. The U.S. was the most active member in the TRM, participating one or both ways in 14 of the 16 subsidiary bodies.\textsuperscript{16} Beijing government has taken the U.S. domestic and WTO multilateral annual review of China’s compliance seriously. A new department was created within the Ministry of Commerce to deal with China’s WTO affairs. Avoiding to solve bilateral trade dispute through the WTO dispute settlement mechanism is the clear policy set by the highest levels of Chinese government’s leadership.\textsuperscript{17}

**The Case Background**

In March 2004 U.S. filed the WTO complaint on its dispute regarding to China’s tax refund policy for integrated circuits. The U.S. case was the first against China since it joined the WTO in December 2001. Since its entry into WTO, the enforcement of China’s accession commitment has been a great concern to many parties. In another word, the controversy over China’s membership has continued. Therefore, the careful examination
of the emergence, evolution and final conclusion of this first dispute case can provide us a better understanding of China’s institutional practice and learning. Regimes are created to constrain state behaviors. Did the WTO membership transform, if yes then how, the domestic trade politics of China and its trade partners?

China provides for Value-Added Tax (VAT) rebate on semiconductor products manufactured and sold within the country while continuing to charge the full 17% VAT on imported semiconductor products. China applied a VAT of 17% on sales of imported and domestically-produced semiconductors. However, in June of 2000, China’s State Council announced that all integrated circuits manufactured in China would receive a rebate of the VAT in excess of 6% of the company’s tax burden (Circular 18). The Policy was amended in September 2001, with an announcement that integrated circuits built in China would be eligible for rebate of the VAT in excess of 3% (Circular 70). In October 2002, the Ministry of Finance (MOF) and State Administration of Taxation (SAT) jointly issued a new circular that reinforces Circular 18 and mandates that the 14 percent VAT rebate be enforced. Another circular extends a 6 percent applied VAT to integrated Circuits (IC) designed in China but produced overseas. The VAT rebates must be applied to research and development or capital expenditures within China. Clearly, this was the measure taken by Chinese government in order to promote its infant semiconductor sector.
GATT Article III on National Treatment prohibits a WTO member country from engaging in activity that treats domestic producers and products more favorably than imported products. Specifically, second paragraph of this article states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. The Chinese implementation of its VAT puts pressure on foreign semiconductor makers to design and manufacture their products within China, or face a cost penalty. The WTO does not allow countries to eliminate tariffs on the one hand, and arbitrarily impose a tax applied disproportionately on the other. While China does provide the benefits to both domestic and foreign-owned facilities in China, the different treatment of domestic production and foreign imports is a violation of its national treatment commitment.31

**Semiconductor as a Strategic Sector**

Since 2001, despite clear frictions regarding various industries, the U.S., as well as the EU and Japan, have refrained from taking any kind of formal action against China in the WTO. Then why did the US government choose to file this semiconductor case, instead of many other disputes that took place in the bilateral trading relationship? What makes the semiconductor so unique and sensitive? What was the policy goal for Beijing’s VAT rebate? What was the real concern of U.S. government?

If we look carefully China’s VAT rebate policy, it provides rebate to both Chinese and foreign manufacturers in China. In fact, according to the numbers revealed by the
Ministry of Information Technology in China, in the first half 2004 only 20 enterprises were eligible for VAT rebate and the total amount of VAT rebate paid was $13.8 million. Among them, most are U.S. investments in China including Intel, Motorola, Texas Instruments, AMD and only two Chinese firms enjoyed the same rebate. The amount from the U.S. source is $25 million in total Chinese government tax rebates for semiconductor manufacturers, which represent less than one-third of domestic semiconductor production. Both the small size of the subsidies and the foreign-owned enterprises as the majority recipients of the fund suggest that the purpose of this policy was trying to promote foreign investment and local production. It did not discriminate foreign-owned manufacturers against Chinese companies but discriminate imports against domestic production.

Semiconductors are the building blocks for American competitiveness in a broad range of high technology goods—from computer to medical technology. Semiconductors are the second largest U.S. export to China and China’s number one import. Today, China is the third largest country market in the world for semiconductors, and enjoys the world’s highest growth rate. By 2010, China is predicted to be the world’s second largest country market for semiconductors, behind only the U.S. China’s semiconductor market growth is occurring within the context of significant growth in China’s computer and telecommunications markets. The demand for chips is driven by China’s increasing role as an electronics manufacturing hub, producing everything from PCs and cellular phones to flat panel displays, digital cameras and DVD players. China is already the world’s
largest mobile phone market, and second largest PC market. Currently domestic Chinese production, including foreign owned facilities in China, represents about 15% to 20% of China market demand, with remaining 80% to 85% met by imports. Semiconductors exports to China in 2003 were $2.4 billion—making them the second largest manufactured export from the U.S. to China. And this figure may actually under-report the full value of U.S. semiconductor products exported to China, as the distributed nature of assembly and final testing in third-countries is not captured in US export figure. With any calculation, U.S. semiconductor industry has enjoyed the biggest share in Chinese market. While the U.S. export of low-end semiconductor products is greatly promoted, its export of semiconductor equipments as well as high-end semiconductors is subject to export control.

China has become the U.S.’s third largest trading partner after Canada and Mexico and its second largest source of imports. Interestingly, never in the Post WWII era has the US had such an important economic partner that was not a close friend or ally. In increasingly complex ways, China is an economic partner and an economic competitor. The policy dilemma here is on the one hand, U.S. wants to export more semiconductor products to Chinese market (which requires China to further eliminate its protectionist measures) and on the other hand, it has the security needs to implement export control and technology transfer toward the high-end semiconductor products. As stated by the U.S. Under Secretary of Commerce for Industry and Security Kenneth I. Juster, "the U.S. Government very much wants to support economic opportunities for the (domestic)
semiconductor industry," but is also aware that "some of these opportunities in China also raise potential security concerns, because advanced semiconductors are at the heart of today's advanced weapons systems." While the U.S. no longer controls the export of general purpose chips or microprocessors to civil end users in China, the equipment used to manufacture sophisticated semiconductors is tightly controlled. Under U.S. export control policy, license applications for semiconductor manufacturing equipment and technology are reviewed on a case-by-case basis by the Departments of Commerce, Defense, State, Energy and the intelligence community. The review process is thorough as the interagency vets the end-user to mitigate concerns that the technology will be diverted.

Since 1990s, China’s efforts to improve its semiconductor manufacturing capability have narrowed the gap between the U.S. and Chinese semiconductor manufacturing technology from between 7 to 10 years to 2 years. China’s most advanced commercial manufacturing facilities can produce chips that are only one generation behind current, commercial state-of-the-art technology. China has made improving its semiconductor manufacturing capability a priority for national and economic security reasons and plans to build as many as 20 multibillion-dollar manufacturing facilities over the next 5 to 10 years with substantial levels of foreign investment. In early 2002, GAO prepared a report for U.S. Senate entitled “Rapid Advances in China’s Semiconductor Industry Underscore Need for Fundamental U.S. policy Review”. Facing the emerging China semiconductor market and growing manufacturing capacity, the report states the U.S. aim at keeping
China at least two generations behind global-of-the-art semiconductor manufacturing capabilities and emphasis the need for government to review current policies and further strengthening export and investment control. For example, in 2001 Shanghai-based Semiconductor Manufacturing International Corp (SMIC), the biggest of its kind in China, faced problems when it tried to import two sets of semiconductor equipment from US equipment vendor Applied Materials, finding the export license for one batch of equipment being suspended by the US Government. SMIC finally gave the order to a Swedish company after several months of fruitless waiting.

In October 2003 the Semiconductor Industry Association (SIA) issued a study entitled China’s emerging semiconductor industry which, among its conclusions, finds that the country’s discriminatory VAT rebate scheme distorts trade investments and imposes a cost penalty for semiconductor importers trying to compete for sales in China. This semiconductor policy dilemma were reinforced by the facts that since 2001 the US have shed nearly 3 million manufacturing jobs and endured 42 consecutive months of economic decline in the manufacturing sector and the growing US trade deficit with China. Facing continuous protectionist pressures from the Congress, US government needs to take some action. China’s VAT rebate was chosen among a number of bilateral trade disputes because of its strategic importance and political visibility, and strong industrial lobbying.

**China’s Domestic Trade Politics**
Chinese Semiconductor manufacturers worked closely with the government in the process of US-China bilateral negotiation and the formulation of the alternative government policies. This is the new development since China’s WTO accession. Before, private sector tended to be excluded from the policy-making process. For example, When President Jiang Zemin announced Beijing’s decision to join the Information Technology Agreement (ITA) upon accession in 1997 at his APEC summit with President Clinton, Chinese enterprises were shocked wit this decision. Because phasing out tariffs on semiconductors, computers, telecommunications equipment and semiconductor manufacturing equipment, as required by ITA, would have great impact on China’s infant high-tech industries. However, these industries did not have the channel to convey their policy preference. That time they were not even informed when the decision was made.34 It seems that Chinese enterprises, especially CSIA, have been actively involved in the process of Semiconductor tax policy dispute with the U.S. After the issue was first raised by the U.S., domestic enterprises were invited to several meetings for policy consultation. Bound by both the WTO regime obligation and the U.S. bilateral pressure, Beijing was prepared to make concession at the beginning. This time they informed the domestic enterprises in advance so they could make timely adjustments. In addition, the industrial sector’s dissatisfaction with the current rebate policy also helped facilitate the conclusion of the negotiation. More importantly, semiconductor manufacturers had the opportunity to provide their policy suggestions and participated in the alternative policy formulation.
Overall, Chinese semiconductor manufacturers were not the proponents of this VAT rebate policy. First, China’s policies regarding value-added tax rebate on semiconductors have not brought substantial financial benefits to domestic Chinese manufacturers. Considering the US$4.6 billion semiconductor output value in 2003, the tax rebates were only US$138 million, which is insignificant to many semiconductor companies in China. Richard Chang, chief executive officer with SMIC, the biggest Chinese manufacturer, estimated that the elimination of the tax rebate policy would cause US$1.7 million of losses for his company in 2004, as compared with US$221 million of revenues of SMIC in the second quarter of 204. Many smaller enterprises were not even eligible for tax rebate because their average tax burden is about or lower than 6%. Mo Dawei, a senior industrial expert, said that according to a survey conducted by official agencies before Circular Number 18, the tax burden for large-scale domestic semiconductor companies was about 6 percent, so they would get 3 percent of VAT rebates at most. According to a CSIA official, with the 6% requirement (Circular 18), no Chinese enterprise applied for rebate; with the requirement of 3% (Circular 70) only few Chinese enterprises received rebate. Neither circular could provide 11% to 14% tax rebate, as charged by SIA. This miscalculation was caused by the confusion between tax burden and tax rate. China's tax rebate policy for chip makers in the domestic market formerly stipulated the portion above the 6 percent line of the firms' "tax burden" - not "tax rate" - would be rebated. Experts estimate that Chinese firms' real tax burden is not more than 6 percent and in some cases as low as 3 or 4 percent. It means domestic firms cannot enjoy significant benefit from the policy. The VAT in China is applied at each link - at a rate of
17 percent of the exchange of goods in the production process. Chip making is a process composed of several links - with each serving as the supplier of the next - before the product finally comes out. At each link, the 17 percent VAT on the increased value is levied. Part of the taxation on the producer at each link is deducted because that portion has been paid and is included in the supply the producer buys from the previous link. Because the deduction is made at each link, the final taxpayer appears to pay a much lower rate of tax, which is called tax burden. Due to taxation differences, however, US chip makers do not pay tax before the final consumption stage. In other words, US chips arrive at Chinese customs free of any taxation. By levying a 17 percent VAT on imports and at the same time grant local products tax rebate over the 6% tax burden, the Chinese Government puts overseas and domestic firms on a level playing field.\textsuperscript{39}

Second, the small size of the subsidies also points to the inability of the Chinese states to implement its policies effectively. Since March 2002, State Council took the role of determining the rebate eligibility of VAT rebate from MII to the Taxation department. However, local taxation departments were not capable of taking this responsibility and delayed the whole tax rebate process. In many occasions the VAT has not been fully rebated because provincial and local authorities may refuse to rebate VAT charges collected by another jurisdiction within China. As a result, though the planned rebates should have totaled 14% of the domestic production, the actual subsidies represent less than one-third of 1 percent of domestic semiconductor production.\textsuperscript{40}
Third, Chinese enterprises was hoping for substituting this VAT rebate policy with other WTO-compliant government policies that can benefit the semiconductor sector as a whole. There is certainly no lack of feedback from the industry. The current policy was not widely understood, and actually benefited fewer than 20 companies, most of which were large, capital-intensive manufacturers, such as SMIC and Huahong-NEC. Many small companies said they never saw a nickel. The industry began to lobby for new government policies that emphasize on infrastructure improvement, general R&D and easy access to capital. According to Elton Zhuo, an official with the Beijing Semiconductor Industry Association, "A lot of little companies are waiting for the new policy and hope it will have some real benefit. The old system was not running so well, so maybe you paid the whole tax and never saw the rebate."  

The Negotiation

U.S. government filed the compliant to the WTO on March 23, 2004. This was an unexpected move though the dispute had existed for a while. Right after the issuing of the circular 18 by State Council, U.S. Semiconductor Industry Association (SIA) communicated with China’s Ministry of Foreign Trade and Economic Affairs (now Ministry of Commerce) in the end of 2000. In December 2001 the SIA complained that circular 18 and the following circular 70 had violated the nondiscrimination principle of the WTO, one month after China joined the WTO. In June 2002 government officials and industry representatives from these two countries had their first face-to-face discussions
at the International Semiconductor Forum held in Beijing. The intergovernmental talks began in 2003. After USTR put this issue in its 2002 Report to Congress on China WTO Compliance, Beijing began to take it seriously. A research group was created including officials from six relevant ministries including Ministry of Finance, State Administration of Taxation, Ministry of Commerce to work on new WTO-consistent industrial policy.42

At the time the U.S. filed the formal complaint, the U.S. and China had bilateral communications on this issue for over three years and Chinese research group already finished their policy report. The gap between the two sides had been narrowed and two governments were close to reach an agreement according to the Chinese side.43 Chong Quan, spokesman of the Ministry of Commerce, said in a statement that China and the U.S. had already held some rounds of bilateral talks on the issue of VAT on integrated circuits, and had made some progress. The Chinese side expresses complete bafflement at the sudden US demand for consultations through the dispute settlement mechanism of the WTO at a time when bilateral consultations are continuing. “In the normal course of bilateral consultations, the US side suddenly raised a request under the WTO dispute resolution mechanism. China really does not understand this”. 44

However, the U.S. side seemed to have a different story. The Financial Times, citing unidentified US officials, reported that US trade representative Robert Zoellick's office planned to delay a filing until after the 15th U.S.-China Joint Commission on Commerce and Trade (JCCT) meeting in Washington on April 19th involving top economic officials
from China and the US, then changed that plan after the Chinese Government told a US trade official in Beijing a week earlier there was no chance of dropping the tax at the meeting. Instead, China chose to make concessions on its controversial WAPI standard and 3G policies on the JCCT meeting.

On April 27 the U.S. and China held consultation in Geneva, EU, Japan and Mexico participated in the consultation as the interested third party. The following bilateral negotiations were held in Beijing and Washington, D.C. on May 27, June 15 and July 1-2 respectively. The two sides reached consensus for the most parts of the MOU and the formal agreement was signed on July 14th. The negotiation only took 123 days and the dispute was resolved before moving to the next step of the dispute settlement procedure--- establishing a dispute settlement panel to consider whether China is acting in accordance with its WTO obligations. According to the Memorandum of Understanding (MOU), Effective immediately, China will not certify any new semiconductor products or manufacturers for eligibility for VAT refunds, will no longer offer VAT (Value-Added Tax) refunds that favor semiconductors designed in China, and, by April 1 of next year, stop providing VAT refunds on Chinese-produced semiconductors to current beneficiaries.

Compared to many other WTO complaints, this negotiation was not difficult. As one Chinese negotiator put, “from the first day of negotiation we knew we had to make concession. In another word we knew the negotiation outcome even before it
As the bilateral trade as well as the trade deficit is increasing, trade frictions are inevitable. However, to Beijing filing complaints in the WTO was unexpected. First, in the past three decades of Beijing’s open-door era, it has been used to negotiating trade disputes bilaterally and behind closed doors. Indeed, after its WTO accession, the U.S. and China has negotiated bilaterally a number of trade disputes including the market access problems for U.S. beef, soybean, auto parts, express delivery, furniture, TV, steel and the rule-based disputes on auto financing, IPR protection and export quotas for Chinese textile products. Second, this WTO complaint was linked to the reputation concern of the Chinese leaders on its WTO commitment compliance. The message from the central leader to the negotiator was clear: trying to resolve it at the consultation stage and keep it low-key.

**Conclusion**

The effect of international regime on state behavior is a central concern of international relations scholarship. To many transition economies, being acceded into international institution is the very first step for them to get integrated into international community. Their commitment compliance has significant consequence on global governance. This case study explores the impact of the extra set rules written in China’s accession protocol on its policy choices. There is much evidence of a willingness to address concerns that the U.S. raised. The negotiation suggests that the reputation concern of Chinese
government constrains its behavior. This does not mean that there will not be compliance problems, and in fact in China there was an undercurrent of concern over the ability of China’s industries to compete in an open home market with the WTO rules put in place. This concern has always been accompanied with domestic protectionist pressure. The active involvement of domestic private sector is a new development within China’s trade politics. Their policy preference also helped to put an end to the bilateral dispute on China’s semiconductor VAT rebate policy.
1 Cowhey, 1993; Fearon, 1994; Gaubatz, 1996; McGillivray and Smith, 1998


10 WTO, Accession of the People’s Republic of China (Decision of November 10, 2001), WT/L/432

11 For the complete document on the protocol and working party report on China’s accession, see [http://www.wto.org](http://www.wto.org).


13 Testimony of Ambassador Charlene Barshefsky Before the. House Committee on Ways and Means. on China's WTO Accession and PNTR. May 3, 2000

14 These are the Council for Trade in Goods, Council for Trade Related Aspects of Intellectual Property Rights, Council for Trade in Services and Committee on Balance of Payments Restrictions, Market Access, Agriculture, Sanitary and Phytosanitary Measures, Technical Barriers to Trade, Subsidies and Countervailing Measures, Antidumping Measure, Customs Valuation, Rules of Origin, Import Licensing, Trade Related Investment Measures, Safeguards, and Trade in Financial Services


17 Interview, May 2006 in Beijing

18 State Council Document Number 18

19 MOF and SAT Circular No. (2002) 70

20 MOF and SAT Circular No. (2002) 140
21 “China’s Compliance with WTO Committee”, Testimony of Daryl G. Hatano, Vice President of Semiconductor Industry Association, Before the Office of the USTR, September 18, 2002


23 Testimony of Anne Craib, Director of International Trade and Government Affairs, SIA, Before the U.S.-China Economic and Security Review Commission, Hearing on China’s WTO Compliance and U.S. Monitoring Efforts, February 5, 2004

24 “China’s Compliance with WTO Committee”, Testimony of Daryl G. Hatano, Vice President of Semiconductor Industry Association, Before the Office of the USTR, September 18, 2002

25 Testimony of George Scalise, President of SIA, “China’s High-Technology Development”, Before the U.S. China Economic and Security Review Commission, April 21, 2005, p.3


29 “Rapid Advances in China’s Semiconductor Industry Underscore Need for Fundamental U.S. Policy Review”, GAO Report to the Ranking Minority Member, Committee on Governmental Affairs, U.S. Senate, April 2002, see http://www.gao.gov

30 Ibid, p.3


32 See http://sia-online.org/pre_release.cfm?ID=287

33 http://kerry.senate.gov/v3/cfm/record.cfm?id=240185

34 Interview

35 “Elimination of VAT rebate will result in the termination of the common practice in Semiconductor sector to cheat for export tax rebate”, Xing Jing Daily, 7/16/2004


37 Interview

38 “China’s High Technology Development”, Testimony of George Scalise, President of SIA, Before the US China Economic and Security Commission, April 21, 2005


“China mulls new aid to chip makers”, *EE Times*, see http://www.eetimes.com/issue/mn/showarticle.jhtml?articleID=51201468


Ibid


Interview, June 2006 in Beijing

Interview, August 2006 in Beijing