USCBC 2014 China Business Environment Survey Results:

Growth Continues Amidst Rising Competition, Policy Uncertainty
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Executive Summary

» The China market continues to deliver important revenue opportunities to American companies, even as GDP growth moderates. Nearly 50 percent of survey respondents report double-digit revenue expansion – fewer than in prior years, but still impressive compared to other markets around the globe.

» US companies remain overwhelmingly profitable in the China market, but increasing local competition and rising costs are combining to pressure profit margins.

» Policy uncertainty continues to temper executive optimism. Companies have seen little tangible impact from China’s economic reforms and report little improvement in any of the top 10 issues over the past year.

» There has been a steady 30 percentage point shift over the past four years in how companies view prospects in China’s market, from “optimistic” to “somewhat optimistic.” However, few executives are pessimistic about their prospects in China, a view consistent with other surveys.

» Uncertainty over policy direction is moderating expansion plans. Fifty percent of companies plan to boost resources in China over the next 12 months, down from almost 75 percent just three years ago. On the other hand, only 2 percent of companies say they will reduce resources in China, with the remainder neither increasing nor decreasing resources.

» Differential treatment of domestic and foreign companies in China runs throughout the top 10 issues and beyond. Real progress in implementing the market-based reforms announced by China’s new leadership and in concluding a US-China Bilateral Investment Treaty are necessary to put the commercial environment on a more positive trajectory.

» While American companies report that their primary competition is with other US and foreign companies in China, competition from domestic industry is growing. Some observers focus concern on preferential treatment received by Chinese state-owned enterprises, but survey data shows again that nationality may trump ownership - Chinese companies, whether state-owned or private, receive benefits that foreign companies do not.

» The lingering challenges of protecting intellectual property rights in China are well-known. While the enforcement environment continues to slowly improve, such improvements have been modest. American companies continue to limit their operations and IP exposure in China because of the lack of adequate protections.

» China’s environmental pollution is starting to impact staffing. Forty percent of companies report that air pollution has made it difficult to retain or assign expatriate staff to China. Pollution has also increased the use of sick leave by expatriate and local staff in China.

» China’s ramped-up enforcement of its relatively new antitrust and competition regime has garnered significant attention in recent months. While both foreign and domestic companies are being investigated, foreign companies appear to be facing increasing scrutiny. Eighty-six percent of respondents are concerned about the lack of transparency, due process, and other issues surrounding competition-related investigations.

» USCBC’s annual survey continues to stand out for the quality and unique profile of its respondents. Half of its respondents are China-based and half are based in the United States, resulting in responses that blend the on-the-ground experience with the global perspective and context. Eighty-five percent of participating companies have been in the China market for more than 10 years, with the majority bringing more than 20 years of experience to the survey’s results.

Top 10 Issues

1. Competition with Chinese companies in China
2. IPR enforcement
3. Foreign investment restrictions
4. [Tie] Human resources: Talent recruitment and retention
4. [Tie] Cost increases
6. Uneven enforcement/implementation of Chinese laws
7. Licensing
8. Transparency
9. Nondiscrimination/national treatment
10. Overcapacity in the China market
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Doing business in China can be a study in contrast for American companies. On the one hand, it remains a strong and growing market for American goods and services. On the other, it is a challenging and sometimes frustrating place to do business for multinational companies, with numerous regulatory barriers preventing the market from being as accessible — and large — as it should be.

This contrast is reflected in the results of the US-China Business Council’s (USCBC) 2014 member survey results. While most American companies continue to view China among the top five markets globally, their optimism about business prospects in China continues to moderate. Why? In addition to operating challenges such as increasing competition and rising costs, uncertainty about China’s policy direction colors perceptions about the business environment.

Foreign companies’ moderating optimism toward China is a significant trend. There has been a steady 30 percentage point shift in outlook over the past four years from “optimistic” to “somewhat optimistic.” At the same time, it is important to note that this shift is within the optimistic side of the spectrum — hardly anyone is pessimistic. In fact, only 1 percent of USCBC members identified themselves as pessimistic or somewhat pessimistic in 2014, largely consistent with prior years (Fig. 1).

USCBC survey data is also consistent with surveys conducted by other business advocacy groups. A significant majority of respondents to surveys by the American Chambers of Commerce in Beijing and Shanghai indicate similar trends (Fig. 2).

Chinese policymakers should take note of the sagging confidence of foreign investors and its causes, particularly as they consider additional economic reforms. China’s leaders have frequently stated their intent to allow the market to be a driver of China’s economy. Doing so — and in a manner that treats domestic and foreign companies equally — will be a powerful signal that the period of policy uncertainty has come to a close.

**Business Outlook**

American companies continue to view China as a top five priority market (Fig. 3), but the number of companies increasing their resource commitment in China continues a slow taper. Fifty percent of companies report plans to boost resources in China over the next 12 months, down from almost 75 percent just three years ago (Fig. 4). Virtually no companies are cutting back on their operations in China, however. Those that are not expanding their operations in China are maintaining current levels and few are redirecting investments from China to other countries (Fig. 5).
Almost three-quarters of companies saw an increase in revenue last year, with nearly half seeing double-digit increases. Fifteen percent of companies reported a decrease in revenue in 2013. Most companies anticipate that their revenue will increase again in 2014 (Fig. 6, 7).

Overall, 83 percent of respondent companies are profitable—consistent with prior years—but at lower margins. Even so, 70 percent report that their China operations are performing better or the same as their global operations. (Fig. 8-10).

What’s squeezing profit margins? Competition from domestic companies and rising costs, as well as Chinese government policies and regulations that put foreign companies at a disadvantage against their domestic competitors. These issues rank among top company concerns in 2014 and are explored in detail later in this report (Fig. 11).
Market challenges remain largely unchanged

This year’s top 10 challenges include many issues that have made the list in previous years, though the order has changed from year to year. As with previous survey results, however, it is clear that issues that move down in rank are not necessarily doing so because the situation has improved. Rather, those issues are most likely eclipsed by more pressing concerns or by increased public scrutiny of other issues. Overall, companies report that little progress has been made in addressing many of these persistent challenges.

For instance, cost increases dropped from the top slot to the fifth, despite separate survey data that indicate costs have not moderated in China. In fact, most respondents note that the challenges associated with cost increases have gotten worse over the past year. This same trend holds true for other policy-related challenges.

To genuinely confront the recurring issues that foreign companies face in China, regulators must focus on major policy changes, such as the conclusion and implementation of a US-China bilateral investment treaty (BIT). Addressing this issue and others will help make real progress on persistent challenges, like investment restrictions, uneven enforcement of laws and regulations, licensing barriers, and lack of national treatment.

Challenges in the services sector

The US economy is largely based on services rather than manufacturing, and Chinese officials have set the development of services as an important imitative goal. Despite such an opportunity for cooperation, China has yet to make the transition from manufacturing to services due in large part to significant restrictions placed on foreign investment in the services sector. Such restrictions insulate Chinese companies from true global competition and prevent foreign companies from bringing knowledge, experience, and product innovation to China. Analyzing the 2014 survey inputs from services companies shows those realities.

Unsurprisingly, services firms rank restrictions on foreign investment as their top concern, followed by competition with Chinese companies and licensing challenges — all of which illustrate the limits China maintains on foreign services companies. Those issues are also reflected in the top constraints on growth in the services sector.
China’s government has regularly stated in broad policy documents and official speeches that it intends to build its services sector. That goal will be best and most effectively achieved by lifting the numerous ownership restrictions that limit American companies from fully participating in the market (Fig. 12). China made such a choice for its manufacturing sector when it joined the World Trade Organization in 2001. Competition is necessary for China to achieve its goals for developing its services sector.
What’s not in the top 10

Other important issues in the US-China commercial relationship do not rank among the top 10, but still remain a challenge for companies. Key issues that fall outside of the top 10 explored in detail later in this report include technology transfer (ranked 11th), antitrust enforcement (ranked 22nd), and innovation policies (ranked 24th).

Cybersecurity concerns have moved up slightly since 2013, from number 14 to number 13. While the US and Chinese governments recently have been at an impasse on cybersecurity, the theft of commercial information and trade secrets remains a serious issue for companies. At this point, companies are well aware of the risks of cyberintrusions and are taking actions to put in place the best defenses possible. That said, individual companies can only do so much to combat these types of intrusions on their own. Effective government-to-government dialogue is needed to get at the sources of these activities and find common ground. USCBC urges both sides to put in place an effective dialogue on these issues and find ways to ensure that commercial espionage does not undermine the important economic relationship between the United States and China.

The impact of China’s exchange rate value on company competitiveness ranks near the bottom of company concerns once again. While the currency topic is one that periodically gets a great deal of attention on Capitol Hill, it is yesterday’s problem, not today’s. China’s currency has appreciated over 30 percent since the country removed its peg against the US dollar. Most economists, including some previous critics on the issue, now agree that the renminbi is at most only modestly undervalued. China needs to continue to move toward a fully-convertible, market-driven exchange rate — but this is an issue tied to China’s financial reforms and is not a trade or commercial issue.

How do we move forward?

The remainder of this report provides a detailed account of the challenges that American companies face in their China operations. It is important to keep in mind the contrast that China presents for companies: an extremely difficult business environment along with a vital, growing market for foreign businesses.

By USCBC’s calculations, China is at least a $300 billion market for American companies — but it should be bigger. Depending on which official statistical source is used, US firms have invested around $70 billion dollars in China since the early 1980s. Chinese companies are only now beginning to ramp up their investments in the United States, which will create additional jobs and opportunities for the American economy as well as tax revenue for local, state, and federal governments.

It is vitally important that the United States and China have a forward-looking framework to guide the commercial relationship, rather than allowing the issues detailed in the following pages to define the relationship between the world’s two largest economies.
Removing barriers that hold back the potential of the bilateral commercial relationship is essential. That is why a successful conclusion of BIT negotiations should be the top priority in the US-China economic relationship (http://uschina.org/reports/bilateral-investment-treaties-what-they-are-and-why-they-matter). USCBC will continue to push both governments to achieve passage of this treaty. A US-China BIT will level the playing field for American and Chinese companies and provide meaningful market access for American companies into China.

**Top 10 Challenges**

When assessing the challenges that American companies face in China, it is important to recognize that many issues overlap. In this year’s top 10, at least six issues are related to preferential treatment for China’s domestic companies:

- Competition with Chinese companies
- Foreign investment restrictions
- Uneven enforcement/implementation of Chinese laws
- Licensing
- Transparency
- Nondiscrimination/national treatment

These preferences are structural in some cases, such as foreign investment restrictions, but are simply a part of how rules and regulations are implemented in most areas. In all cases, they are mechanisms for protecting domestic enterprises. American companies report a variety of areas in which they are seeing signs of protectionism in China that are similar to the areas identified in the top 10 challenges (Fig. 13).

Regardless of type, differential treatment of domestic and foreign companies in China distorts how the economy functions and limits China’s ability to reach its ambitious economic reform goals. As Chinese regulators have noted, fair and vibrant competition is the only way to build a sustainable Chinese economy. As a consequence, it is in the interest of China’s policymakers to treat each of these challenges as priority areas to implement policies that treat domestic and foreign companies equally.
As China’s economy has grown in size and strength, so have its domestic companies — both private and state-owned. While American companies report that their primary competition is with other US and foreign companies in China, the competition they face from domestic industry has grown stronger, and it now ranks as the top challenge in the 2014 survey (Fig. 14).

Robust competition in itself is not a concern for foreign companies doing business in China. American companies are accustomed to strong competitors, which they face in markets all over the world. However, competition based on favoritism for one group of companies over others is a significant concern. While many have focused on preferential treatment for Chinese state-owned enterprises, survey data show that in reality the issue is not ownership structure, but simply nationality. Chinese companies, regardless of ownership, receive benefits that foreign companies cannot (Fig. 15).
Importantly, preferential treatment of domestic enterprise is not in the long-term interest of China or its companies. Access to preferential benefits, such as those shown above, does little to create the type of efficient and innovative companies that China hopes will lead its economy to the next stage of development (Fig. 16, 17). As senior leaders such as China’s Premier Li Keqiang have noted in public statements, Chinese companies will become internationally competitive only through increasing fair and robust competition in China’s market.
The lingering challenges of protecting intellectual property rights in China are well known, and this year’s survey findings reinforce that more must be done to address the issue. IP protection is not just an issue for American companies doing business in China — it also affects Chinese companies. USCBC’s annual membership surveys have consistently found that while some improvements have been made year to year, they are modest. As one survey respondent put it, “IPR enforcement is ever improving, but by far not enough.”

The improvements that American companies have seen are varied, and they include more administrative actions, greater attention to the IPR legal framework, and the creation of IP-focused courts in Beijing, Shanghai, and other locations (Fig. 19).

However, challenges remain. Improved IP enforcement is not simply a matter of ensuring that IP owners are compensated for the fruits of their work — it is also an economic issue for China. The lost opportunities for job creation and innovation can be seen in the areas where American companies are limiting their operations in China because of the lack of
full protection for IP rights. Notably, almost 50 percent of companies hold back on investment and research and development (R&D) in China because of IP concerns; less than 25 percent say the IP environment has no impact on investment decisions (Fig. 20). Increased foreign investment in R&D would help to create the kind of innovative, value-added jobs that China’s government is actively seeking to develop. As a consequence, improving IP enforcement will be an important component of China’s innovation drive.

China has several specific IP enforcement channels, all of which receive mixed reviews from American companies that have considered or used them. In general, China’s civil courts and administrative agencies, such as the State Administration for Industry & Commerce (SAIC) and the Public Security Bureau, are viewed as being the most viable options for IP enforcement, though not in all cases (Fig. 21).

China’s criminal courts are viewed most skeptically by companies, with nearly 50 percent of companies indicating that pursuing criminal cases is not a viable option. A similar percentage of companies said that they have not had cases that would be eligible for criminal enforcement. These results are a strong reminder of USCBC’s longstanding recommendation that China impose criminal penalties for commercial-scale theft of IP and eliminate minimum value thresholds. If such a change were made, more criminal cases could be brought and enforced, and views on the viability of criminal courts would likely improve (Fig. 22).
Foreign ownership restrictions in China continue to serve as widespread market access barriers for American companies. While there were few, if any, new regulations issued in the last year to increase restrictions on foreign investment in China, the issue has been a top priority for many companies. That is due, in part, to China’s announcement in 2013 that it would use the US approach to negotiation of a US-China bilateral investment treaty (BIT).

Specifically, China agreed to use a “negative list” approach in which the terms of the investment treaty apply to all sectors except those expressly excluded in the final treaty. That approach is based on the concept of “pre-establishment,” or equal treatment of foreign and domestic companies even before an investment is made. That format contrasts with China’s current investment approval framework, set up in the Catalogue Guiding Foreign Investment, which restricts foreign companies from participating in over 100 industries and sectors throughout China based on a “positive list.”

China’s domestic economic reforms, announced after the Chinese Communist Party’s Third Plenum in late 2013, focused appropriately on goals such as letting the market play a more decisive role in the economy and widening investment access. For those reforms to be successful, China’s policymakers will need to ensure that foreign and domestic companies are treated equally. A BIT is an important tool to help achieve this objective.

Successful conclusion of US-China BIT negotiations is a high priority for American companies. Success will be assessed in significant part based on the number and range of sectors that China is willing to open to foreign companies. A Chinese negative list that simply codifies existing restrictions, reduces the list only modestly, or removes only low-priority sectors will not be well received by American companies and will significantly reduce the chances of the treaty securing passage by the United States Senate.

That said, Chinese regulators could build support in the American private sector by reducing the number of restricted and prohibited sectors within China’s Catalogue Guiding Foreign Investment prior to the conclusion of BIT negotiations. Steady reductions in investment restrictions in China would be the best sign to international stakeholders that China is serious about undergoing inclusive reforms to its economy, thus building support for passage of a US-China BIT.
While the majority of issues in the top 10 list are challenges that are unique to foreign companies in China, issues such as human resources difficulties impact all companies doing business there. The issue has been among the top five challenges identified in USCBC’s survey for all eight years that the survey has been conducted.

In the most general terms, American companies are paying wages to their Chinese employees at rates that are higher than their domestic competitors (Fig. 23). Even with that difference, most American companies report that they have been increasing wages between 5 and 10 percent annually for at least the last three years (Fig. 24). USCBC member companies anticipate further wage increases in the coming year, as China’s labor market becomes tighter (Fig. 25). Wages
have risen fastest among skilled technical staff and middle management positions, yet turnover remains highest in middle management positions — an indication that these employees are among the most sought after and command higher wages (Fig. 26, 27).

Despite these significant annual wage increases, 55 percent of companies still plan to expand headcount in China in the next year. Although this represents a 15 percent decline from 2013, it still represents a majority of companies, indicating that companies are still actively looking to expand in China despite headwinds (Fig. 28).
Fig. 27  At What Level Was Turnover Most Acute?

Fig. 28  Company Head Count in Next Year Expected to...
**IN FOCUS: Impact of China’s environmental pollution**

China’s environmental pollution has created a related challenge for USCBC member companies. While environmental pollution can have a broad operational impact for companies, human resources are an important dimension: 40 percent of companies report that air pollution and environmental issues have made it difficult to retain staff and transition international talent to China. Pollution has also increased the use of sick leave by staff in China, and it has forced some companies to change operations in order to comply with new pollution policies (Fig. 29).

<table>
<thead>
<tr>
<th>Difficulty retaining staff and attracting international talent to China</th>
<th>Increased cost due to high environmental standards</th>
<th>Improved competitiveness as companies are forced to comply with high environmental standards</th>
<th>Increased sick leave</th>
<th>Required changes to company operations to comply with pollution policies</th>
<th>Other</th>
<th>No impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>40%</td>
<td>27%</td>
<td>19%</td>
<td>17%</td>
<td>15%</td>
<td>20%</td>
<td>13%</td>
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**Fig. 29 Impact of China’s Air and Environmental Pollution**
Cost increases remain a nearly universal concern for American companies operating in China. Unsurprisingly, given its tied rank in the top 10, human resources costs top the list of specific cost concerns. Costs are increasing across the board, however, for energy and utilities, materials, product and operational compliance, and land and rental fees (Fig. 30, 31).

**Challenge #4 [Tie]**

**Cost Increases**

Progress on Issue in Past Year: Deteriorated
- Rank in 2013: ................. 1
- Rank in 2012: .................... 4
- Rank in 2011: .................... 3
- Rank in 2010: .................... 5
- Rank in 2009: .................... 13
- Rank in 2008: .................... 3
- Rank in 2007: Not asked
- Rank in 2006: Not asked

Cost increases remain a nearly universal concern for American companies operating in China. Unsurprisingly, given its tied rank in the top 10, human resources costs top the list of specific cost concerns. Costs are increasing across the board, however, for energy and utilities, materials, product and operational compliance, and land and rental fees (Fig. 30, 31).

**Fig. 30**

Are Rising Costs in China a Concern?
- No 10%
- Yes 90%

**Fig. 31**

Top Cost Concerns*

- Human resources costs 94%
- Rising costs of energy and utilities 33%
- Rising costs of materials 32%
- Rising costs of product/operational compliance 30%
- Land purchase or rental costs 30%
- Rising tax burden 26%
- General inflation outlook 26%
- Payroll taxes / social insurance for expats 15%
- Other 1%

Did Your Company Reduce or Stop Planned Investment in China in the Past Year?
- Yes 14%
- No 86%

*Multiple responses allowed
Despite these concerns, few companies report that they reduced or stopped a planned investment in China in the last year — and no companies indicate they did so due to rising costs (Fig. 32, 33). If companies are reaching the threshold for tolerable cost increases in China, it is not yet impacting their investment plans in that market. As one respondent put it, “Costs are increasing at a pace that is difficult to offset.”
American companies have consistently reported that they are treated differently than their domestic counterparts in the implementation and enforcement of Chinese laws and regulations. One such concern relates to the uneven enforcement of labor and environmental laws in China, which allows companies with lower standards to violate established laws and puts those who bring their international standards to China at a competitive disadvantage. Another concern is the harsher enforcement of product safety regulations on foreign companies, despite their strong track records in these areas and rapid resolution of problems when they are identified. One survey respondent said that there has, “definitely [been] increased scrutiny since early 2013. Although [the laws also cover] local companies… MNCs [multinational companies] do seem to be getting special attention.”
Antitrust enforcement

This year, the area that has garnered the most attention from foreign companies is enforcement of China’s antitrust law, known as the Antimonopoly Law (AML). In recent months, the press and the public have paid considerable attention to this issue. While both foreign and domestic companies have been targets of investigations, foreign companies appear to have faced increasing scrutiny in recent months. Eighty-six percent of companies are at least somewhat concerned about these issues, with over half specifically citing enforcement as the issue, rather than the legal framework for the law (Fig. 34, 35).

Even though most American companies report that they have not been targeted with antitrust investigations, almost 30 percent of USCBC member companies are concerned they will be subjected to one. Among the most significant concerns for foreign companies are challenges with due process, lack of transparency, and fair treatment in investigations (Fig. 36, 37).
Licensing remains a top issue for American companies, though the issue slipped in the top 10 rankings — likely due to the higher profile of other issues in 2014. Almost 60 percent of companies report that they have experienced licensing problems in China, including securing product approvals, investment approvals, business expansion, renewing business licenses, and even routine business activities (Fig. 38-40). Just over half of companies, 52 percent, report that their domestic competitors do not face the same licensing challenges (Fig. 41).

**Fig. 38** Has Your Company Experienced Challenges with Administrative Licensing in China?

- **Yes** 57%
- **No** 43%

**Fig. 39** Types of Licensing Problems Experienced*

- Product approval or certification: 43%
- Foreign investment approval: 49%
- Business expansion: 34%
- Renewing or amending business licenses: 21%
- Routine business activities: 21%
- Other: 4%

**Fig. 40** Where Licensing Problem Occurred*

- Central government: 74%
- Provincial government: 51%
- City or district government: 45%
- Investment zone officials: 6%

*Multiple responses allowed
From one survey respondent, “The playing field is increasingly leaning in the favor of [Chinese] national champions, who continue to increase capacity and receive preferential treatment. We’re also seeing lengthy or stalled licensing and investment approvals, and a general lack of government action to move files forward in the approval process.”

Another respondent put it more simply, “[There are] significant delays in license application reviews and approvals for foreign firms.”

Many, though not all, of the licensing delays appear to be happening at the central government level, but they decline steadily as the level of the decision maker moves closer to the local and investment zone level. This may be a reflection of progress made in decentralizing licensing approvals. Still, most companies report that they have not seen a material impact from those changes, and questions remain about how evenly licensing and approval processes are conducted (Fig. 42). Regardless of reason, more needs to be done to ensure equal treatment of domestic and foreign companies in licensing (http://uschina.org/reports/improving-china%E2%80%99s-licensing-system-recommendations-key-sectors-2014).
Challenge #8
Transparency

Progress on Issue in Past Year: Unchanged
| Rank in 2013: | 8 |
| Rank in 2012: | 11 |
| Rank in 2011: | 9 |
| Rank in 2010: | 7 |
| Rank in 2009: | 8 |
| Rank in 2008: | 4 |
| Rank in 2007: | 5 |
| Rank in 2006: | 5 |

Transparency and national treatment are two central components of a well-functioning and competitive market. Providing an opportunity for public comment on laws and regulations prior to implementation enables companies to provide constructive input on how policy goals can effectively be reached without hindering business and impacting consumers. Treating domestic and foreign companies equally ensures that the market allows the best products and most competitive companies to reach consumers.

American companies have seen some progress in these issues over the years. As one survey respondent noted, “Transparency has improved of information disclosure online, but overall [it is] still far from enough.” However, issues still remain with transparency throughout the regulatory process. USCBC’s 2014 transparency report highlights some of these challenges and how well key government agencies are doing in improving on these issues (http://uschina.org/reports/china-2014-regulatory-transparency-scorecard).

Challenge #9
Nondiscrimination/National Treatment

Progress on Issue in Past Year: Unchanged
| Rank in 2013: | 7 |
| Rank in 2012: | 15 |
| Rank in 2011: | 8 |
| Rank in 2010: | 12 |
| Rank in 2009: | 12 |
| Rank in 2008: | 17 |
| Rank in 2007: | 15 |
| Rank in 2006: | 9 |

These issues are fundamental and relate to many of the challenges discussed elsewhere in this report, including licensing, IPR protection, competition, and preferences for domestic companies. Transparency and national treatment will also be included in US-China bilateral investment treaty (BIT) negotiations. They should both be priorities for China’s policymakers beyond the BIT negotiations, however, as they are the cornerstones of a well-functioning, market-based, competitive economy.
Challenge #10
Overcapacity in the China Market

Progress on Issue in Past Year: Unchanged
Rank in 2013: ...................... 11
Rank in 2012: ...................... 15
Rank in 2011: ..................... 8
Rank in 2010: ..................... 12
Rank in 2009: ..................... 12
Rank in 2008: ..................... 17
Rank in 2007: ..................... 15
Rank in 2006: ..................... 9

As with transparency and national treatment, overcapacity has an impact on markets. In China’s case, the impact can be felt both domestically and internationally. Overcapacity issues have arisen in a number of Chinese sectors, from cement and steel to glass and chemicals.

China has made some progress at stemming overcapacity issues. China’s movement toward market-determined prices for energy, for example, should help to slow overproduction by companies who are continuing to make products even as demand has slowed. While such changes will likely result in some businesses closing or consolidating, the appropriate balancing of supply and demand is in China’s best economic interests. At the same time, Chinese policymakers should consider methods to address overcapacity issues that are balanced and fair, and that do not unfairly burden foreign companies.
Innovation promotion policies and Strategic Emerging Industries

China’s innovation policies have been the focus of international attention since at least 2009, when the central government’s indigenous innovation policies were first released.

While China has made modifications to address some foreign company concerns about provisions that favored domestic companies, American companies have mixed views of the impact innovation promotion policies have on market access in China. Fifty-six percent of respondents view these policies as a strategic opportunity or have already seen a positive impact on their sales and operations. The remaining 44 percent view these policies as strategic concerns or have seen a negative impact on their operations (Fig. 43).

One survey respondent explained the opportunities created by China’s innovation policies this way: “The products we sell are high-end and allow our customers to create more differentiated and innovative products. As Chinese companies move away from simply competing on cost/price, and more towards innovation/differentiation, it creates more demand for high-end technology.”

By contrast, the risks of China’s innovation policies were explained this way by another respondent: “[China’s] national champion approach risks [creating an] unfair playing field.” Favoring certain companies has a negative impact on innovation in China, as it does not create the proper system of incentives to drive companies to pursue rigorous processes that promote product and process innovation.

The High and New Technology Enterprise (HNTE) designation, one of China’s primary innovation incentive programs that provides tax credits for innovative companies, has yet to be significantly accessed by American companies. Almost 30 percent of companies report that they have been approved for HNTE status and another 30 percent may apply in the future (Fig. 44). No companies report that they have applied for the status and been denied. That said, some companies have reported problems with local implementation of HNTE rules such as local IP ownership and information disclosure requirements that make the program less attractive to innovative foreign companies. In addition, some companies that have previously received HNTE status have faced challenges when trying to renew their approval, again due to new interpretations by local officials.

Similarly, China’s Strategic Emerging Industries (SEI) program has had limited impact for American companies. Seventy-two percent of companies assess their ability to participate in SEI programs as good or moderate, but only 35 percent report that they are very interested in doing so. Another 64 percent report that they are somewhat interested in receiving SEI benefits, but that participating in the program is not a top company priority (Fig. 45-48).

One potential issue for foreign companies may be the lack of clarity about the benefits of being characterized as an SEI.
As one survey respondent put it, “Our products fall into the SEI category, but we don’t know/understand the real implications and potential impact on our business.”

Questions remain about future policies in this area, and how policymakers may approach development in these industries. (http://uschina.org/government-change-course-china%E2%80%99s-strategic-emerging-industries)

Ultimately, American companies’ concerns about these policies were summed up by a respondent, “We just want to make sure innovation is competition-neutral.”
Technology transfer

Related to China’s drive to become more innovative is its interest in having foreign companies transfer technology to Chinese companies in its market, thus significantly shortening the timeline for developing innovative products. This issue has gotten considerable attention from US policymakers and companies: Sixty-two percent of companies report that they are concerned about transferring their technology to China, particularly as it relates to the protection of intellectual property rights and proprietary information and the enforcement of technology licensing agreements (Fig. 49, 50).

The reality, however, is more nuanced. Despite these concerns, 80 percent of companies report that they have not been asked to transfer technology to China in the last three years (Fig. 51). Of those that have been asked to transfer technology, only 15 percent report that the technology would be controlled by a Chinese entity (Fig. 52, 53).

An important aspect of the discussion of these issues is the options that companies have when such requests are made. Only 7 percent of companies report that they had to comply with a technology transfer request even when they deemed it unacceptable. The other companies indicate that the requests were either acceptable or that they were able to modify, avoid, or withdraw from the transaction (Fig. 54, 55).

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<thead>
<tr>
<th>Fig. 50</th>
<th>Top Concerns about Transferring Technology to China*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Protection of IP</td>
<td>85%</td>
</tr>
<tr>
<td>Protection of proprietary information during certification</td>
<td>77%</td>
</tr>
<tr>
<td>Enforcing licensing agreements</td>
<td>67%</td>
</tr>
<tr>
<td>Government dictating licensing negotiations</td>
<td>27%</td>
</tr>
<tr>
<td>Difficulties in negotiating licensing fees</td>
<td>10%</td>
</tr>
<tr>
<td>Other</td>
<td>4%</td>
</tr>
</tbody>
</table>

*Multiple responses allowed
There is an important link between these issues and the investment barriers that American companies face in China. Due to current restrictions on foreign investment, some companies are forced to partner with domestic companies to operate in China. In those circumstances, companies may need to negotiate technology transfer agreements with current or potential investment partners — a business transaction that has implications for the protection of the company’s intellectual property. Eliminating these types of joint venture requirements would allow companies to maintain control of their IP in China and implement company-wide procedures to protect it.

**Fig. 52**  Who Asked that Technology Be Transferred?*

- Company: 54%
- Central government: 38%
- Local government: 23%

**Fig. 53**  Who Would Control the Technology in China?

- Our company: 70%
- Our company and a Chinese entity: 15%
- Chinese entity: 15%

**Fig. 54**  How Did Your Company Respond to This Requirement?

- Acceptable and transferred: 43%
- Unacceptable and avoided request entirely: 7%
- Unacceptable and only transferred some: 14%
- Unacceptable but had to comply: 7%
- Unacceptable and withdrew from transaction: 29%

**Fig. 55**  Negotiation of Licensing Fees for Transferred Technology

- Able to negotiate commercially acceptable payments for technology transferred: 43%
- Able to negotiate some fees, but below commercially acceptable amount: 43%
- Unable to negotiate licensing fees and transferred technology at no charge: 14%
Respondent Profile

US- and China-based executives
The US-China Business Council (USCBC) annual membership survey incorporates a unique mix of US- and China-based executives. Respondents were almost equally divided between those based in China and those based in the United States. The remainder were located elsewhere in Asia (Fig. 56).

In addition, respondents range from CEOs of global corporations to executives based in the field. Survey results incorporate both strategic and tactical perspectives.

Cross-sector representation
USCBC members who completed this year’s survey represented a cross-section of US companies doing business in China. Sixty-three percent of respondents represented manufacturing companies, and 42 percent represented service providers. Many respondents’ companies are active in both sectors. Nine percent worked for companies in primary industries, such as agriculture and oil and gas. Of USCBC’s 220 member companies, 110 participated in the survey (Fig. 57).

Fig. 56  Respondent Location

- United States: 46%
- China: 47%
- Other: 7%

Fig. 57  Type of Operations in China*

- Manufacturing: 63%
- Services: 42%
- Primary industries (agriculture, resource extraction, etc.): 9%
- Other: 6%

*Multiple responses allowed
Long experience in the China market

USCBC member companies have a long history of doing business in China: Fifty-six percent of respondents’ companies have been in China for more than 20 years, and 29 percent have been in China for 11–20 years (Fig. 58).

Chinese customers

The overwhelming majority of USCBC member companies report that they are doing business in China to access China’s domestic market. Twenty-one percent use China as an export platform to reach other markets around the world, though only 13 percent use their China operations to produce products that are shipped back to the United States (Fig. 59).