

The Evolution of US - China Tax Policies in the Second Phase of the Trade War from Tariff Retaliation to Systemic Decoupling

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Abstract. The U.S.-China trade war's second phase (2022-2025) shifted tax policies from tariff retaliation to systemic decoupling. This paper shows policy evolution across phases via comparative analysis of tariff measures, policy documents, and trade data. The first phase of the trade war (2018-2022) saw reciprocal tariffs: U.S. imposed duties on \$550B Chinese goods; China responded symmetrically, using VAT cuts and export rebates, with bilateral trade dropping 12-19%. In the second phase from 2022 to 2025, the main focus shifted to the technology: U.S. imposed 35% tariffs on advanced semiconductors with export controls, while China adopted non-tariff barriers, 15% tax for chip firms, and standard setting. Apart from that, it analyzes WTO disputes to U.S. unilateralism violating rules, China leveraging WTO mechanisms, and finds decoupling accelerating via trade diversion, investment fragmentation, and tech silos. Digital trade grew to \$125B in 2024, offering engagement. The study concludes that targeted policies could foster "competitive coexistence." Finally, it shows the possible influences and future outlook.

Keywords: U.S.-China Tax Policies, Tariff Retaliation, Systemic Decoupling, WTO Legitimacy Disputes, Digital Trade and Cross-Border E-Commerce

1. Introduction

The U.S.-China trade war, which emerged in 2018, has undergone a profound transformation as it entered its second phase (2022-2025), marked by a critical shift in the nature of tax and trade policies. What began as a phase dominated by reciprocal tariff retaliation in the first period (2018-2022) has evolved into a more complex landscape characterized by strategic competition and a growing trend toward "systemic decoupling" in the second phase.

In the initial stage, both the United States and China utilized tariffs as their main policy tool, with the U.S. imposing tariffs on over \$550 billion of Chinese goods by 2019, targeting machinery, electronics, and consumer products with rates up to 25%. China responded with symmetric tariff measures, imposing 25% tariffs on U.S. soybeans, 10% on LNG, and 20% on automobiles—key sectors in U.S. agricultural and industrial states. To buffer domestic impacts, it reduced manufacturing VAT from 16% to 13% in 2019 and expanded export tax rebates for tariff-hit industries (textiles with up to 16% rebates, machinery with 13%). However, as the conflict

progressed into the second phase, the U.S. escalated its tariff policies, focusing on high-tech industries, while China shifted its strategy beyond mere tariff retaliation. Instead, China has prioritized enhancing systemic resilience, which includes promoting technological self-reliance through tax incentives and engaging in standard competition to reduce dependence on U.S.-dominated systems.

This evolution not only reflects the deepening of economic and technological frictions between the two nations but also points to the broader phenomenon of systemic decoupling—a deliberate effort to separate their economic and technological spheres, which will be presented in the following context. Such a shift has far-reaching implications for the global trade order, supply chains, and international cooperation. Understanding the dynamics of these policy changes, their manifestations, and their impacts is crucial for navigating the future of U.S.-China economic relations and ensuring global economic stability. This paper aims to explore these developments, analyze the associated WTO legitimacy disputes, examine the role of digital trade as a potential breakthrough, and propose policy implications for the way forward.

To achieve its objectives, this study employs a mixed-methods approach, combining qualitative analysis of policy documents (including U.S. tariff notices, Chinese tax incentive policies, and WTO dispute rulings) with quantitative data on trade flows, investment trends, and digital trade volumes from government agencies and international organizations. The main structure of this paper is as follows: Section 1 traces the evolution of U.S.-China tax policies from the first phase (2018–2022) to the second phase (2022–2025); Section 2 analyzes the legitimacy disputes of these policies under WTO rules; Section 3 explores the manifestations, drivers, and global spillovers of systemic decoupling; Section 4 examines digital trade as a potential breakthrough amid decoupling; and Section 5 puts forward policy implications and future prospects.

2. Evolution of tax policies: from first phase to second phase

The trade war has witnessed a distinct shift in the use of tax policies, from reciprocal tariff measures in the first phase to a focus on strategic sectors and technological competition in the second. This evolution reflects deepening geopolitical rivalry and a redefinition of how tax policy influence national security and economic dominance.

2.1. First phase (2018–2022): tariff-centric retaliation

The initial phase was characterized by mutually retaliatory tariff hikes, with both nations using tax policy as a primary tool to exert economic pressure.

In terms of the U.S. tariff initiatives, under Section 301 of the Trade Act, the U.S. imposed tariffs on over \$550 billion of Chinese goods by 2019, targeting machinery, electronics, and consumer products. At the trade policy level, the Trump administration implemented multiple rounds of large-scale tariff adjustments on China starting from 2018. According to statistical data from the Peterson Institute for International Economics (PIIE), the average U.S. tariff rate on Chinese goods rose steadily from 3.1% at the beginning of 2018 to approximately 20% and stabilized at around 19.3% in 2023 [1]. Justified as responses to "unfair trade practices", for instance, intellectual property concerns, these measures bypassed WTO mechanisms, prioritizing unilateral leverage over multilateral norms.

As for China's response, they retaliated symmetrically, imposing tariffs on \$110 billion of U.S. goods—focused on politically sensitive sectors like soybeans, LNG, and automobiles. To buffer

domestic impacts, it reduced manufacturing VAT from 16% to 13% in 2019 and expanded export tax rebates for tariff-hit industries (textiles, machinery), aiming to sustain competitiveness [2].

As a result, the tariff war disrupted global supply chains, with U.S.-China bilateral trade dropping 12–19% by 2019 [3]. Multinational firms began "friendshoring" production to Southeast Asia and Mexico, while third economies like Brazil (soybeans) and Vietnam (electronics) benefited from diverted trade. The IMF estimated a 0.5% global GDP loss due to the conflict.

2.2. Second phase (2022–2025): strategic escalation and paradigm shift

By 2022, the conflict entered a new phase, with tax policies subordinated to technological containment and self-reliance. This phase shown a shift from short-run trade leverage to long-run technological autonomy, with tax policies now serving broader geopolitical goals.

The U.S. shifted to sector-specific tariffs targeting China's tech ambitions, imposing 35% duties on advanced semiconductors and AI chips, and 25% on solar components [4]. These were paired with export controls (e.g. expanded Entity List restrictions on Huawei and SMIC) and ally pressure to cut China off from global tech supplies. The strategy, aligned with the CHIPS Act (2022), aimed to maintain U.S. dominance in "dual-use" technologies.

While China took actions. Avoiding direct tariff retaliation, China adopted three tactics:

(1): Non-tariff barriers: Stricter inspections on U.S. agricultural and energy imports, reducing U.S. corn and shale oil access.

(2): Tech subsidies: 15% corporate tax rates for semiconductor firms and 200% R&D tax credits, paired with \$30 billion in state subsidies for domestic chip development.

(3): Standard-setting: Accelerating global adoption of BeiDou navigation and EV charging standards, challenging U.S.-led frameworks in ASEAN and developing markets [5].

3. WTO legitimacy disputes: clash between unilateralism and multilateral rules

The evolution of U.S.-China tax policies has laid bare profound tensions between unilateral action and multilateral trade rules, with the WTO struggling to mediate disputes. This section analyzes how U.S. policies challenge WTO norms, China's strategic use of WTO mechanisms, and the applications of global trade governance [6].

3.1. WTO rules and U.S. policy contradictions

The WTO's foundational principles, non-discrimination (most-favored-nation, MFN), prohibition of unilateral tariffs, and binding dispute settlement, which are directly challenged by U.S. actions in both phases of the trade war.

The U.S. reliance on Section 301 to impose tariffs violates Article II of the GATT, which requires tariffs to be bound at negotiated rates, and Article I, which mandates MFN treatment. In 2020, the WTO Dispute Settlement Body (DSB) ruled in DS543 that U.S. tariffs on \$200 billion of Chinese goods were "inconsistent with WTO obligations," rejecting the U.S. national security justification. A subsequent ruling in DS589 (2022) found that U.S. tariffs on \$350 billion of Chinese goods were illegal, allowing China to impose retaliatory tariffs on \$64 billion of U.S. goods.

As for the erosion of the Appellate Body, the U.S. has blocked appointments to the WTO Appellate Body since 2017, rendering it non-functional by 2019. This has crippled the WTO's dispute settlement system: without an Appellate Body, rulings cannot be enforced, allowing the U.S.

to ignore adverse decisions. As former WTO Director-General Roberto Azevêdo noted, "The system is on life support... great powers are increasingly acting as if rules do not apply".

In terms of double standards in tariff application, the U.S. has exempted allies from certain tariffs—e.g., EU steel tariffs were lifted in 2021 while Chinese steel tariffs remained—violating MFN principles. This "friendshoring" of trade policy undermines the WTO's goal of a level playing field.

3.2. China's utilization of WTO mechanisms and reform advocacy

China has strategically used the WTO to counter U.S. unilateralism while positioning itself as a defender of multilateralism.

Firstly, litigation as a tool: China has filed 17 WTO cases against the U.S. since 2018, more than any other member. Beyond DS543 and DS589, China challenged U.S. tariffs on solar panels (DS512) and EV batteries (DS601), winning partial rulings that constrained U.S. policy options. These cases serve dual purposes: securing legal victories and signaling China's commitment to rules-based trade.

Secondly, coalition-building with developing nations: China has aligned with the G20 developing nations to push for WTO reform, advocating for stronger special and differential treatment (SDT) for emerging economies and stricter rules on industrial subsidies—issues that resonate with nations critical of U.S. and EU protectionism. At the 2023 WTO Ministerial Conference, China led a coalition of 60 countries to block U.S.-backed proposals to weaken SDT, demonstrating its influence in multilateral forums.

Finally, proposing WTO modernization: China's 2024 WTO reform proposal calls for: (1) restoring the Appellate Body by 2026, (2) updating rules to address digital trade and state-owned enterprises (SOEs), (3) clarifying the "national security" exception to prevent its abuse.

While the U.S. has rejected key elements—particularly SDT—China's proposal has gained traction among middle-income nations, positioning it as a constructive reformer.

4. Systemic decoupling: manifestations, drivers, and global spillovers

The second phase of the trade war has accelerated "systemic decoupling"—a certain reduction in economic interdependence between the U.S. and China across trade, technology, and finance. This decoupling is not accidental but a product of strategic choices, with tax policies playing a supporting role in reshaping economic relationships.

4.1. Economic decoupling: trade diversion and investment fragmentation

Economic decoupling is most visible in diverging trade and investment flows, as both nations reduce reliance on each other.

Trade diversion: U.S.-China bilateral trade peaked at \$659 billion in 2018 but fell to \$583 billion in 2024, with the share of U.S. imports from China dropping from 21% to 16% [7]. This decline is offset by increased trade with third countries: U.S. imports from Vietnam rose by 80% from 2018 to 2024, while China's imports from Russia surged by 150%, driven by energy and agricultural goods.

Investment fragmentation: U.S. FDI in China fell from \$14 billion in 2018 to \$8.1 billion in 2024, with tech sectors seeing a 70% drop. Conversely, Chinese FDI in the U.S. plummeted from \$19 billion in 2016 to \$3.2 billion in 2024, due to U.S. Committee on Foreign Investment in the United States (CFIUS) restrictions. Both nations are prioritizing "friendshoring": U.S. firms direct

60% of new Asian investments to India and Vietnam, while Chinese firms invest heavily in Brazil and Southeast Asia.

Financial decoupling: U.S. regulators delisted 160 Chinese firms from Wall Street between 2020 and 2024, citing audit disputes, while China's "A-share" market now hosts 70% of its tech IPOs, up from 30% in 2018. Currency usage is also shifting: 15% of China's trade is settled in yuan in 2025, up from 2% in 2018, as it signs currency swap agreements with Saudi Arabia and Brazil.

4.2. Technological decoupling: the "splinternet" and innovation silos

Technological decoupling is the most deliberate and consequential form of decoupling, with tax policies and export controls reinforcing a split between U.S.-centric and China-centric tech ecosystems.

(1): Semiconductor sector: The U.S. ban on exporting advanced chipmaking equipment to China has forced China to develop domestic alternatives. By 2024, China's SMIC mass-produced 14nm chips, sufficient for automotive and consumer electronics but not cutting-edge AI. Meanwhile, U.S. firms like Intel and AMD face reduced access to China's \$180 billion chip market, prompting them to build factories in Europe and Japan.

(2): Digital fragmentation: The internet is splitting into "Western" and "Chinese" spheres. China's Great Firewall now blocks 90% of U.S. social media and cloud services, while the U.S. restricts TikTok and WeChat. This "splinternet" raises costs: global tech firms like Microsoft spend \$15 billion annually maintaining separate China-compliant platforms.

(3): Research collaboration decline: U.S.-China co-authored scientific papers fell by 38% between 2018 and 2024, with AI and biotech seeing the steepest drops. This threatens global innovation: a 2024 study found that U.S.-China collaboration had historically accelerated breakthroughs in renewable energy by 25%.

4.3. Global spillovers: third countries caught in the middle

Decoupling forces third countries to navigate a "geopolitical trilemma": aligning with the U.S., China, or maintaining neutrality—each with economic costs.

Firstly, allies' balancing acts: The EU, caught between its economic ties to China (€850 billion trade in 2024) and security ties to the U.S., has adopted a "de-risking" strategy: restricting Chinese investment in critical tech but resisting full decoupling. For example, Germany's Volkswagen continues to invest in Chinese EV factories but complies with U.S. restrictions on sharing battery technology.

Secondly, small states' opportunism and risk: Nations like Vietnam and Malaysia benefit from supply chain relocation, with Vietnam's GDP growing by 6–7% annually (2022–2024) due to electronics exports. However, they face pressure to choose sides: Vietnam's 2024 decision to allow U.S. chip firms to build factories (with tax incentives) drew criticism from China, which threatened to restrict rare earth exports.

Finally, commodity market realignments: Countries rich in critical minerals (lithium, cobalt) are courted by both powers. Chile, the top lithium producer, signed a U.S.-backed trade deal in 2024 (with tariff reductions on lithium exports) while also negotiating a "strategic partnership" with China. This "resource diplomacy" creates new economic opportunities but also risks volatility.

5. Digital trade as a potential breakthrough: resilience amid decoupling

While traditional trade faces decoupling, digital trade (such as cross-border e-commerce, digital services, and data flows) has emerged as a partial exception, offering avenues for limited engagement. This section explores its dynamics, challenges, and potential to mitigate decoupling.

5.1. Dynamics of cross-border e-commerce growth

Cross-border e-commerce has proven resilient to tariffs and geopolitical tensions, driven by consumer demand and digital platform innovation.

(1) Growth trajectory: According to data from the General Administration of Customs, China's total import and export volume of cross-border e-commerce increased from 1.06 trillion yuan in 2018 to 2.38 trillion yuan in 2023, representing a 1.2-fold growth over the five years. Among the 2.38 trillion yuan in 2023, exports reached 1.83 trillion yuan, up by 19.6%, while imports stood at 548.3 billion yuan, growing by 3.9%. In 2024, this figure rose to 2.8 trillion yuan, a year-on-year increase of 18.6%, accounting for more than 30% of the country's total import and export volume of goods trade, which was 6.2 percentage points higher than the overall growth rate of China's foreign trade in the same period [8].

(2) Sectoral trends: U.S. consumers import \$45 billion in Chinese goods annually via e-commerce—primarily electronics (30%), apparel (25%), and home goods (20%)—while Chinese consumers buy \$80 billion in U.S. products, including health supplements (35%), luxury goods (25%), and baby products (20%) [9].

(3) Logistical innovation: Fulfillment networks like Amazon's Global Logistics and JD.com's Asia-Europe Railway reduce delivery times from 40 days to 10–15 days, while digital payment systems (PayPal, Alipay) simplify cross-border transactions. These innovations lower barriers for SMEs: 60% of U.S. SMEs using Amazon Global export to China, up from 15% in 2018.

5.2. Challenges: regulatory fragmentation and geopolitical risks

Despite growth, digital trade faces significant challenges, rooted in regulatory differences and geopolitical mistrust. First of all, regulatory divergence: U.S. and Chinese rules on data localization, consumer protection, and product standards create compliance costs. China's 2021 Data Security Law requires cross-border data transfers to undergo security assessments, while the U.S. Restrict Act (2024) bans platforms with "foreign adversary" ties—directly targeting TikTok. These rules force firms to build separate data systems, increasing costs by 20–30%.

Then, digital tax disputes: China's 2022 digital services tax (DST) imposes a 3% tax on revenue from Chinese users by foreign tech firms (e.g., Google, Meta), while the U.S. imposes a 10% tariff on Chinese digital goods (software, streaming services). The OECD's global tax deal (2021) aimed to resolve this but remains unimplemented, creating uncertainty.

Last but not least, geopolitical pressure: Platforms face "de-platforming" risks: U.S. lawmakers introduced 15 bills in 2023–2024 to ban TikTok, citing data security, while China restricted access to Google Services in 2023, impacting U.S. digital service exports.

5.3. Opportunities: regulatory cooperation and SME empowerment

Despite challenges, digital trade offers opportunities for targeted cooperation, particularly if regulatory barriers are addressed.

Bilateral digital trade agreement: A U.S.-China pact on data flows (e.g., mutual recognition of data protection standards) could reduce compliance costs by \$15 billion annually. Modeled on the U.S.-EU Privacy Shield (pre-2020), it could exempt SMEs from onerous data localization requirements.

SME empowerment: E-commerce lowers entry barriers: 80% of U.S. SMEs exporting to China via Amazon Global have fewer than 50 employees, while 70% of Chinese SMEs on Tmall Global have <100 employees. These firms lack the resources to navigate traditional trade barriers, making digital platforms critical for global access.

New business models: Live-streaming commerce—popularized by China’s Taobao Live and U.S.’s Instagram Shops—drives 30% of cross-border e-commerce, allowing real-time product demonstrations and cultural engagement. Social commerce, integrating shopping with social media, further bridges consumer trust gaps.

6. Policy implications and recommendations

To mitigate the risks of systemic decoupling and foster constructive competition, policymakers must pursue coordinated bilateral and multilateral actions, leveraging areas of mutual interest while managing differences. Systemic decoupling is unlikely to reverse entirely, but a "competitive coexistence" model is feasible: rivalry in tech and strategic sectors balanced by cooperation in climate, global health, and digital trade. Tax policies will play a role in this equilibrium, which is targeted to avoid systemic harm while protecting core interests.

Digital trade, if nurtured, could serve as a "confidence-building measure," demonstrating that limited integration benefits both nations. Ultimately, the stability of U.S.-China economic relations depends on recognizing that neither can fully decouple without incurring massive costs—and that multilateral rules remain the best framework for managing competition.

6.1. Bilateral measures: building trust through targeted cooperation

Firstly, reinstate high-level economic dialogue: On January 15, 2020, China and the United States signed the Economic and Trade Agreement between the People's Republic of China and the United States of America, namely the Phase One China-U.S. Economic and Trade Agreement, which halted the two-year trade war between the two countries. China committed to purchasing \$200 billion worth of U.S. goods and services over the two-year period from January 1, 2020 to December 31, 2021. The agreement also imposed on China a series of obligations centered on the protection of intellectual property rights. In exchange for these commitments, the United States agreed to cancel or suspend the imposition of harsh tariffs on most goods imported from China [10].

Then, establish "no-war zones" in trade: Protect sectors critical to global welfare from tariffs and restrictions:

Climate tech: Eliminate tariffs on solar panels, wind turbines, and EV batteries to accelerate decarbonization.

Medical supplies: Maintain tariff-free trade for pharmaceuticals and medical equipment, as during the COVID-19 pandemic.

Agriculture: Restore pre-2018 tariff rates on soybeans, corn, and pork, with transparency in biosecurity inspections to avoid non-tariff barriers.

Lastly, negotiate a digital trade agreement: Align on: (1) data flow rules (e.g., mutual recognition of privacy standards), (2) temporary suspension of digital taxes pending OECD implementation, and (3) safeguards for SMEs using cross-border platforms.

6.2. Multilateral reforms: strengthening global governance

Reform the WTO: Prioritize restoring the Appellate Body by 2026, with rotating judges and streamlined procedures. Update rules to address digital trade, industrial subsidies, and SOEs, balancing U.S. concerns about "unfair competition" with China's focus on development rights.

Expand plurilateral cooperation: Encourage U.S. and Chinese participation in initiatives like the Digital Economy Partnership Agreement and the Indo-Pacific Economic Framework's trade pillar. These forums allow for "mini-lateral" cooperation on specific issues, building trust incrementally.

Support developing economies: Establish an association to assist nations harmed by supply chain shifts, funded by a small tax on cross-border capital flows. This could reduce resentment and prevent alignment with one power bloc.

7. Conclusion

The evolution of U.S.-China tax policies from reciprocal tariffs to tools of systemic competition reflects a deeper geopolitical realignment, with profound implications for global trade, technology, and governance. The first phase (2018–2022) demonstrated the limitations of tariff-centric strategies, while the second phase (2022–2025) revealed the risks of unchecked decoupling—fragmented supply chains, stunted innovation, and strained multilateral institutions.

Yet, opportunities for mitigation exist. Digital trade offers a pragmatic avenue for limited engagement, while targeted policy reforms—bilateral "no-war zones," WTO modernization, and digital cooperation—could reduce tensions. The path forward requires recognizing that competition is inevitable but must be bounded by rules to avoid systemic collapse.

As the world's two largest economies, the U.S. and China bear a responsibility to manage their rivalry constructively. By aligning tax and trade policies with shared global interests—from climate action to pandemic preparedness—they can foster a more stable, prosperous global economy.

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