

What is Chinese “Innovation Mercantilism” and How Should the UK and Allies Respond?

Robert D. Atkinson, President, Information Technology and Innovation Foundation
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During the post-war period there were two main economic systems: free-market (albeit with different levels of state involvement in different nations) and communist. With the fall of the Soviet Union, the “West”, and market-based capitalism, had supposedly triumphed. We went from “one world, two systems”, to “one world, one system”.

It was in this context that China was welcomed into the World Trade Organization in 2001, with the expectation that, while China was far from a market economy, joining the “free traders club” of the WTO would lead it to become one.

It is clear to all but the most stubborn free traders that this was wrong. Whether China ever had any intention of becoming a market-based economy – the source of heated debates – is largely irrelevant. What is clear is that China’s “state capitalist” system is at fundamental odds with the principles and rules of the World Trade Organization and that we are back to “one world, two systems”.

While China’s system can appear market-based, and the Chinese Communist Party (CCP) goes to great pains to portray it as such, in fact, it is a system in which the purpose of enterprises – private and public – is not to make money; it is achieve global wealth for China.¹

CHINA’S FOUR-STAGE INNOVATION MERCANTILIST PLAYBOOK

The CCP employs an array of tools to obtain that alignment between state and enterprise. In particular, for over a decade, China has embraced “innovation mercantilism” to gain global market share in most advanced technology industries, including existing (such as semiconductors and 5G equipment) and future (such as AI, biotechnology, and quantum computing).

China has a well-worn, four-stage innovation mercantilism playbook that is used to guide the development of virtually every targeted industry and technology.

Stage one: Allow foreign imports.

Stage two: require foreign companies to set up joint ventures and engage in technology transfer in exchange for market access. This is supplemented by rampant intellectual property theft, through both human and cyber means.

Stage three: Once Chinese firms have incorporated foreign technology, the government massively subsidizes their progress, while at the same time squeezing foreign firms out of the Chinese market.

Stage four: With now successful firms, the state subsidizes them firms to enter foreign markets, while at the same time works to manipulate global technology standards bodies to ensure the dominance of Chinese technical standards.

China is following that playbook in host of technologies and industries, including biotech (stage 2); aerospace and semiconductors (stage 3); and solar panels, Internet applications, and high-speed rail (stage 4).

THE PLAYBOOK FOR TELECOM EQUIPMENT

The industry farthest along in the application of China's innovation mercantilist playbook is telecommunications equipment. In 1979 the Chinese government designated the telecom equipment industry as one in which China sought "absolute control".² But Chinese firms were so backward, the CCP allowed domestic telephone companies to buy more technologically advanced foreign equipment.

China moved quickly to stage two and required foreign companies seeking to sell in China to set up joint ventures. Within 10 years virtually every major foreign telecom equipment company and China went from 100 percent of market provided by imports in 1982 to 0 percent in 2000, with 60 percent of from foreign JVs and 40 percent indigenous suppliers.³ Huawei and ZTE directly benefited from this.

China supplemented that with massive intellectual property theft. Perhaps the most egregious was the cyber theft from Canadian telecom equipment company Nortel.⁴

Without more capable Chinese firms that could absorb the technology, JV's were not enough. As a result, the CCP called on the People's Liberation Army (PLA) to fund the development of telecom

switches (at a time when Huawei founder Ren Zhengfei was a member of the PLA) which it later transferred to Huawei and other Chinese firms.⁵

Once Huawei and ZTE gained capabilities, stage three kicked in with Chinese governments showering them with subsidies, including R&D grants, cheap credit from state banks, and an undervalued yuan. Huawei alone received over \$75 billion in subsidies.⁶ China also severely limited foreign market access, by raising tariffs and requiring state-owned telecom companies to limit foreign purchases.

Finally, at stage four, the government provided massive aid for Huawei and ZTE to gain foreign market share. For example, Chinese banks made loans to bail out foreign telecom service providers that were tied to buying equipment from Chinese companies.⁷

WHY SHOULD POLICY MAKERS CARE?

Why does it matter what China does domestically? Some economists argue that if China wants to engage in state capitalism, let it.

But consider the following thought experiment: Parliament amends the UK Company law to create two kinds of corporations, A-corp and B-corp and randomly assigns half of U.K. corporations to each group. For A-corps, nothing changes. But B-corps now enjoy special privileges and rules. They are exempt from laws governing intellectual property theft. They receive more favorable tax incentives. UK governments procure goods only from B-corps. They get sizeable subsidies, including to buy their A-corp rivals. And they are able to enlist UK courts to win capricious legal claims against A-corp rivals.

The result of such an experiment would be dire: The best, most innovative A-corp firms would lose market share; A-corps would be loath to invest in R&D, given that B-corp rivals would be able to purloin it; and there would be massive waste as inefficient B-corp firms expand more than market forces would dictate. Now extrapolate that to the global economy and you get a sense of the harms the Chinese system has imposed on capitalist economies.⁸

And of course, China is seeking not only self-sufficiency but global dominance in virtually all advanced industries and technologies. Their success would have disastrous consequences on allied military advantage.

FOUR CHOICES TO RESPOND

Advanced, free-market democracies have four choices: complacency, change, containment, and competition.

Complacency: Hoping things work themselves out, which many western China scholars advocate, risks Western decline and Chinese global economic, technological and foreign policy hegemony.

Change: Pressing China, either bilaterally or multilaterally, to roll back its innovation mercantilist regime – while worth trying, is unlikely to show significant results. As long as China is controlled by the CCP, there is not much hope that the world can be remade in the Ricardian image of free-trading nations pursuing comparative advantage through fair, rules-based trade.

After all, the Trump administration took steps, at a cost to the United States economically and politically, to get China to roll back some of its most egregious innovation mercantilist practices and it largely failed. The Biden administration hopes to do so through an alliance-based approach, but some key nations appear more interested in defending their exporters' interests than in ruffling Beijing's feathers. Even if they did join, China shows no signs of changing course, as we have seen with China's 16th 5-year plan that doubles down on innovation mercantilism.⁹

Some, especially Brussels, believes WTO reform is the ticket. But the WTO's one nation, one vote system makes real reform that would enable tough action against China difficult.

Containment: While containment was possible with the Soviet Union – the United States sold them Pepsi, Levi's jeans, and grain – containment is much more difficult for with China, in large part because allied nation businesses are so embedded in the Chinese market. Nonetheless, some joint efforts make sense.

Allied nations should seek market-based decoupling, whereby they encourage and support their firms to leave China, especially establishments designed for export. They should help low-wage nations, especially India, that might serve as alternative low-cost centers of foreign production. They should also incentives for companies to reshore Chinese production, something Japan and Taiwan have done. The UK could combine this goal with its "leveling up" initiative to provide tax incentives to move production from China to economically disadvantage areas of the UK.¹⁰

What containment should not mean is cutting off commercial exports to China, including cutting off exports of computer chips and other key inputs to a firm like Huawei. Unless all allies, including Europe, Japan, South Korea, Taiwan, and the UK, agree on a particular technology export ban, such a ban will principally hurt the nation(s) imposing it.

In fact, it is in the long-term economic and military interests of allied-based economies and their companies to sell as many non-military goods and services to China as possible. Every pound's worth of semiconductors or jet engine exports a UK firm sells to China is a yuan that Chinese firms do not make, and a pound that can support UK R&D.

Allied nations should also formally cooperate in a host of areas. They should step up commercial counterintelligence efforts and cybersecurity to limit Chinese access to key intellectual property.¹¹ They should cooperate on limiting Chinese investment, including venture capital investments, in their countries. They should more effectively track Chinese companies that benefit from intellectual property theft or unfair subsidies, and limit their market access.

Allied nations should form a new "NATO for trade" to combat Chinese trade aggression. Since the Chinese coverup of the origins of the COVID-19, the Chinese communist party has stepped up its intimidation of foreign governments and even individuals who dare to challenge its actions. The Communist party regularly weaponizes its vast array of policy tools to punish any nation that doesn't kowtow to Beijing. It threatens to cut off exports of foreign students, tourists, and key minerals and limit imports a nation's products or punish their foreign firms doing business in China. No nation wants to individually bear the brunt of the Chinese attack, so most usually quietly capitulate.

Allied nations should form a pact where they agree to come to the aid of each other when economically threatened by the CCP. This new organization – DATO (Democracies' Alliance Treaty Organization) – would be governed by a council of participating countries and if any individual nation is threatened or attacked, DATO would quickly convene and potentially agree to take joint action to defend the nation attacked. For example, if China threatened to cut all students to a nation, DATO nations could agree that they would ban Chinese students. If China threatened to put a country's firms on its "unreliable list", the DATO nations could agree to limit imports from Chinese firms. Any democratic nation would be welcome to join, including Taiwan, but should any nation not take the needed steps to respond after a DATO decision, they would lose the right to be a member.

Competition: Unless allied nations do a better job of boosting technological innovation and production at home, China will win. But to do that effectively, Anglo-American nations in particular will need to cast off the constraining yoke of neo-classical economics that asserts that any government action to support advanced industries and technologies is some kind of Gosplan socialism. This will open the debate to fresh, empirically-based, pragmatic analysis, rather than the ideological edicts related to industrial strategy that now pass for expert insight from economists and publications that align with them.¹²

To be sure, the UK is farther down this intellectually liberating path than the United States, as evidenced by the new and proposed UK initiatives, including the new “DARPA” and the “leveling up” initiative to encourage more technology hubs. But still, more, such as a more generous R&D tax credit, can be done.¹³

Allied nations needs not just their own national advanced industrial strategy, but an allied strategy to ensure that as a group, allies have the ability to produce innovative products at competitive prices in a set of key areas. Such an alliance should build on each nation’s key areas of technology (in the UK’s case this would involve technologies like aerospace, AI, semiconductors and biotechnology, among others). And firms in cooperating nations would be able to participate in national programs from member nations.

CONCLUSION

It is possible that once Xi leaves office that reformers will gain power, or even that as Chinese’ per-capita incomes grow that democracy will prevail. But to rely on this as providing for allied nations’ economic and technological security is wishful thinking. Allied nations need to work vigilantly and cooperatively to ensure that by 2049, the 100th anniversary of the Chinese Communist revolution, that allied nations are still strongest economically and technologically.

ENDNOTES

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3. Qing Mu and Keun Lee, "Knowledge diffusion, market segmentation and technological catch-up: The case of the telecommunication industry in China," *Research Policy*, vol. 3, iss. 6, (2005) 759–783 764, <https://doi.org/10.1016/j.respol.2005.02.007>.
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 9. [China Targets AI Chips Among Seven Battlefronts in Tech Race With U.S. - WSJ](#)
 10. [Killing Two Birds With One Stone: Why Congress Should Establish a Tax Incentive For Companies Reshoring Production from China to U.S. Labor Surplus Areas | ITIF](#)
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 13. [Enhanced Tax Incentives for R&D Would Make Americans Richer \(itif.org\)](#)