Coalition of Services Industries (CSI) Submission: Initiation of Section 301 Investigation: China's Acts, Policies, and Practices Related to Technology Transfer, Intellectual Property, and Innovation Docket Number: USTR-2017-0016

The Coalition of Services Industries (CSI) appreciates the opportunity to submit comments to assist the Office of the United States Trade Representative (USTR) in its Section 301 investigation into China's actions, policies, and practices related to technology transfer, intellectual property, and innovation. This written statement will highlight various actions and policies that China has implemented that encourage or require the transfer of technology, limit innovation, or otherwise affect American economic interests in specific services sectors. However, these comments will not focus on intellectual property.

CSI, established in 1982, is the leading industry association devoted exclusively to helping America's services businesses, increasingly digitally enabled services, and workers compete in world markets. CSI member companies represent a broad spectrum of the U.S. services sector, including distribution services, express delivery, financial services, media and entertainment, telecommunications, information and communication technology (ICT) services, and professional services. These services are a critical enabler for U.S. economic growth.

Overview of U.S.-China Services Trade

China is a critical and increasingly important market for services in the global economy. In 2000, the United States exported nearly $5.1 billion in services, making China the 12th largest destination for U.S. services exports. Last year, China was the second largest services export market for U.S. services suppliers; U.S. services exports to China were $53.5 billion, while the United States imported $16.1 billion, resulting in a $37.4 billion services trade surplus.[1] Based on current trends, China will become the top destination for U.S. services exports by 2020.

The United States has maintained a services trade surplus with China since 1999. Total U.S. services exports to China have seen a 13-fold increase since 1999 (first data available), which has resulted in the services trade surplus growing from $1.3 billion to $37.4 billion, a growth rate of nearly 2,800 percent, in under two decades.[2] This is on top of the $55 billion in services supplied through majority U.S.-invested companies in China in 2014 (latest data available).[3] This strong U.S. growth comes despite the number and scope of barriers that China has implemented.

China has long insisted that it is an open market with clear and fair rules. Unfortunately, this does not match reality. China uses a variety of tools, including opaque rules, licensing requirements, discriminatory practices, selective regulatory enforcement, and other barriers, all of which ensure that U.S. firms have an increasingly difficult time competing on a fair playing field in China. It should be noted that China has made commitments that will improve the climate in country for U.S. services companies; this includes using negative lists for investment. China also committed that its innovation and other industrial policies would be consistent with non-discrimination and would not require technology transfer as a cost of doing business in China. That said, despite these pledges, follow-through is lacking, and issues for U.S. services suppliers remain.

China's Restrictive Treatment of Data and Technology
Over the last decade, China has taken wide-ranging steps to restrict data flows, including through requirements to localize data and servers in China, and impede technology. China's increased controls over the Internet are creating barriers to the cross-border flow of data and the ability of companies to operate in China. Because of the widespread use of and reliance on data by many services firms, these practices have significant impacts, including in insurance, banking, and cloud computing, among other areas. A spate of recent regulatory rules in China are clamping down on Internet flows, making it difficult and unpredictable for companies that operate in the Chinese market. The inability to operate cross-border, the loss of efficiency, and increase in costs, among other impediments to operating in China, reduce U.S. competitiveness and stifle innovation writ large. China has cited concerns over national security as the justification for these restrictions, but in September 2015 and June 2016, China committed to the United States that measures it has taken to enhance cybersecurity in commercial sectors would be non-discriminatory and would not impose nationality-based conditions or restrictions. These restrictions are in direct contradiction of these commitments.

Further, it appears that China's new Cyber Security Law (CSL), along with other current and proposed regulations, has the potential to create additional, discriminatory barriers and impose significant compliance burdens due to its broad and vaguely defined scope. Particularly concerning are China's restrictions on cross border transfer of data by network operators and operators of critical information infrastructure (CII). Draft implementing measures indicate that China intends to take a very expansive approach to CII, capturing a number of different activities (including key business tools such as cloud computing and big data) and subjecting them to the law's much more stringent data localization requirements. The CSL also potentially subjects U.S. companies to security reviews. This includes the proposed requirements to review companies' proprietary source code and allow the government to review and approve encryption measures. As noted in the letter to China's Cybersecurity Administration signed by a global coalition of industry associations, including CSI, China should delay full implementation of the CSL along with other recent ICT regulatory and legislative actions, to allow sufficient time to work with U.S. industry and government experts to revise implementing measures that create technical barriers to trade, hinder market access, and/or diminish cybersecurity.[4] Unfortunately, China is pressing forward while the data flow and storage restrictions mandated by the CSL, as well as other discriminatory aspects, remain unaddressed.

In addition, China has proposed new draft regulations regarding cloud computing services which, if implemented, combined with existing Chinese laws, would force every U.S. cloud service provider to transfer valuable U.S. intellectual property, surrender use of their brand names, and hand over operation and control of their business to a Chinese company in order to operate in China. These proposed regulations are of concern to all services companies. Cloud services provide an effective and secure way for services companies to provide their services cross-border as well as within China. To address this, the United States should secure China's commitment to allow U.S. cloud service providers to obtain and hold all necessary licenses for the operation and provision of cloud services in China, including those related to software, hardware, facilities, and infrastructure; allow foreign investment in Chinese companies established to provide cloud services in China; and allow U.S. cloud service providers to sign contracts for the provision of cloud services in China and use their trademarks and brands to market their cloud services. China should also allow U.S. cloud service providers to procure telecommunication services (including bandwidth) for the provision of cloud services on the same terms available to Chinese companies. China's deployment of cloud computing technologies will be better enhanced by adopting global standards and policies that reflect the international and borderless nature of this critical and strategic industry. Yet China remains largely off limits to foreign ICT companies due to equity caps investment restrictions, in-country hosting requirements and a slew of market entry barriers.

Express Delivery

For express delivery firms, China has blocked foreign companies' full access to its domestic letter and document market. In the domestic express delivery market, China has also applied overly burdensome regulatory approaches to these foreign firms. One such example is the requirement for 100 percent open-box inspection, x-ray inspection, and shipper ID check for all express shipments. Additionally, express operators are required to have registrations with Post authorities at the local level. It is very burdensome for operators to obtain and maintain the registrations, simply because there are too many cities in the express network. These restrictions unfairly target foreign firms, especially U.S. firms, and undermine these operations.

Telecommunications

China's accession to the World Trade Organization (WTO) permitted it to maintain foreign equity limits on value-added and basic telecommunications services that restricted market access for foreign suppliers. Although there was an expectation that China would eventually open up the sector to greater foreign participation, the expectation has not come to fruition. In fact, China has classified a number of new services as telecommunications services and limited foreign participation in emerging digital services. China's publication of a new Telecom Services Catalog in December 2015 expanded regulation and market access barriers to a host of new services not typically regulated, including cloud computing, content delivery networks, and online platforms (under a broadly written provision for Information Services). China's foreign direct investment (FDI) limitations and expansive definition for value-added services, FDI limitations and high capitalization requirements for basic telecommunications services, and lack of an independent regulator remain key outstanding issues. For example, China imposes a 50 percent equity cap on foreign investment in value-added telecommunications services, and limits foreign equity to 49 percent in basic telecommunications services These equity cap restrictions ultimately force technology transfer, allowing the Chinese firm to benefit from U.S. services suppliers' expertise.

Insurance

U.S. access to China's insurance and retirement securities markets remains difficult as a result of restrictive Chinese measures. Foreign insurers have less than a 5 percent cumulative market share in what is the third-largest insurance and pensions market in the world.[5] Given the size and future growth of China's insurance markets and the relatively small market share of foreign firms, the economic opportunity for foreign insurers, absent the discriminatory equity cap and prohibition on U.S. companies in the enterprise annuities sector (401k), is exponential and would deliver significant commercial benefits to U.S. industry.

These mandatory ownership structures and equity caps ultimately give Chinese firms a great degree of control, which render these entities beneficiaries of technology transfer. Current Chinese regulation places a 50 percent cap on foreign equity in life, health, and pension companies, a restriction that has been in place since China's accession to the WTO in 2001. While U.S. industry and the U.S. government have worked for years across different fora and platforms to eliminate this barrier to the Chinese insurance market, China has been unwilling to budge. In fact, the newly updated "Catalogue for the Guidance of Foreign Investment Industries" shows that China will maintain the 50 percent cap on foreign equity for life insurance companies. China has not yet authorized any U.S. investment in the enterprise annuities industry. There is also a 33 percent equity cap in the securities sector.

China has made some progress in liberalizing the non-life insurance sector. In 2013, China removed all restrictions on foreign non-life insurers. In January 2017, China's State Council issued the "Circular on Several Measures to Expand the Opening-up and Actively Utilize Foreign Investment," which committed to lower entry restrictions on foreign investment in several service sectors, including insurance, banking, and securities.[6] However, there is also a proposal for new regulations to restrict domestic shareholding in foreign-invested insurance companies (both life and property casualty), which will diminish the value of existing investments.

Banking and Securities

The Chinese banking sector remains challenging for U.S. companies to enter and operate within. With mandatory ownership structures, foreign equity caps, and capital requirements, and other unclear rules, China has made it more difficult for foreign banks to establish and expand their market presence in China. It is then unsurprising that foreign banks' collective market share in 2013 was below 2 percent.[7]

Chinese rules make it such that U.S. banks, securities, and other bodies are unable to compete on an equal footing with domestic institutions. This includes an environment that imposes forced technology transfer as a precondition for market access. For instance, U.S. banks are subject to a 20 percent investment ceiling (for single foreign shareholders) and a 25 percent investment limit (for multiple foreign shareholders) in local Chinese banks. Further, once a foreign-funded business in the banking sector is established, it is limited in its activity for two years. Following this waiting period, a business can expand the scope of the business, assuming it has met certain conditions, which includes holding over $10 billion in total assets.[8] There are also other restrictive regulations, including stipulations that foreign banks in China must work through branches, as opposed to subsidiaries, which have legal and economic impacts.

Equity caps on foreign ownership of securities joint ventures have not been lifted in China since 2012, and remain at 49 percent, despite the commitment to "gradually raise" the equity caps from the 2016 Strategic & Economic Dialogue (S&ED).[9] A commitment to ensuring that a foreign firm can establish a wholly-owned company in its market is a bedrock free market principle that the United States and a significant number of other countries committed themselves to many years ago.

China has made good on some of its pledges however. For instance, China established an independent regulator for the financial information sector, but only after facing a WTO case brought by the United States in 2008.[10] China has committed to expand opportunities for U.S. financial services firms to acquire settlement and underwriting licenses as part of the 2016 S&ED.[11]

Conclusion

Market access barriers, especially those that by design or practice, encourage technological transfer, remain in place for U.S. services companies that operate in China. These restrictions, like equity cap limitations, licensing restrictions, other regulatory barriers, and outright bans on foreign investment, impede U.S. services firms from tapping to the Chinese market. Further, China's restrictions on data flows, ICT, cloud technologies, and services also serve as obvious obstructions for U.S. services firms. While some initial steps have been taken in the right direction, problem areas remain and make the Chinese market still largely untapped for U.S. companies.

---

[1] Bureau of Economic Analysis "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail, "China, March 21, 2017, https://www.bea.gov/itable/.

[2] Bureau of Economic Analysis "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail, "China, March 21, 2017, https://www.bea.gov/itable/.

[3] "Table 3.2. U.S. International Trade in Services by Area and Country, Seasonally Adjusted Detail," Bureau of Economic Analysis, U.S. Department of Commerce, March 21, 2017, https://www.bea.gov/itable/; "Table 2.3. U.S. Trade in Services, by Country or Affiliation and by Type of Service," Bureau of Economic Analysis, U.S. Department of Commerce, December 19, 2016, https://www.bea.gov/itable/.

[4] "May 2017 Association Letter on Cybersecurity Law Implementation," The U.S.-China Business Council, May 2017, https://www.uschina.org/advocacy/regulatory-comments-on-china/may-2017-association-letter-cybersecurity-law-implementation.

[5] "The 13th Five-Year Plan – China's transformation and integration with the world economy," KPMG, October 2016, https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2016/10/13fyp-opportunities-analysis-for-chinese-and-foreign-businesses.pdf.

[6] "Circular on Several Measures to Expand the Opening-up and Actively Utilize Foreign Investment," State Council of China, January 17, 2017, http://www.gov.cn/zhengce/content/2017-01/17/content_5160624.htm.

[7] "Future Directions for Foreign Banks in China 2014," Ernst & Young, 2014, http://www.ey.com/Publication/vwLUAssets/EY-foreign-bank-china-report-2014/$FILE/EY-foreign-bank-china-report-2014.pdf.

[8] "2017 National Trade Estimate," China, Officer of the United States Trade Representative, Executive Office of the President, March 2017, https://ustr.gov/about-us/policy-offices/press-office/reports-and-publications/2017/2017-national-trade-estimate, 87-88.

[9] "2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track," U.S. Department of Treasury, June 7, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx.

[10] "China — Measures Affecting Financial Information Services and Foreign Financial Information Suppliers," World Trade Organization, https://www.wto.org/english/tratop_e/dispu_e/cases_e/ds373_e.htm.

[11] "2016 U.S.-China Strategic and Economic Dialogue Joint U.S.-China Fact Sheet – Economic Track," U.S. Department of Treasury, June 7, 2016, https://www.treasury.gov/press-center/press-releases/Pages/jl0484.aspx.