THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

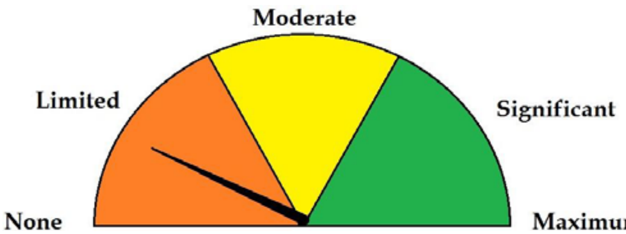
USCBC China Economic Reform Scorecard: Steps Forward Undermined by Steps Back

October 2016

Executive Summary

- The latest US-China Business Council (USCBC) assessment of China's economic reform efforts has not changed since the previous update in February 2016. Although some positive steps were made in a few areas, setbacks and counterproductive policies persist, and doubts remain about the government's follow through on the three-year old pledge at the Third Plenum to allow the market to play a "decisive role."
- In the first nine months of 2016, Chinese government agencies released several policies that show incremental positive movement in a few areas.
    - Recent liberalizations in China's financial sector include the ability for foreign firms to directly trade more products in China's inter-bank bond market, the relaxation of quotas for Qualified Foreign Institutional Investors (QFII), and the nationwide expansion of a free trade zone (FTZ) pilot that seeks to improve cross-border financing mechanisms for foreign firms.
    - The State Council announced a regulatory review mechanism intended to ensure fair competition in the market. The system requires government agencies to self-review policies and eliminate anti-competitive components before implementation. While these changes would be positive, the mechanism lacks a process to enforce compliance.
    - China revamped its tax regime for the services sector by replacing the decades-old business tax with a value-added tax, which largely aligns with international practice.
- In that same period, there were several setbacks for reform.
    - Highly touted reforms to the nationwide system managing inbound foreign direct investment implemented in early October failed to introduce any new sector openings and, after bureaucratic infighting, failed to use the "negative list" piloted in free trade zones over the past three years. Top leaders had repeatedly pointed to the free trade zone pilot as the next wave of reforms and openings.
    - Meaningful state-owned enterprise (SOE) reform remains largely stagnant. While some initial steps to address overcapacity in certain sectors have been announced, SOE reform to date largely favors government-directed industry consolidation and allows struggling borrowers to swap bad debt for equity, rather than promoting or encouraging bankruptcies, acquisitions, and commercial restructuring that would be expected in a market-driven approach. SOE corporate governance also remains untouched.
- Additionally, there has been a lack of movement on other major systemic issues affecting American and other foreign companies in China. For example, mandates to use "secure and controllable" technology in key sectors operate as a *de facto* market access barrier, as many end users assume that Chinese technology is necessary in order to comply with new and existing measures and make purchases accordingly. Chinese regulators also continue to issue problematic regulations that prohibit cross-border data sharing. These types of regulations disrupt the flow of information for firms whose efficient business operations and security rely on smooth global communications.
- The 13th Five-Year Plan, released in March 2016, highlights the need to expand sector openings, reduce market access barriers, and encourage foreign capital and advanced technology to improve the overall quality of foreign investment in China. However, these statements remain aspirational. Changes from Third Plenum reform priorities to the "supply side" reforms in the 13th FYP leave doubt about whether—and to what extent—policy changes will have a meaningful effect on market access or help level the playing field for foreign companies. Tangible reforms, such as reducing foreign ownership restrictions in key sectors, would boost business confidence in China's reform policy direction.

USCBC Assessment: Steps Forward, Steps Back



USCBC's latest assessment of China's economic reform efforts has not changed since the previous update in February 2016. Although some positive steps were made, setbacks and counterproductive policies persist.

Between January and early October 2016, Chinese government agencies released some narrowly tailored reform-related policies that address foreign company market access and level playing field concerns. Simultaneously, other actions and policies have raised questions about whether market forces will be allowed to play a bigger role in driving key sectors of China's economy. In the technology sector, the use of "national security" for protectionist purposes continues to raise concerns. These mixed signals from the Chinese government foster uncertainty among foreign businesses about China's reform direction, and work against China's own goals for economic transformation.

Among the reform-related policies tracked during this period are some that aspire to cultivate a more competitive environment, change pricing methodology and other regulations in the healthcare sector, and offer a few liberalizations for foreign financial firms. For example, the State Council established a review mechanism for fair competition in the market. The system requires government agencies to review policies and eliminate anti-competitive components before finalization. Policies regulating market access, industrial development, investment, bidding, government procurement, codes of business conduct, and qualification standards are among those specified for review. This plan is ambitious in scope and has the potential to help level the playing field for foreign companies operating in China. However, there is no mechanism to ensure compliance, and the broad exclusions outlined in the plan might undermine its effectiveness.

This period also saw the release of the Draft Market Access Negative List. First announced in October 2015, the full list released in April is an important step in codifying the laws and regulations affecting market access. Because the list did not include any new liberalizations, it instead served as a collection of existing laws and regulations— falling short of foreign company expectations for meaningful market openings.

The Chinese government made incremental strides to further liberalize the financial services sector by allowing foreign firms to directly trade more products in China's inter-bank bond market, relaxing quotas for Qualified Foreign Institutional Investors (QFII), opening third party payment card processing to foreign companies, and expanding nationwide an existing FTZ pilot that seeks to improve cross-border financing mechanisms for foreign firms. Other new policies laid out key tasks for the reform of China's healthcare sector, including allowing the prices for some medical services to be set by the market, rather than by the government.

However, a number of developments offset this incremental forward progress. Foreign investment law amendments implemented in early October failed to introduce new sector openings and, after bureaucratic infighting, failed to use the "negative list" piloted in free trade zones over the past three years. The resulting mechanism is based on the existing 2015 Catalogue Guiding Foreign Investment (CGFI), rather than the FTZ negative list. Had the latter approach been used, foreign ownership restrictions would have been liberalized in a handful of additional areas, such as oil seed processing, gas stations, biofuel production, and shipping agencies. Top leaders had repeatedly pointed to the free trade zone pilot as the next wave of reforms and openings. Failure to implement it nationwide as promised sent a negative signal about the politics of the reform debate in China.

Additionally, regulations in the information and communications technology (ICT) sector continue to use "national security" for protectionist purposes have yet to be addressed. Policies, such as the second draft of the Cybersecurity Law, have been released with little to no improvement upon previous versions. A lack of clarity on the meaning of "secure and controllable" or "secure and reliable" technology in the medical device, insurance, and ICT industries places foreign companies at a competitive disadvantage for sales to certain customers since many assume that Chinese technology is necessary in order to comply with new and existing measures and make purchases accordingly

13th Five-Year Plan: Supply-side and SOE Reforms

The March 2016 National People's Congress (NPC) concluded with the release of China's 13th Five-Year Plan (FYP) on Economic and Social Development. The priorities, which will guide China through 2020, include resolving nationwide industrial overcapacity, promoting investment, supporting SOE reform, reforming healthcare coverage, and advancing technological innovation. Supply-side economic reform initiatives are present throughout the FYP.

The supply-side concept, appearing prominently in the FYP and other official editorials and documents, refers to reforms in population mobility and support, land transfers, and the financial sector, as well as tax cuts and continued administrative simplification. Few of these topics are new, and while some statements have called for allowing the market to play a decisive role, implementation plans contradict overall goals on the market's role.

Recognizing the negative effect of overcapacity on the industrial system, the FYP calls for the reduction of supply in affected sectors by merging, upgrading, and restructuring underperforming companies. The plan strikes a cautious tone on layoffs and relocation of displaced workers—an inevitable outcome if a company goes out of business. To further illustrate the mixed messages, one section of the plan, entitled "Vigorously push forward SOE reforms," begins by calling for implementers to "unswervingly strive to make SOEs strong, superior, and large."

If implemented as envisioned, supply-side reforms would reduce the government's role in the economy, and could reduce regulatory barriers, increase competition, and create a market where foreign companies compete more equitably with domestic companies. To date, however, the effectiveness of the reforms remains unclear. While steps to address overcapacity in certain sectors have been announced, policy changes favoring government-directed industry consolidation have resulted in larger, yet still inefficient, enterprises. Truly progressive reform measures would allow bankruptcies, acquisitions, and commercial restructuring of failing or inefficient companies.

The State Council decision in October to allow debt-for-equity swaps for struggling firms indicates that market-driven solutions are taking a back seat to government intervention and support. This program will remove debt from the ledgers of borrowers by making banks shareholders of insolvent firms, rather than forcing the liquidation or reorganization of those companies.

The FYP notes the need to expand openings, reduce market access barriers, and encourage foreign capital and advanced technology to improve the overall quality of foreign investment in China. Specific examples include calls to expand market access for foreign companies engaged in banking, insurance, securities, and pensions. USCBC analysis of policies released after the FYP indicates limited progress in all of these areas.

Although the FYP makes a passing reference to "allowing the market to play a decisive role in allocating resources," this guiding concept of economic reform announced at the Third Plenum three years ago continues to fade as other reform priorities emerge.

Despite the number of reform policies released by Chinese government agencies since economic reforms began in 2013 (more than 570, by USCBC's latest count), many are still not broadly applicable across industry sectors or specific enough in implementation detail to address foreign company issues, and few reduce market access barriers for foreign companies. Instead, many of these policies address minor operational issues or are limited to particular sectors. Others do not clearly apply to foreign companies.

This lack of meaningful change is further reflected in USCBC's 2016 annual member survey results, in which most companies indicated they are not seeing significant changes to the business environment from China's reforms.

USCBC encourages Chinese officials to move forward with policies that will send a clear signal that meaningful economic reforms remain viable, such as those in the USCBC Board of Directors' Statement of Priorities in the US-China Commercial Relationship. Key steps should include establishing concrete policies that liberalize investment, boosting the role of the market in the economy—including in reforming SOEs and addressing overcapacity—creating a level playing field for foreign and domestic firms, and promoting further legal and regulatory reform.

For more information about USCBC's methodology, see Appendix 1. For USCBC's complete list of reform-related policies, see Appendix 2.

Appendix 1: Methodology

USCBC tracks reform developments to address two major questions:

- What tangible progress have Chinese central government agencies made toward implementing economic reform?
- What effect will reforms have on US companies and their operations in China?

To answer these questions, USCBC has compiled a list of reform-related policies since the start of the Xi Jinping administration. The current assessment includes more than 40 months of policies from March 2013 through early October 2016. These policies are divided into themes, such as the role of the state and the market, foreign investment, and institutional reforms. Given the role of the China (Shanghai) Pilot Free Trade Zone (Shanghai FTZ) as the "test lab" for nationwide reforms, this report also analyzes specific Shanghai FTZ-related policy announcements. USCBC will continue to monitor policies developed for the Shanghai FTZ and the three subsequent free trade zones in Fujian, Guangzhou, and Tianjin.

This report assesses the effect of China's reform efforts on foreign company operations by rating each policy's direct and immediate effect on foreign company concerns.

- Each policy is assessed as having either a significant, moderate, limited, negative or no effect for foreign company operations in China.
- USCBC's overall assessment uses a multi-color dashboard, rating China's reform effort as limited, moderate, or significant based on its effect on foreign companies.

Research and Data Collection

For the purposes of this report, USCBC compiled a database of policy developments and announcements related to economic reform. These policies include:

- National-level policies that direct and implement reforms in broad areas;
- National-level policies that promote reforms in specific priority areas or individual sectors;
- National-level policies that apply to operations in four free-trade zones (Shanghai, Fujian, Guangzhou, and Tianjin); and
- Policies related to the Shanghai FTZ, given the zone's importance in testing and promoting economic reform.

This report does not attempt to include every policy change since the March 2013 leadership transition, nor does it include draft policies. Instead, this report focuses on concrete and finalized policies that might affect business operations and are tied to economic reform goals. This report also reviews landmark reform documents—such as the Third Plenum Decision—that set clear, high-level direction for wider economic reforms. This report excludes speeches and pronouncements by Chinese leaders about *intended* reforms unless they include specific policy announcements or changes.

USCBC's research focuses on the central government for several reasons. First, reforms are being directly driven in most cases by the central government leadership. Second, it is extremely challenging to track and assess local government policies or to assess their implementation. Thus, this report excludes reform policies by provincial and local governments unless they have national implications, such as those related to the Shanghai FTZ and the free trade zones in Fujian, Guangdong, and Tianjin.

To compile data for this report, USCBC conducted detailed reviews of relevant government webpages on a fixed schedule. USCBC also monitored other government websites, media sources, and a broad mix of information channels to identify concrete policies related to economic reform.

Assessing Individual Policies

Each policy was categorized from a list of key reform themes and subthemes. USCBC used the following themes to categorize policies:

- Overall Reform
- Foreign Investment
- Administrative Licensing and Approvals
- Institutional Reforms
- Role of the State and the Market
- Financial Reforms
- Pricing Reform and Competition Policy
- Rule of Law/Legal and Judicial Reform
- Taxation and Budget
- Corruption, Bribery, and Party Discipline
- Urban/Rural Issues

- Other Reforms

Each policy's effect on foreign company operations in China was then assessed, with consideration given to the breadth of impact across industries, the geographic scope of the policy, and the level of foreign company concern addressed. For each policy, USCBC considered the direct effect and the impact of follow-up implementation policies. The effect of each policy is rated on a five-color scale:

- **Significant** (green) The policy has a positive effect on a wide variety of industries with foreign investment in China, and it has the potential to significantly impact companies' abilities to operate in those sectors nationwide. For these policies, implementation is either completed or likely. This category may also include State Council or National People's Congress directives that indicate a significant shift in policy direction across multiple areas of reform.
- **Moderate** (yellow) The policy has: the potential to have a significant positive impact on companies in a wide variety of industries with foreign investment in China, but questions remain regarding implementation speed or ability; a moderate impact on a wide variety of industries with foreign investment in China, with implementation completed or likely; or a significant positive effect for companies in only one sector or in a narrow range of sectors with foreign investment in China, with implementation completed or likely.
- **Limited** (orange) The policy has a limited effect on one sector or on a narrow range of foreign investment sectors, or it has only an indirect effect or benefit for foreign companies investing in China.
- **None** (white) The policy will have no clear direct or indirect effect on foreign companies.
- **Negative** (red) The policy will have an adverse effect on foreign companies.

The database includes a handful of broad policy documents that set high-level strategic direction for economic reform but do not contain guidelines for implementing those reforms, such as the November 2013 Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms. In these cases, the assessment is based on how relevant the scope of reform is to top foreign company issues. These policies are marked with specific text indicating that the effect of these policies is aspirational.

Providing an Overall Assessment

Based on an overall review of the importance and effect of individual policies, this report assesses the Chinese government's overall efforts to promote meaningful economic reform.

As detailed above, USCBC's overall assessment uses a three-color dashboard, rating China's overall reforms as limited, moderate, or significant based on their effect on foreign companies. USCBC's overall rating is based on multiple rounds of internal discussion about numerous factors, including the average rating of policies in the database and how much of an effect the overall body of reform policies has had on the business environment as a whole.