

**China's WTO Implementation:
An Assessment of China's Second Year of WTO Membership
Written Testimony by the US-China Business Council
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Submitted in response to the Office of the USTR's Request for Comments and Notice of Hearing Concerning China's Compliance with World Trade Organization (WTO) Commitments (Federal Register, Page 43247, 7/21/03)

The US-China Business Council (USCBC) is pleased to provide the Office of the US Trade Representative (USTR) with the following assessment of China's compliance with its WTO commitments in its second year of WTO membership. Issues related to China's WTO entry have been integral to USCBC work for more than a decade as part of broader efforts to help US member companies succeed in the China market. The Council has systematically tracked implementation efforts since China acceded to the WTO on December 11, 2001, and the Council's WTO Working Group has met quarterly since that time to discuss problems and progress. This report is not intended to be comprehensive, but rather to highlight for USTR key developments of particular significance to USCBC members.

I. Executive Summary

Important new market openings scheduled for 2003, together with outstanding problems that arose during China's first year of WTO membership, make year two especially significant for foreign companies operating in China. A range of WTO-mandated tariff reductions took effect relatively smoothly on January 1, 2003, but China must still implement a number of important commitments on market access in services by December 11, 2003 (see Annex). Of critical concern is how China will allow foreign firms to expand their scopes of business in ways necessary to the full realization of WTO-mandated trading and distribution rights. According to China's WTO commitments schedule we should be at least half way toward the realization of trading and distribution rights, with full implementation to take place by December 11, 2004. Unfortunately, to date, China has only granted export sourcing rights and the right to establish minority trading joint ventures—an apparent contravention of China's terms of accession, which dictate that no specific form of incorporation would be required to trade by December 11, 2004.

The inability of government ministries in China to reach policy consensus, and the enactment of questionable policies for the apparent purpose of protecting domestic interests, have slowed the pace of implementation and emerged as serious problems. The newly established Ministry of Commerce (MOFCOM) and its predecessor, the Ministry of Foreign Trade and Economic Cooperation

(MOFTEC), have made considerable efforts to coordinate and implement WTO commitments, yet have run into trouble forging consensus among competing agencies on more than one occasion. In other instances, US companies have faced outright protectionist policies implemented by PRC government officials. The formation and growing activism of quasi-governmental industry associations in the most protected industries is cause for concern. These groups represent powerful protectionist constituencies before the PRC government on issues such as standards setting. Companies note that many PRC government officials and business executives see WTO commitments as the maximum that can be offered, rather than a minimum level of openness to foreign investment and trade. Implementing regulations in many sectors, in defining the terms of access, delay or severely restrict foreign participation.

In July and August 2003, USCBC conducted a survey of member company views on China's implementation of its WTO commitments to date. On a scale of 1 (excellent) to 10 (failure), USCBC members gave China an average unweighted score of 5.2, the academic equivalent of a C, on its implementation efforts so far. In their responses, USCBC members noted some progress during year two in the areas of transparency, intellectual property legal framework and structure and enforcement, as well as tariffs and standards. Members cited trading rights, distribution rights, and non-discrimination and national treatment as areas in which there has been a pronounced lack of progress or, in which new problems have appeared.

When asked to identify the major obstacles to WTO implementation in their priority areas, a majority of firms identified "government protectionism" and "industry protectionism" as the two main obstacles to progress. Respondents also highlighted inadequate access to China's rulemaking process as a significant barrier to effective market access. Low levels of understanding among PRC government officials was not seen to be a problem except in the areas of customs/trade administration and transparency. A lack of resources was perceived to be a significant barrier only in intellectual property rights enforcement.

II. Year One Holdover Issues

Tariff reductions appear to be occurring satisfactorily. For certain products, China has lowered tariffs ahead of the WTO schedule. China has also done a relatively good job of issuing and revising legislation to meet its yearly commitments. Extensive bilateral discussion has resulted in limited progress on some year-one issues, but contentious issues such as express mail, tariff-rate quotas (TRQs), insurance branching, high capital requirements in services, and genetically modified organism (GMO) policy are far from resolved.

Agricultural and industrial quotas and tariff-rate quotas

PRC regulations announced industrial quota amounts for 2003 import quotas on autos, tires, rubber, and crude or processed oil that meet or exceed minimum WTO commitments. Auto quota allocations that were left over from 2002 were partially extended to 2003. China lifted quotas for motorcycles and crane lorries and chassis on January 1, 2003, one year ahead of schedule. Yet, China still maintains separate catalogues of products that require registration or import permits in direct violation of the WTO national treatment principle. China has yet to release comprehensive implementing regulations for quota allocation, and the process remains opaque.

In agriculture, complicated import licensing procedures still pose barriers for US firms. China maintains a distinction between products imported under normal trade for domestic consumption and

those imported under processing trade for export. The distinction allows for quota to be allocated for processing-trade purposes on a first-come, first-served basis. This violates WTO national treatment principles because it gives preferences to products not bound for the domestic market. Progress so far has been limited in spite of significant pressure from US industry and the US government. China needs to issue all of its allocated TRQs to a variety of qualified users in a timely manner.

China also requires firms to obtain import licenses to receive shipments of certain products even after they have received quota allocations. And China refuses to provide information about companies that have received a quota allocation and the amount that has been allocated, preventing exporters from identifying eligible importers. Companies in several industry sectors continue to report problems of state companies receiving non-state allocations.

Agricultural GMO standards and SPS measures

Investment provisions detailed in 2001 foreign investment rules constitute a retreat from earlier market-access provisions and restrict US companies from investing in China's agricultural biotechnology sector. US companies are pleased that China extended GMO certificates until April 2004 under the temporary administrative regime for GMO imports. New sanitary and phytosanitary (SPS) measures target imports of soybeans, however, and threaten US-China agricultural trade.

High capital requirements for services

Foreign service firms in many industries face unreasonably high capital requirements to establish a commercial presence and to establish branches and sub-branches in a variety of services. These include banking, insurance, logistics, and telecom services. China's recent insurance implementing regulations significantly reduce capital requirements from earlier draft regulations, but the amount of money required to establish and branch is still much higher than levels in most other countries.

Auto finance regulations

While USCBC sources indicate regulations may be released before the end of 2003, as USCBC goes to press, auto finance rules have yet to be finalized and issued. The rules are already almost two years late.

Value-added, consumption, and border taxes

China revoked preferential tax policies enjoyed by 20 border-trade products on June 1, 2003. The move is an important step toward treating goods imported through normal trade and border trade equally, although China has not abolished preferential treatment for all products traded on the border. Preferential treatment for integrated circuit (IC) products manufactured in China continues to discriminate against IC imports. Similar value-added tax (VAT)-related complaints have been raised with regard to fresh and live seafood, corn, and fertilizer.

III. Year Two Assessment of Priority Issues

The following issues are discussed in order of importance to USCBC member firms. In USCBC's recent survey, each responding company was asked to select five priority issues from a list of 23 choices. The following 11 issues emerged as the most important concerns for USCBC firms in the order listed. Issues received a weighted score to reflect their relative importance to respondents. The score was calculated according to the number priority indicated by each member firm according to the following scale: Priority 1=5 points; Priority 2=4 points; Priority 3=3 points; Priority 4=2 points; Priority 5=1 point.

Issue	Weighted Score
1. Trading Rights (ability to import and export product)	112
2. Transparency	106
3. Distribution (ability to distribute product to wholesalers, retailers, and end users within China)	97
4. Standards, Technical Regulations, and Conformity Assessment	96
5. Intellectual Property Rights (IPR): Enforcement	85
6. Non-Tariff Measures (quotas, licenses, tendering requirements)	79
7. Tariffs	76
8. Specific Market-Access Service Commitments	73
9. Non-Discrimination/National Treatment	61
10A. Customs and Trade Administration (classification, valuation, rules of origin)	57
10B. IPR: Legal Framework (patent, trademark, copyright)	57

1. Trading Rights (See Distribution Rights below)

Trading and distribution rights in China are in flux. Some regulations have been issued, but companies are uncertain about how full trading and distribution rights will be implemented by December 11, 2004. In lieu of regulatory clarity, most companies have contracted with trading companies or third-party logistics companies to handle portions of the chain that require specific licenses and have used trading companies located in Shanghai's Waigaoqiao free trade zone to import, store, and manage products. Of particular concern are signs that China may seek to restrict the scope of these rights by product area.

China committed to allow existing foreign-invested enterprises (FIEs) to obtain full trading rights (beyond import as inputs or for self-use) for almost all products over a three-year phase-in period. Joint venture enterprises with minority-share equity were to have been granted full trading rights as of December 11, 2002. Although MOFTEC (now MOFCOM) published provisional regulations in February 2003, the new regulations do not address how existing FIEs in which the foreign investor has a minority stake may obtain full trading rights. They also do not move far enough toward the December 11, 2004 deadline by which time trading rights are to be allowed via notification and without the imposition of any additional investment or approval requirements.

2. Transparency

China's uneven implementation of its commitments regarding transparency remains a particular disappointment for foreign firms. Transparency is an issue that affects all firms; it is among the most important of China's WTO commitments.

The WTO requires new regulations to be subject to a period of public comment before they take effect. But in China, public comment periods for new rules are still not universal and when a government agency does provide one, the comment period is often too short to be useful. For example, China did not publicly issue its draft revisions to the 1994 auto-policy guiding rule and did not provide an opportunity for foreign companies to comment. And although foreign investors

understand that draft rules on retail, franchise, or direct selling have been completed, the regulations have not appeared publicly.

The first transitional review mechanism (TRM) process in fall 2002 failed to reach the expected level of transparency from the Chinese delegation. While China has been reasonably responsive to specific requests for information in committee meetings in Geneva since the first TRM and seems to prefer this format, it is important that China remain responsive to requests for information and report on changes to its laws, regulations, and procedures. Failure to use the WTO consultative mechanism in committee meetings throughout the year and at the TRM, combined with problems on implementation, is likely to result in heightened pressures for unilateral action on trade disputes with China from within the US Congress and affected US industry and for multilateral action within the WTO's dispute resolution process.

3. Distribution Rights

A key outstanding issue is how imported products may be distributed in China. For US companies, trading and distribution rights are fundamentally interrelated. Having rights in one area without the other does little to help a company establish an integrated supply chain logistics operation. US companies hope that China will implement trading and distribution rights in tandem and that new rules will enable companies to integrate these two components into their overall operations. Unfortunately, PRC officials have stated so far that they intend to implement trading and distribution rights completely separately and without consideration for how the rights are fundamentally interrelated within a company's operations. Many companies are concerned that China may require separate distribution channels for imported and domestic products.

As it stands today, any FIE in China may distribute only the products it manufactures in China and may provide after-sales services only for such products. China maintains that only companies with a specific distribution license may distribute third-company products or imported parent company products, regardless of whether the company has trading rights. Only FIE holding companies may, with specific approval, distribute small quantities of imported products for market testing (though a March 2003 rule change allows holding companies to provide after-sales services for all imported parent-company products). China may try to link distribution rights to a company's scope of business. USCBC discussions with PRC regulators indicate that China is considering rules that would allow existing FIEs to import and distribute products within a specific industry but not across industries. For example, a pencil manufacturer could import and distribute pencils but not automobiles. It is not yet clear whether such FIEs would be limited to distributing parent company products or if they would be able to distribute other companies' products as well.

China issued the July 2002 Notice on Relevant Issues Regarding the Experimental Establishment of Foreign-Invested Logistics Companies, which technically meets China's commitments to allow distribution companies with foreign minority investment by December 11, 2002. But China has yet to define how existing FIEs may expand the scope of their current operations to include distribution. The July 2002 notice allows existing FIEs to apply to have logistics added to their business scope, but China has not issued implementation rules to detail such procedures. According to the July 2002 notice, foreign-invested logistics companies must have registered capital of \$5 million.

4. Standards, Technical Regulations, and Conformity Assessment

US companies have expressed frustration about their lack of access to China's standards-setting process in a variety of sectors. Currently, no formal mechanism exists for foreign companies to participate in the development of standards in China. The standards development process is opaque, and comment periods on pending standards, when offered, are too short to allow meaningful comment.

China does not recognize standards certification and testing that takes place outside of China. China also has yet to implement the regulatory framework necessary to allow foreign-invested testing and certification organizations to conduct conformity assessment services for the domestic market. Majority-owned ventures are to be allowed in this area by no later than December 11, 2003.

Greater coordination is still needed between the State Administration of Quality Supervision, Inspection, and Quarantine (AQSIQ) and PRC Customs. Since China implemented new "CCC" (China Compulsory Certification) mark requirements on August 1, 2003, US companies have reported inconsistent application of the new rules. Shipments of imported products not requiring a "CCC" mark have been denied entry, adding expense and delay. Domestic products required by law to display the "CCC" mark but that are without it are still readily available through normal commercial sales channels.

5. Intellectual Property Rights: Enforcement

10.B Intellectual Property Rights: Legal Framework

USCBC concurs with USTR's Special 301 report assessment in 2003 that China has failed to enforce patent, trademark, and copyright protections effectively. Lack of transparency and coordination among government agencies, local protectionism and corruption, high thresholds for criminal prosecution, and lack of training all hinder enforcement. Though China has made important efforts to combat copyright piracy and trademark counterfeiting in the area of legislation, piracy and counterfeiting at the wholesale and retail level, and over the Internet, remain rampant due to inadequate penalties; uncoordinated enforcement among local, provincial, and national authorities; and a lack of transparency in China's administrative and criminal enforcement system. The piracy rate for optical media products is reported to be well over 90 percent.

6. Non-Tariff Measures (quotas, licenses, tendering requirements)

As discussed above in "Year One Holdover Issues," companies face difficulties regarding quota allocation and the administration of TRQs. The TRQ administration process entails burdensome licensing requirements and procedures for obtaining and using a TRQ allocation. Quotas are allocated in unviable quantities, and a portion of quota is still reserved for use in export-processing trade. China maintains a complex matrix of rules governing the licensing of such imports as general commercial goods, mechanical-electrical products, goods subject to designated trading, and technology products. Catalogues have up to four classification categories: free import (no restrictions); automatic licensing; restricted; and prohibited. Further breakdowns distinguish goods according to their type and use. Despite efforts by negotiators to clarify the process, the system remains opaque and cumbersome. The 2003 mechanical-electric product quota management rules announcement was particularly opaque and indicates that problems in this area still need to be addressed. Localization mandates in China's draft

auto policy provide incentives for auto companies to procure high-value parts locally instead of importing them.

7. Tariffs

10.A. Customs and Trade Administration

Tariff reductions appear to be occurring on time, but as tariffs fall, some companies are reporting new problems emerging in the areas of valuation, VAT, and licensing that affect the cost and ease of importing products. For example, China made commitments to value digital products according to the value of the underlying carrier medium rather than the imputed value of the content (i.e. on the basis of projected royalties). In June 2003, however, China issued regulations that call for valuation according to the imputed value of content, not according to the value of the underlying carrier medium.

China announced in late December 2002 that it had reduced tariffs, as required, on 7,445 eight-digit Harmonized Schedule (HS) codes. Tariff cuts that took effect January 1, 2003 reduce China's average rate on an unweighted basis to 11.1 percent.

The problem of end-use certification for 15 products covered under the Information Technology Agreement (ITA) has been addressed by a compromise that transfers authority for issuing end-use certificates from the Ministry of Information Industry (MII) to China's General Administration of Customs. During a review period, US officials will examine whether US companies are adversely affected under the new system. After this period, complaints will be lodged within the ITA framework at the WTO.

8. Specific Market-Access Commitments in Services

While half of USCBC survey respondents reported some progress in market access, an equal number of respondents reported no progress or the emergence of new problems in this area. The major problem emerging in services appears to be a two-layered approach by PRC regulators. Basic laws are enacted that "allow" or "permit" for new investment in previously restricted sectors as required by WTO commitments, but the terms of entry are prohibitively high or cumbersome. In effect these rules curb market access for all firms and especially for smaller firms. Delays in licensing have also prevented companies from establishing or expanding operations. Ambiguity about core commitments, such as how to branch or sub-branch in insurance or how to define telecommunications value-added services (VATS) are also preventing forward movement in services.

Construction and Engineering

The Foreign-Invested Construction Enterprise Management Rules, which took effect on December 1, 2002, allow for the establishment of wholly foreign-owned construction enterprises (WFOCEs) two years ahead of China's commitment schedule. The rules require domestic parties to contribute at least 25 percent of registered capital in joint ventures. As outlined in China's WTO commitments, the rules restrict WFOCEs to wholly foreign-financed projects and Sino-foreign projects with majority foreign investment. Foreign companies in the engineering and construction sector are concerned about the timing and commercial implications of new construction enterprise regulations, Ministry of Construction Decree 113 and (114, which has not been formally issued). The timing between the repeal of existing regulations and enactment of the new measures would create a regulatory gap, forcing current

operators to operate illegally during the interim period. Draft regulations threaten to retreat from practices allowed prior to WTO entry. Concerned parties have not had an adequate opportunity to discuss with PRC regulators how to bring the rules closer to international practices.

Insurance

Revisions to the Insurance Law took effect January 1, 2003. One revision removes the requirement in Article 101 of the 1995 law that 20 percent of underwritten contracts be reinsured with the China Reinsurance Co., thereby meeting China's WTO commitments to lower the compulsory cession level by 5 percent each year beginning December 11, 2002. Article 91 of the 1995 law was also revised to allow both life and non-life insurers to sell short-term health insurance and accidental injury insurance, though the prohibition on operating both life and non-life insurance business remains. High capital requirements to establish and branch and ambiguity on how to branch and sub-branch continue to be important obstacles for the industry, especially as firms apply to provide services in a new range of cities scheduled to open to foreign life and nonlife insurers and insurance brokers by December 11, 2003: Beijing, Chengdu, Chongqing, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan, and Xiamen.

Legal services

The Ministry of Justice approved on December 16, 2002 the establishment of a second office for 11 law firms that already have one office in China. China had committed to lift restrictions on the number of offices a law firm could establish within one year of its WTO entry.

Logistics

China adopted the Rule on the Administration of Foreign-Invested International Freight Forwarding Agent Enterprises on January 11, 2003, replacing a December 2001 rule by the same name. The rule is notable for its translation of the WTO commitment to allow "majority foreign investment" into an arbitrary 75 percent cap on foreign investment. Many in the sector had hoped China would not cap foreign investment.

Telecom services

China's commitments to expand geographic access and to allow 50 percent foreign equity in value-added telecom and paging services by December 11, 2003 remain unrealized because of vague regulatory guidelines and a failure to license firms in these new areas. MII's revised Catalogue on Telecommunications Services Classification, issued in March 2003, remains an obstacle to foreign investment because it does not define which items within the revised VATS section are open to foreign investment. MII officials have maintained that the VATS operations listed in China's WTO commitments are exhaustive and that not all VATS operations are open to foreign investment.

9. Non-Discrimination and National Treatment

This core principle of WTO membership remains a fundamental problem for firms in China across a wide range of sectors. A majority of USCBC firms report no progress in this area. Both government protectionism and industry protectionism are seen to be the main obstacles to realizing equal treatment for foreign and domestic products and services. In particular, China's VAT regime favors domestic products over imports; import-licensing procedures favor goods bound for export processing over those bound ultimately for the domestic market. Many of the problems highlighted above indicate that

PRC policies continue to offer domestic companies more favorable treatment. This entrenched problem will require significant efforts that focus on each problem area in order to attain fair treatment for foreign goods and services in China.

V. Looking Ahead

The PRC government has been slow to implement its most significant commitments, and in some important areas, efforts now appear stalled. Recent trends indicate that China has fallen into a pattern of re-negotiating its WTO entry terms line by line as questions are raised about implementation problems. Restrictive terms and new barriers threaten to negate the very terms of access to which China has committed.

In 2002, impending senior-level Chinese Communist Party and government leadership transitions and intra-bureaucratic difficulties impeded progress. In 2003, adjustments related to the new MOFCOM and the outbreak of Severe Acute Respiratory Syndrome (SARS) stymied progress. USCBC believes that China should act now to resolve outstanding issues and to meet year-two commitments by December 11, 2003 to maintain the international community's faith in both China's intent and ability to honor its WTO obligations.

Implementation of these commitments does not only entail enactment of new provisions that announce the opening or liberalization of a particular area. To be meaningful, implementation also requires detailed rules and procedures that reflect the full terms and spirit of China's WTO accession agreements and ensure that market access as negotiated is allowed in fact.

Now, almost two years into China's WTO membership, USCBC has observed that the source of many of the problems discussed in this testimony rest with agencies belonging to the central government in Beijing, not at the local level. The main obstacles to implementation are government protectionism and industry protectionism; minor obstacles include a lack of understanding or resources. It is up to China's central government to apply pressure internally, if necessary, to make sure its agreements are fully implemented. If implementation continues to stall, as we enter the critical juncture of year three of China's membership, USCBC supports the strongest efforts by USTR in direct contact with China's leaders at the highest levels to eliminate these difficulties before they do further damage.

China is now a WTO member. USCBC and its members are watching closely for a cooperative transitional review process this year, expecting to see improved responsiveness from the PRC delegation. USCBC is also watching the lead up to the fifth WTO Ministerial Conference to be held in Cancun, Mexico, with great interest, as China begins to demonstrate what type of WTO member it will be. Preliminary indicators show that China is at odds with the US agenda in Doha and appears to prefer a more closed, as opposed to a more open, global trading system as evidenced by its unwillingness to reduce industrial tariffs and its leadership role along with India and Brazil to fight efforts to limit agricultural subsidies and price supports. China's original expression of interest in joining the Government Procurement Agreement has taken on new urgency with recent government directives to procure only domestic software, and USCBC hopes that China will continue to discuss with USTR and other GPA members about how to formally join in the near future. USCBC hopes that recent statements are not indicative of future positions and that in short time China understands what is at stake in the Doha round and joins the United States and others in working toward further trade liberalization.

Annex: China's Year-Two Services Commitments

China must meet the following WTO commitments in services by December 11, 2003:

Advertising

Permit foreign majority ownership in advertising firms

Banking

Allow foreign financial firms to provide local currency services in Chengdu, Chongqing, Fuzhou, and Ji'nan and local currency services to Chinese enterprises

Commission agents and wholesale

Allow foreign majority ownership and no geographic or quantitative restrictions for foreign service suppliers of most imported and domestically produced products (with some exceptions)

Freight forwarding

Provide national treatment for additional registered capital requirements for joint ventures (JVs); allow foreign freight forwarding agencies to set up a second JV after a first JV has been in operation for two years

Insurance

- Permit wholly foreign-owned subsidiaries of foreign nonlife insurers
- Reduce to 10 percent the mandatory cession to China Reinsurance Co. of all lines of primary risk for nonlife personal accident and health insurance business
- Allow foreign life and nonlife insurers and insurance brokers to provide services in Beijing, Chengdu, Chongqing, Ningbo, Shenyang, Suzhou, Tianjin, Wuhan, and Xiamen
- Permit foreign nonlife insurers to provide the full range of nonlife insurance services to both foreign and domestic clients
- Reduce insurance brokers' asset requirements to \$300 million

Retailing

- Permit foreign majority ownership in JV retailing enterprises
- Open all provincial capitals, plus Chongqing and Ningbo, to JV retailing enterprises
- Permit foreign service suppliers to retail all products, except for books, newspapers, and magazines

Technical testing and analysis and freight inspection

Permit foreign majority ownership, except in statutory inspection services for freight inspection services

Value-added telecommunications and paging

Eliminate geographic restrictions and permit foreign investment at 50 percent

SOURCE: Protocol on the Accession of the People's Republic of China, Annex 9: Schedule of Specific Commitments on Services Year Two Services Commitments.