



ITI Testimony before the U.S.-China Economic and Security Review Commission

***Hearing on China's Five Year Plan, Indigenous Innovation and
Technology Transfers, and Outsourcing***

Presented by:

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The Information Technology Industry Council (ITI) appreciates the opportunity to provide testimony on China's indigenous innovation and industrial policies. ITI represents global leaders in innovation, from all corners of the information, communications, and technology (ICT) sector, including hardware, software, and services. China is a key market for ITI member companies, and hundreds of thousands of American jobs in high tech are directly tied to robust trade and business with China. Some of the largest beneficiaries of that trade are U.S. workers and businesses, many of them small businesses, who manufacture electrical machinery and equipment or develop software. Yet while U.S. exports to China are on the rise - last year, U.S. exports to China were nearly \$92 billion dollars, up four-fold from a decade ago¹ - U.S. tech companies operating in the China market continue to face some of the most difficult market access barriers in the world.

We welcome China's efforts to create more innovative companies and to promote the development of innovative capabilities. Indeed, our companies have decades of experience building and creating innovative products throughout the world. However, China's approach to innovation -- "indigenous innovation" -- is rife with challenges and shortcomings.

Today, I would like to highlight some of the most problematic examples of policies that make up China's indigenous innovation drive and undermine the ability of foreign companies to compete

¹ <http://www.uschina.org/statistics/tradetable.html>

fairly in the China market. Then I would like to offer a few recommendations on how the United States can address these challenges. Getting the China trade calculus right and building a stronger, healthier bilateral trade relationship is in the strategic interest of the United States.

The Challenge of China's Indigenous Innovation Policies

It is not China's drive to innovate that is such a challenge for us. We support that. Our primary challenges relate to China's approach to spurring domestic innovation through a thicket of policy expressions that veer dramatically from global norms and are often patently discriminatory.

At its core, this is a problem of market access for us, though there are certainly broader strategic implications that come into play as well.

At a time when the global economy is still in recovery mode, governments should be doing their utmost to promote tried-and-tested practices that will engender economic success for businesses and the public alike. Unfortunately, time and again, the U.S. business community, and in particular the technology community, has run into problems with the Chinese government as it attempts to create and impose rules and regulations that are incompatible with global industry best practices and frustrate our ability to do business in that market. Indigenous innovation policies are the latest incarnation of this troubling reality.

China's indigenous innovation policies have been around for some time, but were introduced more formally in the 2006 *Medium- and Long-Term National Plan for Science and Technology*. The chief aim of this document was to foster the development, commercialization, and procurement of Chinese products and technologies. More precisely, it was developed to give a leg up to domestic producers by compelling government agencies to adopt rules and regulations favoring products that use Chinese-developed ideas and technologies. One concrete goal of the plan, for example, is for China to import only 30 percent of the technology it uses from overseas by 2020. The problem is, such policies more often than not do this at the expense of foreign players who have worked for decades in partnership with China to promote growth and prosperity and deliver innovative products to the people of China. This potentially puts at risk all

past and future investments that our companies have made in that market.

Getting Down to Specifics

While the policies may have understandable intentions, the means to achieve the ends and the consequences for companies from the United States and other countries do not bode well for our immediate commercial concerns or for the perpetuation of a troubling model that others might replicate.

One of the most notable of China's policies to advance indigenous innovation was its effort to establish a national catalog of products to receive significant preferences for government procurement. Among the many problematic criteria for eligibility were stipulations that products contain intellectual property developed and owned in China, and that associated trademarks be originally registered in China. This was an unprecedented use of domestic intellectual property (IP) as a condition of market access that no other country in the world requires, and one which made it nearly impossible for American companies to qualify. IP is developed all over the world, not just in one country. China has since backed away from this policy, and at the most recent U.S.-China Strategic and Economic Dialogue (S&ED) agreed to eliminate all indigenous innovation catalogs. We will need to be vigilant to ensure that this happens. But the indigenous innovation policy drive extends well beyond the catalogs.

China has been a persistent offender when it comes to IPR infringement. In its recently released report, *China: Effects of Intellectual Property Infringement and Indigenous Innovation Policies on the U.S. Economy*, the U.S. International Trade Commission (ITC) estimated that "U.S. IP-intensive firms' losses from IPR infringement in China were approximately \$48 billion in 2009," and that "firms in this segment of the U.S. economy also spent approximately \$4.8 billion in 2009 to address possible Chinese IPR infringement in 2009."² Across the U.S. economy, the effect is dramatic. The ITC further estimated that the United States would gain about 2.1 million jobs if China brought its IPR enforcement levels up to U.S. standards, and cited industry

² http://www.usitc.gov/press_room/news_release/2011/er0518jj2.htm

estimates that such improvement would bring close to 1 million jobs to knowledge-based industries.³ The Chinese government has not invested the same resources to combat IPR theft – and if protecting innovative ideas is a key underpinning of an innovative society, China is doing itself and its domestic industry a disservice in this area.

The impact of China’s propensity to develop and deploy its own country-specific standards that are not always based on their technical merits is of great concern to the ICT sector as well. Several years ago, for example, China endeavored to mandate a homegrown wireless standard called WAPI, despite the existence of a technology widely used around the world known as WiFi. Under the auspices of the U.S.-China Joint Commission on Commerce and Trade (JCCT), China ultimately agreed in 2004 to take steps toward a market-based, technology-neutral approach to the development of next generation wireless standards and to “suspend indefinitely its proposed implementation of WAPI as a mandatory wireless encryption standard.” Despite this, China has pushed forward with WAPI anyway, and it is now a *de facto* mandated standard enforced by using the handset “type approval process” controlled by the Ministry of Industrialization and Information Technology (MIIT). To be sure, WiFi handsets are available in China now, but only if WAPI technology is built-in and enabled.

Emboldened, China may now be looking to do the same thing with PCs and servers by requiring that such equipment sold in the country include a technically unknown and untested “Trusted Cryptography Module” chip -- despite the existence of an internationally developed standard known as TPM, or Trusted Platform Module. Our understanding is that a few government ministries currently require TCM, but we are watching carefully the development and potentially wider deployment of this technology.

This trend sets a troubling precedent for future technology standards and represents a significant departure from global adoption of harmonized ICT standards. It also creates unnecessary technological complexity, compromises the basic principle of technology neutrality in policymaking, and undermines China’s commitments under the JCCT and the WTO. Our

³ http://www.usitc.gov/press_room/news_release/2011/er0518jj2.htm

industry is a strong proponent of standards that are voluntary, industry-led and global. Use of global standards based on industry consensus and technical merit is a long-established international norm that has served us well, promoting innovation, transparency, and system interoperability. With a global economy that becomes more integrated by the day, global solutions to standards setting undergird the way we develop and build our products.

Beyond standards development, China continues to increase burdensome testing and certification regulations on ICT products sold in both government procurement and commercial markets that are inconsistent with global norms. We often see overlapping, unnecessary or onerous testing requirements related to safety and other product testing. China has in place certification requirements to disclose sensitive technical information to government affiliated-labs for certain information security products sold to government buyers – something no other government does. The far-reaching Multi-Level Protection Scheme (MLPS), for example, would place completely unworkable testing requirements on many high-tech products going into critical infrastructure systems in China, and similar to the indigenous innovation catalog, MLPS contains domestic IP requirements as well.

In sum, whether through government procurement, standard setting, cyber-security, safety testing, or an unwillingness to enforce laws to protect intellectual property and prevent counterfeiting and piracy, the two common threads running through most of our challenges with China are policies that advantage domestic companies at the expense of foreign firms and that attempt to force the transfer of technologies. It is incredibly important to address these now, as such protectionist models could be replicated in other markets.

The Way Forward

There is little doubt that indigenous innovation polices are having an adverse effect on U.S. competitiveness. U.S. companies in China compete without the advantage of tax incentives and subsidies offered to Chinese companies under the policies. As the recent ITC report stated, the policies “appear to have eroded the competitive positions of U.S. and other foreign firms in

China while creating new barriers to foreign direct investment (FDI) and exports.” In terms of the effect on the domestic economy, it is important to note that intellectual property and innovation have long played a prime role in driving the U.S. economy. The technology industry has been at the forefront of this drive for many years now, and therefore any attempt to hamper innovation abroad will have repercussions at home.

How do we address these myriad challenges? The U.S. Government should continue concerted efforts to address specific trade barriers, as well as strategically address the broader, underlying trends of protectionism and promotion of Chinese national champions. We commend past efforts by our government to address China’s indigenous innovation policies, and we urge continued support of bilateral dialogues such as the S&ED, JCCT, and Innovation Dialogue. The Administration’s role in rolling back numerous policies, including the indigenous innovation catalogs, has been instrumental. The United States should continue working closely with the private sector and with other governments to develop a clear, coordinated strategy for encouraging China to adopt global norms. When we have been most successful in dealing with China, it has been the result of close cooperation among governments and between our government and the private sector. And this needs to be an on-going, results-based effort.

Second, realizing the potential of a strong partnership will also depend on us taking steps here in the United States to improve our competitiveness. Looking east for solutions should not be our only priority. We must also do some work here at home to ensure our workforce and economy remains competitive with China and our other global trading partners. Lowering the corporate tax rate, adopting a territorial tax system, and promoting innovation incentives that promote research and development and intellectual property, among others will make the U.S. more competitive globally. And expanding the number of permanent green cards and temporary, high-skilled visas will both solve the current need for high-skilled workers and raise revenues. Additionally, robust investment in science, technology, engineering, and math (STEM) programs and education will create a talented workforce and keep America competitive for decades to come. These steps will take advantage of existing U.S. strengths, increase the ability of U.S. firms to create world-class innovative products, and make them more competitive globally.

Conclusion

To be sure, China presents myriad challenges today, and it will continue to do so for the foreseeable future. China's economic system relies heavily on the decisions of its bureaucrats rather than its markets, lacks the transparency and inclusiveness of capitalist economies, and has an unacceptable record when it comes to addressing IPR infringement, including piracy and counterfeiting and piracy. While it is clear that China's leadership is committed to improving IPR enforcement, we have yet to see major changes or increased sales. A thicket of vague rules, regulations and mandatory standards thwart U.S. trade and investment with China and call into question its position as an aspiring global leader. These policies hinder China's leadership evolution in the global economic community and limit the flow of cutting edge products to China's economy and its people.

We must, however, get China trade right. The Chinese economy is too big and too influential to have it any other way. Its market is too important to the United States and to the rest of the world. China is not a monolith. It is a diverse, complicated country that includes recidivist forces determined to go their own way through the implementation of problematic policies, such as indigenous innovation, which are discriminatory and protectionist.

But, there are also Chinese forces of change in government and industry that recognize if China is ever going to reap the full benefits of its economic might, it must transition toward fuller integration into the international economy, adopt global standards and regulatory practices, and fall in line with other widely accepted norms. Through sustained, firm, and sensible engagement, we need to identify these forces, work to empower them, and collaborate with them to effect positive change.

I am confident that we can successfully chart this course. Too much is at stake to do otherwise.
Thank you.

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