

U.S. China Economic and Security Review Commission

Hearing on ***“Chinese State-Owned Enterprises and U.S.-China Bilateral Investment”***

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Panel II: U.S. Investments in China

Testimony of

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**Summary**

Good morning Vice-Chair Slane, Commissioner Wessel and other members of the Commission and staff. Thank you for the opportunity to testify here today. Growing U.S. trade deficits with China cost the United States 2.4 million jobs between 2001 and 2008 alone (Scott 2010b). More than two-thirds of the jobs displaced were in the manufacturing sector, and growing trade deficits with China are the greatest threat to the future health of U.S. manufacturing.

Foreign Direct investment has played a key role in the growth of China’s manufacturing sector. China is the largest recipient of FDI of all developing countries (Xing 2010), and is the third largest recipient of FDI over the past three decades, trailing only the United States and the United Kingdom (Table 2). Foreign Invested Enterprises (both joint ventures and wholly owned subsidiaries) were responsible for 55% of China’s exports and 68% of its trade surplus in 2010, as reported by China.<sup>1</sup> While FDI in China slowed in 2009 as a consequence of the global recession, it recovered strongly in 2010, increasing \$27.5 billion (35.2%). In my remarks today I will emphasize four main conclusions:

- While U.S.-based MNC’s are responsible for a relatively small share of total FDI in China, FDI from the U.S. and other developed countries (in the OECD) has played a disproportionately large role in the rapid growth of China’s GDP, productivity and exports. In addition, published academic research and data reviewed here suggests that MNCs from the United States may be under-reporting FDI in China. Under-reporting of FDI by U.S. MNEs should be addressed by officials and researchers from the U.S. Bureau of Economic Analysis (see specific policy recommendations, below).
- China has used a number of activist policies to attract and retain FDI, and to maximize exports and other benefits received from these facilities. First, the RMB (yuan) was devalued by 57.2% between July of 1986 and January of 1994, primarily in three distinct moves (Figure 2), and held

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<sup>1</sup> Ministry of Commerce, China (2011) and Invest in China (2011).

at this level until July 2005. The best estimates are that the RMB is still 25% to 40% undervalued (Cline 2009 and 2010). China's currency manipulation is illegal under the GATT/WTO agreements and the IMF charter, as well as U.S. law (Scott and Bivens 2006). Currency manipulation dramatically lowers Chinese production costs and provides an effective subsidy to Chinese exports; it also acts as a barrier to imports from other countries. Second, China provided tax holidays and has offered FIEs preferential tax rates for corporate profits, and reduced value added tax rates.<sup>2</sup> China has also offered other incentives to MNEs that established subsidiaries and joint ventures in its "Special Economic Zones" (Xing 2010). Finally, China has provided tens of billions of dollars of illegal subsidies to firms in industries such as steel, glass, paper and new green technology industries.<sup>3</sup> Most of these incentives and subsidies are illegal under the terms of the WTO and U.S. fair trade laws.

- Taken as a whole, China's FDI promotion regime has provided massive, illegal subsidies to MNEs from the United States and other countries. These subsidies have encouraged firms to outsource production from the United States and other developed countries to China; they have contributed to the rapid growth of China's exports to the U.S. and the world; and they have severely suppressed U.S. exports to China, and to the world (China is now the most important competitor for U.S. exports on world markets).
- The United States can and should adopt new policies to level the playing field between the U.S. and China. Trade and manufacturing policies should be used to defend and recover production in the United States, and to maximize production and employment in U.S. manufacturing establishments. These policies should emphasize the benefits of U.S. production and employment. Support for the headquarters operations of domestic or foreign MNEs should be, at most, a secondary concern of domestic trade policies.

Enforcement of important U.S. fair trade laws, such as anti-dumping and countervailing duty (CVD) measures, requires a qualifying group representing domestic producers or workers that generate at least 25% of domestic volume of the like product to file a legal complaint. Litigation of these cases can cost millions of dollars, with uncertain outcomes—many such cases are rejected.<sup>4</sup> As U.S. industries have offshored production, and become increasingly dependent on low-cost foreign suppliers, their interest in filing fair trade complaints has declined. U.S. firms investing in China such as GM, Motorola, Johnson & Johnson, and the Blackstone Group, and large retailers such as Walmart, Target and CVS benefit directly or indirectly from China's currency manipulation and subsidies. These firms are more likely to threaten or otherwise discourage their suppliers from participating in fair-trade enforcement cases. Thus, fewer and fewer trade cases are being filed, simply because of the costs and difficulty of obtaining the support of a qualifying domestic injured party.

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<sup>2</sup> Some or all of these tax preferences were phased out under the terms of a new Chinese Law in 2008 (Du, Harrison and Jefferson 2011). However, existing FIEs were allowed to retain some of the benefits offered prior to the passage of the new law. New tax rates for FIEs will be phased in until 2012, and firms granted tax holidays will continue to benefit until the expiration of those agreements.

<sup>3</sup> Haley (2008, 2009, 2010) and Scott (2010 and 2011).

<sup>4</sup> The Congress and USTR can self-initiate some trade cases. However, this option is rarely used.

Specific policies that should be considered include:

- Policies that threaten to impose strong sanctions on China for its illegal currency manipulation such as the [Fair Trade Act of 2011](#), co-sponsored by Senators Brown and Snowe and Representatives Ryan and Murphy, and the much tougher Schumer-Graham currency reform measure adopted by the Senate in 2005.<sup>5</sup>
- The Congress should re-authorize the [Super 301](#) provisions in U.S. Trade Law, which required the USTR to initiate negotiations with priority countries to eliminate trade practices that impeded U.S. exports, including currency manipulation.<sup>6</sup>
- The U.S. should establish an independent agency to pursue violations of U.S. unfair trade law, including illegal tax subsidies and other types of direct and indirect subsidies.<sup>7</sup>
- Congress could consider chartering and funding an independent organization, like the Congressional Budget Office, that could investigate and file unfair trade complaints on behalf of Congress, or could refer complaints to committee for consideration of Congressional action.
- [Recently, a WTO appellate body ruled](#) that the U.S. cannot simultaneously apply antidumping and CVDs to products imported from China under its non-market economy rules when imposition of such duties would amount to double-counting, that is, when the prohibited subsidy has contributed to the below-market pricing that is the subject of the anti-dumping margin.<sup>8</sup> This ruling also sharply limited the definition of a “Public Body” (which can deliver subsidies), and rejected claims that State Owned Enterprises (SOEs) “exercised governmental functions on behalf of the Chinese Government.” This ruling will sharply limit the ability of the United States to impose Countervailing Duties in cases involving Chinese subsidies. U.S. fair trade law may have to be amended to provide new legal and economic approaches to the assessment of countervailable subsidies that do not affect subject-import prices, and to address the role of SOEs. As an alternative the United States may wish to rethink its commitment to and participation in the WTO dispute settlement mechanism. The U.S. has lost several high-profile cases in recent years<sup>9</sup> and there is a growing perception that WTO appellate judges are choosing “to substitute their own views for the rules negotiated by the WTO

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<sup>5</sup> The Ryan-Murphy bill which passed the House in 2010 would allow the Commerce Department to consider currency manipulation as a subsidy in CVD cases. This proposal would affect a small share of imports from China (at least initially). The Schumer-Graham 2005 amendment would have imposed a substantial (27.5%) across-the-board tariff on imports from China.

<sup>6</sup> The U.S. agreed to eliminate Super 301 investigations when the WTO was formed in 2004, under the Uruguay Round trade agreements.

<sup>7</sup> A direct subsidy could include, for example, below-market pricing for energy and raw materials. An indirect subsidy would be obtained by a firm in China that purchased subsidized materials, such as steel and glass made with subsidized energy and raw materials.

<sup>8</sup> Full disclosure: I have appeared as a witness for domestic producers of steel pipe in a number of antidumping and CVD injury investigations before the U.S. International Trade Commission over the past two decades, most recently in the 2011 case involving drill pipe and collars from China (Investigation Nos. 701-TA-474 and 731-TA-1176 (Final)).

<sup>9</sup> See, for example, the WTO decision that Boeing received illegal subsidies ([Steinhauser 2011](#)).

parties” (Otteman 2011). The costs of participation in WTO dispute resolution may have begun to exceed its benefits and it may be time for the U.S. to withdraw from the dispute settlement process.

- Rules contained in the 2001 US-China WTO accession agreement regarding treatment of China as a non-market economy (NME) will expire at the end of 2016. These rules allowed U.S. petitioners in antidumping cases to treat China as a NME, which presumes that most prices are administered by the state. Comparable home prices for subject products are constructed based on prices in a third country. Rules governing application of the NME status will then revert to the WTO standard in 2016.<sup>10</sup> Domestic petitioners will be required to prove that “all domestic prices are fixed by the State.” Otherwise, prices in China will be used as a basis for anti-dumping cases, which will favor producers in China (who benefit from many low, administered input prices). China is a mixed economy and manages many, but not all, domestic prices in most cases. The WTO NME rules are clearly defective in this case, and should be revised to allow treatment of China as a NME. If WTO members fail to approve these changes, this will provide another reason why the United States should consider withdrawing from the WTO dispute settlement process.
- U.S. manufacturing is falling farther and farther behind; China became the largest exporter in the world in 2009 (Figure 6)<sup>11</sup>, and recently passed the United States to become the largest manufacturer in the world. One reason for this is that the United States lags far behind other countries in the use of industrial policies and other types of economic development initiatives, such as workforce development and training, publicly supported R&D, and also the use of preferential public procurement policies. China, in particular, is not a signatory to the WTO government procurement agreement. Other OECD countries who are signatories still manage to use government procurement to support domestic industrial development, for example through military offset programs (Herrnstadt 2010). The U.S. needs to develop a wide range of economic development initiatives. In addition, the U.S. should consider withdrawing from the government procurement agreement, so that more extensive Buy-American programs can be developed.
- There is great need for enhanced reporting and analysis of data on U.S. FDI in China. BEA data on the operations of US MNCs show that U.S. FDI in China reached \$162 billion in 2008, about 16.6% of total FDI in China (Figure 3). Other academic research Table 3 below (Xing 2010) reports that the U.S. share was only 6.4%. In addition, U.S. MNCs are

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<sup>10</sup> Note 2, paragraph 1 of Article VI of the GATT reads as follows: “It is recognized that, in the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, special difficulties may exist in determining price comparability for the purposes of paragraph 1, and in such cases importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.”

<sup>11</sup> Figure 6 includes exports of all commodities, including oil. However, none of the countries shown in the Figure is a major oil exporter. Furthermore, most exports, especially for these countries, consist of manufactured commodities.

accumulating vast stocks of retained earnings abroad (a total of \$1.8 trillion was accumulated between 1999 and 2010 alone—see Figure 5 for flows). This may help explain the discrepancy between the data on the flow of new FDI shown in U.S. balance of payments reports, and changes in the stock of US FDI in China (from reports on the operations of US MNCs)—Figure 4 below. These data show that FDI, as reported in U.S. Balance of Payment Statistics, represents just the financial tip of US FDI abroad. Much greater information is needed on how U.S. and other MNCs finance foreign operations. Funding for construction of a new factory in China can flow directly from the home company in the United States, from retained earnings abroad, and from borrowed capital. In one widely reported example, Evergreen Solar recently announced that it was closing a factory to make solar panels in Massachusetts, and moving it to China. Chinese banks offered Evergreen financing for two-thirds of the cost of their new plant at rates “as low as 4.8 percent” with no principal payments or interest payments due until the end of the loan in 2015 (Scott 2011). This example illustrates that more and better data are needed on the financing of US FDI abroad. MNCs obtain great benefits from deferring taxes on these earnings. These companies should be required to provide more data on where those earnings are invested.

- In exchange for the great benefits earned by U.S. MNCs, including tax deferral and access to OPIC and EXIM bank financing, US MNCs should be required to provide much more data on their domestic and foreign operations. In order to better track trends in outsourcing, all U.S. multinationals should be required to publicly disclose the location, output and employment of domestic facilities that are closed or substantially downsized, and similar, plant-level information should be provided for all new facilities outsourced abroad, including greenfield investments and investments in existing production facilities. Foreign MNCs operating in the United States also benefit from federal, state and local incentives and access to publicly financed foreign trade and investment guarantees. They should be required to provide similar data in exchange. These provisions should also extend to contract manufacturing, technology licensing and other related forms of outsourcing. Finally, multinational retail corporations such as Walmart, Target and CVS that engage in substantial amounts of international goods trade (buying and selling large volumes of imported manufactured products and other commodities) should also be required to report annually on product sourcing and domestic and foreign employment, at the plant level.
- Funding for collection and analysis of data on the operations of U.S. and foreign multinationals needs to be substantially increased. Policies developed using these data can contribute to improvements in U.S. trade balances, and to increases in domestic manufacturing output, employment and tax revenues. Such investments will reduce government budget deficits.

## Analysis: Foreign Direct Investment in China

China was the third largest recipient of FDI in the world in 2009, as shown in **Table 1**, behind only Luxembourg and the United States. Some large recipients of FDI, such as Luxembourg and the United Kingdom are heavily involved in financial intermediation, and recycle large shares of their FDI inflows to ultimate destinations in other countries, including China. China received no recorded FDI prior to 1982. China passed several laws allowing for foreign joint ventures (in 1979) and wholly owned foreign enterprises (in 1986) that first opened China to foreign investors (Xing 2010). At first, China granted foreign investors participation in special economic zones (SEZs) and gradually opened all of China to FDI in the late 1990s. However, FDI remains concentrated in China's Southern and Central coastal provinces (Du, Harrison and Jefferson 2011).

Inflows of FDI to China rose rapidly in the early 1990s, plateaued at around \$40 billion per year and then took off rapidly following China's entry into the WTO in 2001, as shown in **Figure 1**. FDI in China peaked at \$147 billion in 2008, fell sharply during the great recession in 2009 and then increased \$27.5 billion (35.2%) in 2010 (Invest in China 2011). Aggregate inflows to China total \$1.05 trillion between 1978 and 2010, as shown in **Table 2**, and China is the largest recipient of FDI of all developing countries.

According to reported data, the major sources of FDI in China have been its closest neighbors, as shown in **Table 3**. Hong Kong, Taiwan and Macau (not shown), or greater China, is responsible for about half of the accumulated FDI in China, according to published reports. However, a large share of this investment may be "round-trip," having originated in China and then re-invested there. Such investments are encouraged by the low tax rates and other benefits conferred on foreign investors in China. Prior to 2008, profits of foreign investors were taxed at a 15% rate, while domestic investors faced a statutory income tax rate of 33% (Du, Harrison and Jefferson 2011). This incentive was eliminated, and corporate tax rates were unified at 25% in 2008. However, foreign investors were "grandfathered" in and will continue to receive preferential tax rates until 2012.

The United States and other western nations are reportedly responsible for small shares of FDI in China, as shown in Table 3. However, published academic research and data reviewed below suggests that MNCs from the United States may be under-reporting FDI in China.

Foreign Invested Enterprises (both joint ventures and wholly owned subsidiaries) were responsible for 55% of China's exports and 68% of its trade surplus in 2010, as shown in **Table 4**. Foreign Invested Enterprises (FIEs) employed 3% of China's labor force, but generated about 22% of its output (Whaley and Xin 2010). Their overall productivity was nine times greater than that of the average Chinese firm. Within manufacturing, the productivity ratio of FIEs and domestic firms was 4:1. Due to their high productivity, it is also estimated that FIEs were responsible for about 40% of China's recent economic growth.

Du, Harrison and Jefferson (2011) (DHJ) analyzed a unique dataset on the performance of domestic and FIEs in China. They collected data on all firms that generated more than 5 million yuan in output, and also included all state-owned enterprises (SOEs), most of which exceeded this threshold. Their data demonstrate the remarkable breath and impact of FIEs in China. Their dataset (from the Chinese

Ministry of Commerce) included complete information on the performance of 1.5 million enterprises for the period 1998-2007. The number of FIES rose from 96,135 in 1998 to 255,042 in 2007. Enterprises from Hong Kong, Taiwan and Macau (HMT) made up an average of 8.9% of the observations in the dataset over the entire period of investigation. Investors from other countries (largely members of the Organization for Economic Cooperation and Development) represented 7.9% of the observations.

DHJ also evaluated the comparative impacts of FDI from the HMT region with that from other countries. They found that FDI from the HMT countries is not associated with higher productivity at the firm level, while FDI from other countries (primarily those in the OECD) is associated with higher productivity. One explanation for this is that the HMT investments originate in China and embody Chinese technology and management techniques. FDI from firms in the OECD transfers technology and western management systems to Chinese firms. DHJ also found substantial upstream and downstream spillover effects from were associated with investments from other (non HMT) countries.

On average, capital invested in these firms increased 10.7% per year, while labor grew only 1.3%. Total Factor Productivity (TFP) increased 5.6% per year. Real output of these firms grew 13.5% per year, and TFP growth was responsible for a remarkable 40% of that output growth. Overall, estimates are that without FDI, China's GDP growth, which has exceeded 10% per year since 1982 (World Economic Outlook 2011), could have been 3.4% lower (Xing 2010).

FDI plays an even more important role in China's high-tech exports. For example, in the information and computer technology sector, in 1998, China generated \$20.3 billion worth of exports in this sector (11% of China's total exports), and FIEs were responsible for 73.7% of this output. In 2008, China exports in this sector increased to \$415.6 billion (29.1% of total Chinese exports), and FIEs were responsible for 85.2% of this output.

### **Reasons for Growth of FDI in China**

A number of factors have contributed to the growth of FDI in China. The existence of a large pool of low wage labor has certainly been important, but that labor was not mobilized for the production of exports until China made the decision to become a market economy in the with its "open door" policy and economic reforms of 1978, and reforms of its foreign investment laws in the 1980s noted above (Xing 2010). China has also used a number of activist policies to attract and retain FDI, and to maximize exports and other benefits received from these facilities. First, the RMB (yuan) was devalued by 57.2% between July of 1986 and January of 1994, primarily in three distinct moves (**Figure 2**), and held at this level until July 2005. The best estimates are that the RMB is still 25% to 40% undervalued (Cline 2009 and 2010). China's currency manipulation is illegal under the GATT/WTO agreements and the IMF charter, as well as U.S. law (Scott and Bivens 2006). Currency manipulation dramatically lowers Chinese production costs and provides an effective subsidy to Chinese exports; it also acts as a barrier to imports from other countries. Second, China provided tax holidays and has offered FIEs preferential tax rates for corporate profits (as noted above), and reduced value added tax rates. China has also offered other incentives to MNEs that established subsidiaries and joint ventures in its "Special Economic Zones" (Xing 2010). Finally, China has provided tens of billions of dollars of illegal subsidies to firms in industries such

as steel, glass, paper and new green technology industries (Haley 2008, 2009, 2010 and Scott, 2010a and 2011). Most of these incentives and subsidies are illegal under the terms of the WTO and U.S. fair trade laws.

Taken as a whole, China's FDI promotion regime has provided massive, illegal subsidies to MNEs from the United States and other countries. These subsidies have encouraged firms to outsource production from the United States and other developed countries to China; they have contributed to the rapid growth of China's exports to the U.S. and the world; and they have severely suppressed U.S. exports to China, and to the world (China is now the most important competitor for U.S. exports on world markets).

### **U.S. Outward Foreign Direct Investment**

There is great need for enhanced reporting and analysis of data on U.S. FDI in China. BEA data on the operations of US MNCs shows that U.S. FDI in China reached \$162 billion in 2008, as shown in **Figure 3**, about 16.6% of total cumulative FDI in China (Table 2, above).<sup>12</sup> Other academic reports Table 3 (Xing 2010) report that the U.S. share was only 6.4%. Data from surveys of the operations of U.S. MNCs in China yield different estimates of the flow of funds to such operations.

Similar results are obtained for the annual flows of U.S. FDI to China. **Figure 4** reports two contrasting estimates. The first is based on data from the U.S. balance of payments statistics (which report on U.S. current and capital account transactions, on a quarterly basis). The second estimate is net change in the value of U.S. FDI in China from the operating statistics reported by U.S. multinational companies (also reported by the BEA), for the period 1999-2008. There are important conceptual differences in the two series—the latter includes valuation changes while the former does not. But the differences in the data are strikingly large. Flows based on the MNC survey report exceed those in the Balance of Payments statistics by a factor ranging from 2:1 to more than 5:1 for the period covered in Figure 4.

In addition, U.S. MNCs are accumulating vast stocks of retained earnings abroad (a total of \$1.8 trillion was accumulated between 1999 and 2010 alone—see **Figure 5** for flows). This may help explain the discrepancy between the data on the flow of new FDI shown in U.S. balance of payments reports, and changes in the stock of US FDI in China (from reports on the operations of US MNCs)—Figure 4. These data show that FDI, as reported in U.S. Balance of Payment Statistics represents just the financial tip of US FDI abroad. Much greater information is needed on how U.S. and other MNCs finance foreign operations. Funding for construction of a new factory in China can flow directly from the home company in the United States, from retained earnings abroad, and from borrowed capital. In one widely reported example, Evergreen Solar recently announced that it was closing a factory making solar panels in Massachusetts, and moving it to China. Chinese banks offered Evergreen financing for two-thirds of

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<sup>12</sup> Note that this estimate is conservative. Data on the operations of U.S. MNCs is released about 21 months after the end of a given calendar year. This estimate (16.8%) compares total U.S. FDI in China in 2008 (as reported by US MNCs) with total FDI in China in 2010. It is likely that total U.S. FDI in China, as will be reported by US MNCs, increased in 2009 and 2010 (global inflows of FDI to China slowed in 2009, but they were not reversed; and US BOP data show FDI in China outflows of \$7 billion in 2009 more than offset by FDI inflows of \$9 billion in 2010, as shown in Figure 4).



the cost of their new plant at rates “as low as 4.8 percent” with no principal payments or interest payments due on the loan until the end of 2015 (Scott 2011). This example illustrates that more and better data is needed on the financing of US FDI abroad. MNCs obtain great benefits from deferring taxes on these earnings. These companies should be required to provide more data on where those earnings are invested.

### **US multinational companies prosper while manufacturing suffers at home**

Outsourcing has resulted in the loss of millions of and the closure of tens of thousands of factories in the United States in the past decade, but profits of U.S. multinationals have soared. The U.S. lost 3.6 million manufacturing jobs between January 2000 and December 2007, the peak of the last business cycle, and outsourcing was responsible for the vast majority of these job losses. An additional 2 million manufacturing jobs were lost through February 2011, primarily due to the Great Recession.<sup>13</sup>

The global earnings of U.S. MNCs on direct investment abroad rose from \$146 billion in 2000 to \$420 billion in 2010, and increase of 187% (earnings are shown on the black line in Figure 5, and measured on the left axis). U.S. MNCs obtain a tremendous financial advantage through FDI because they are allowed to defer taxation on earnings that are not repatriated (that is, those that are reinvested abroad). Figure 5 shows that the share of earnings repatriated (shown on the red bars and measured on the right axis) has fallen from 49% in 1999 to 25% in 2010, while the share repatriated has risen from 51% in 1999 to 75% in 2010 (shown on the blue bars).

The only exception to the trend of a rising share of retained earnings came in 2005, when a special tax incentive was offered to businesses that repatriated earnings. Even in that year, repatriated earnings exceed total earnings that year by only \$10 billion.<sup>14</sup> Over the entire period of 1999-2010, U.S. MNCs accumulated over \$1.8 trillion in retained earnings abroad (this figure is net of earnings repatriated in all years, including 2005). This is an incredible pool of tax deferred capital that was available to finance FDI abroad in all countries, including China. In effect U.S. taxpayers have subsidized FDI abroad, effectively “loaning” U.S. MNCs approximately \$640 billion for FDI abroad.<sup>15</sup> US MNCs are able to invest these funds tax and interest free, and enjoy the profits earned on these investments, until those funds are repatriated to the United States. Based on the trends show in Figure 5, and absent significant changes in U.S. tax and regulatory policy, it is unlikely that the vast majority of those funds will ever be repatriated. They have become, in effect, a permanent subsidy to U.S. MNCs investing abroad.

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<sup>13</sup> U.S. Bureau of Labor Statistics. 2011. “Current Employment Statistics.” <http://www.bls.gov/ces/>

<sup>14</sup> It is important to note that the 2005 incentives for repatriation of foreign earnings had no discernable effect on total U.S. non-residential investment. The total contribution of fixed non-residential investment to U.S. GDP growth increased from 0.61 percentage points in 2004 to 0.69 points in 2005 to 0.84 points in 2006 before slowing as the U.S. entered the great recession. This pattern is typical for the late stages of a recovery, as businesses begin to bump up against capacity limits. A much stronger upswing in non-residential investment occurred in 1997 and 1998, towards the end of the previous business cycle.

<sup>15</sup> This estimate applies the statutory 35% corporate tax rate to the sum of total retained earnings from FDI abroad for the period 1999-2010.

## Conclusions and policy recommendations

The United States can and should adopt new policies to level the playing field between the U.S. and China. Trade and manufacturing policies should be used to defend and recover production in the United States, and to maximize production and employment in U.S. manufacturing establishments. These policies should emphasize the benefits of U.S. production and employment. Support for the headquarters operations of domestic or foreign MNEs should be, at most, a secondary concern of domestic trade policies.

Enforcement of important U.S. fair trade laws, such as anti-dumping and countervailing duty (CVD) measures requires a qualifying group representing domestic producers or workers that generate at least 25% of domestic volume of the like product to file a legal complaint. Litigation of these cases can cost millions of dollars, with uncertain outcomes—many such cases are rejected. As U.S. industries have offshored production, and become increasingly dependent on low-cost foreign suppliers, their interest in filing fair trade complaints has declined. U.S. firms investing in China such as GM, Motorola, Johnson & Johnson, and the Blackstone Group, and large retailers such as Walmart, Target and CVS benefit directly or indirectly from China’s currency manipulation and subsidies. These firms are more likely to threaten or otherwise discourage their suppliers from participating in fair-trade enforcement cases. Thus, fewer and fewer trade cases are being filed, simply because of the costs and difficulty of obtaining the support of a qualifying domestic injured party.

Other specific trade and economic development policies that should be considered include:

- Policies that threaten to impose strong sanctions on China for its illegal currency manipulation such as the [Fair Trade Act of 2011](#), co-sponsored by Senators Brown and Snowe and Representatives Ryan and Murphy, and the much tougher Schumer-Graham currency reform measure adopted by the Senate in 2005.
- The Congress should re-authorize the [Super 301](#) provisions in U.S. Trade Law, which required the USTR to initiate negotiations with priority countries to eliminate trade practices that impeded U.S. exports, including currency manipulation.
- The U.S. should establish an independent agency to pursue violations of U.S. unfair trade law, including illegal tax subsidies and other types of direct and indirect subsidies.
- Congress could consider chartering and funding an independent organization, like the Congressional Budget Office that could investigate and file unfair trade complaints on behalf of Congress, or could refer complaints to committee for consideration of Congressional action.
- [Recently, a WTO appellate body ruled](#) that U.S. cannot simultaneously apply antidumping and CVDs to products imported from China under its non-market economy rules when imposition of such duties would amount to double-counting, that is, when the prohibited subsidy has contributed to the below-market pricing that is the subject of the anti-dumping margin. This ruling also sharply limited the definition of a “Public Body” (which can deliver subsidies), and rejected claims that State Owned Enterprises (SOEs) “exercised governmental functions on behalf of the Chinese Government.” This ruling will sharply limit the ability of the United States to impose Countervailing Duties in cases involving Chinese subsidies. U.S. fair trade law may

have to be amended to provide new legal and economic approaches to the assessment of countervailable subsidies that do not affect subject-import prices, and to address the role of SOEs. As an alternative the United States may wish to rethink its commitment to and participation in the WTO dispute settlement mechanism. The U.S. has lost several high-profile cases in recent years and there is a growing perception that WTO appellate judges are choosing “to substitute their own views for the rules negotiated by the WTO parties” (Otteman 2011). The costs of participation in the WTO dispute resolution process may have begun to exceed its benefits and it may be time for the U.S. to withdraw from the dispute settlement process.

- Rules contained in the 2001 US-China WTO accession agreement regarding treatment of China as a non-market economy (NME) will expire at the end of 2016. Rules governing application of the NME status will then revert to the much tougher WTO standard.<sup>16</sup> Domestic petitioners will be required to prove that “all domestic prices are fixed by the State.” China is a mixed economy and manages many, but not all, domestic prices in most cases. The WTO NME rules are clearly defective in this case, and should be revised to allow treatment of China as a NME. If WTO members fail to approve these changes, this will provide another reason why the United States should consider withdrawing from the WTO dispute settlement process.
- U.S. manufacturing is falling further and further behind; China became the largest exporter in the world in 2009 (Figure 6), and recently passed the United States to become the largest manufacturer in the world. One reason for this is that the United States lags far behind other countries in the use of industrial policies and other types of economic development initiatives, such as workforce development and training, publicly supported R&D, and also the use of preferential public procurement policies. China, in particular, is not a signatory to the WTO government procurement agreement. Other OECD countries who are signatories still manage to use government procurement to support domestic industrial development, for example through military offset programs (Herrnstadt 2010). The U.S. needs to develop a wide range of economic development initiatives. In addition, the U.S. should consider withdrawing from the government procurement agreement, so that more extensive Buy-American programs can be developed.
- Funding for collection and analysis of data on the operations of U.S. and foreign multinationals needs to be substantially increased. Policies developed using these data can contribute to improvements in U.S. trade balances, and to increases in domestic manufacturing output, employment and tax revenues. Such investments will reduce government budget deficits.

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<sup>16</sup> Note 2, paragraph 1 of Article VI of the GATT reads as follows: “It is recognized that, in the case of imports from a country which has a complete or substantially complete monopoly of its trade and where all domestic prices are fixed by the State, special difficulties may exist in determining price comparability for the purposes of paragraph 1, and in such cases importing contracting parties may find it necessary to take into account the possibility that a strict comparison with domestic prices in such a country may not always be appropriate.”

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**Table 1: 2009 Foreign Direct Investment, Inflows**

Top Five, Globally		
	\$ Billions	% of 2009 Total
1 Luxembourg	194.8	17.0%
2 United States	134.7	11.7%
3 China, P.R.: Mainland	78.2	6.8%
4 United Kingdom	72.9	6.4%
5 France	60.0	5.2%
Top 10 Developing		
	\$ Billions	% of 2009 Total
1 China, P.R.: Mainland	78.2	6.8%
2 China, P.R.: Hong Kong	52.4	4.6%
3 Russian Federation	36.8	3.2%
4 India	34.6	3.0%
5 Brazil	25.9	2.3%
6 Mexico	14.5	1.3%
7 Poland	13.8	1.2%
8 Kazakhstan	13.6	1.2%
9 Chile	12.7	1.1%
10 Turkey	8.4	0.7%
Euro Area		
	\$ Billions	% of 2009 Total
Euro Area	298.654	26.0%

Source: 2009 FDI Inflows, Dir. Inv. In Rep. Econ., N.I.E., IMF, and Economic Policy Institute.

**Table 2: Aggregate FDI Inflows, 1978-2009**

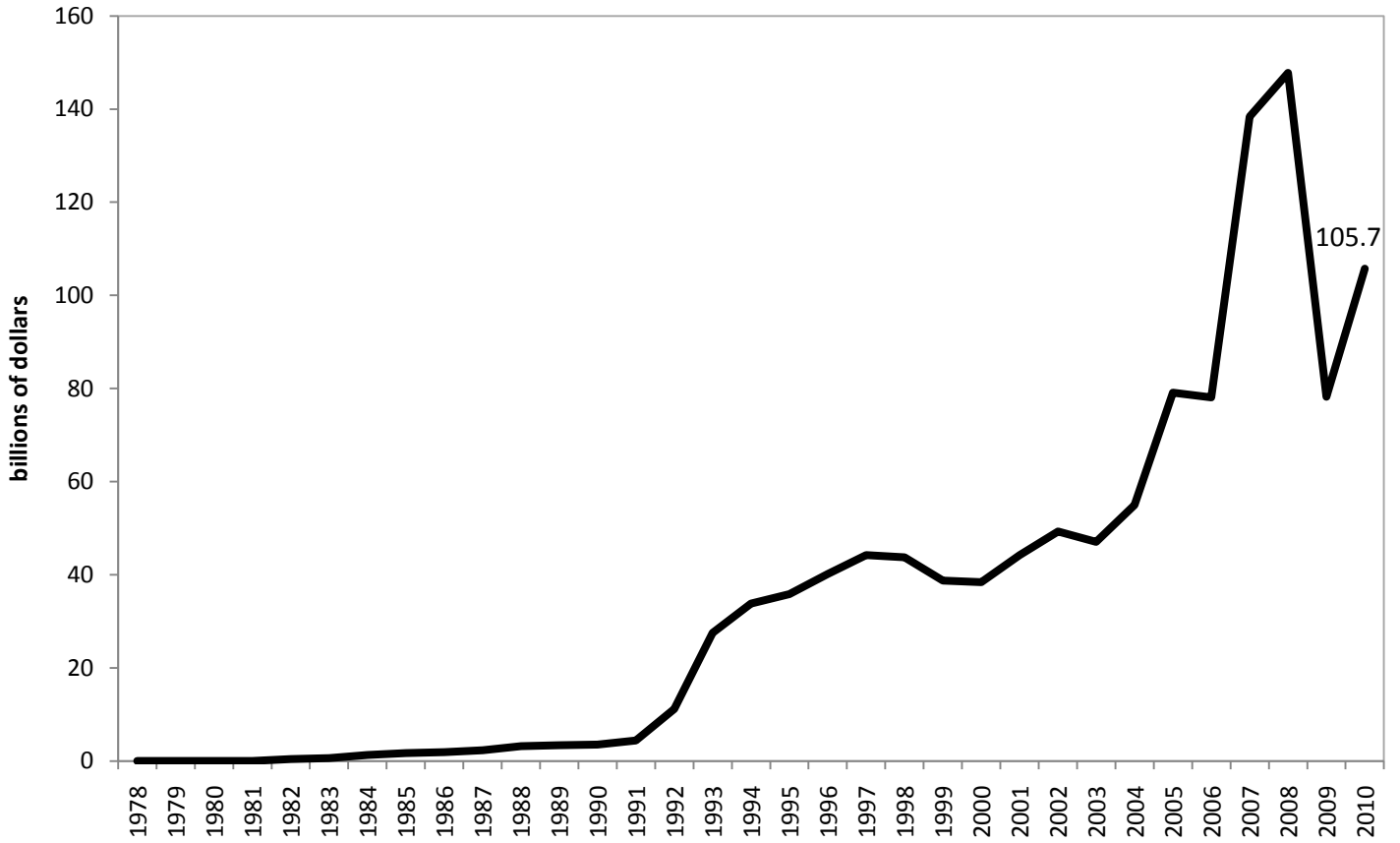
Top Five, Globally		
	\$ Billions	% of World Total
1 United States	3124.1	18.1%
2 United Kingdom	1451.6	8.4%
3 China, P.R.: Mainland	1053.4	6.1%
4 Luxembourg	1021.7	5.9%
5 France	875.2	5.1%
Top 10 Developing Nations		
	\$ Billions	% of World Total
1 China, P.R.: Mainland	1053.4	6.1%
2 China, P.R.: Hong Kong	427.4	2.5%
3 Brazil	366.2	2.1%
4 Mexico	330.2	1.9%
5 Russian Federation	258.0	1.5%
6 India	168.9	1.0%
7 Saudi Arabia	157.3	0.9%
8 Chile	115.5	0.7%
9 Thailand	101.9	0.6%
10 Turkey	98.3	0.6%
Euro Area		
	\$ Billions	% of World Total
Euro Area*	2932.461	17.0%

Source: 2009 FDI Inflows, Dir. Inv. In Rep. Econ., N.I.E., IMF, and Economic Policy Institute.

\*Note that Euro Area data begins in 1998.

Figure (1)

### FDI Inflows in China, 1978-2010



Source: 2009 FDI Inflows, Dir. Inv. In Rep. Econ., N.I.E., IMF, and Economic Policy Institute



**Table 3: Major Sources of FDI in China, 1985-2008**

Sources	Major Sources of FDI in China, 1985-2008							
	1985-1990		1991-2000		2001-2008		1985-2008	
	Value (Billion USD)	Share (%)	Value (Billion USD)	Share (%)	Value (Billion USD)	Share (%)	Value (Billion USD)	Share (%)
The World	15.9	100.0	327.7	100.0	510.7	100.0	854.3	100.0
Hong Kong	9.7	60.9	159.0	48.5	178.2	34.9	346.9	40.6
Taiwan	0.0	0.0	25.8	7.9	21.4	4.2	47.2	5.5
Japan	2.2	13.6	25.2	7.7	37.4	7.3	64.7	7.6
Korea	0.0	0.0	10.5	3.2	31.5	6.2	42.0	4.9
Singapore	0.2	1.3	16.8	5.1	20.6	4.0	37.6	4.4
USA	1.9	12.1	27.6	8.4	29.5	5.8	55.1	6.4
Germany	0.2	1.3	6.1	1.9	9.2	1.8	15.5	1.8
UK	0.2	1.2	8.4	2.6	6.9	1.4	15.5	1.8
France	0.1	0.9	4.0	1.2	4.4	0.9	8.6	1.0

Source: table from: Yuqing Xing, "Facts About and Impacts of FDI on China and the World Economy," China, an International Journal, Volume 8, Number 2, September 2010; Table 1, page 7, Economic Policy Institute.

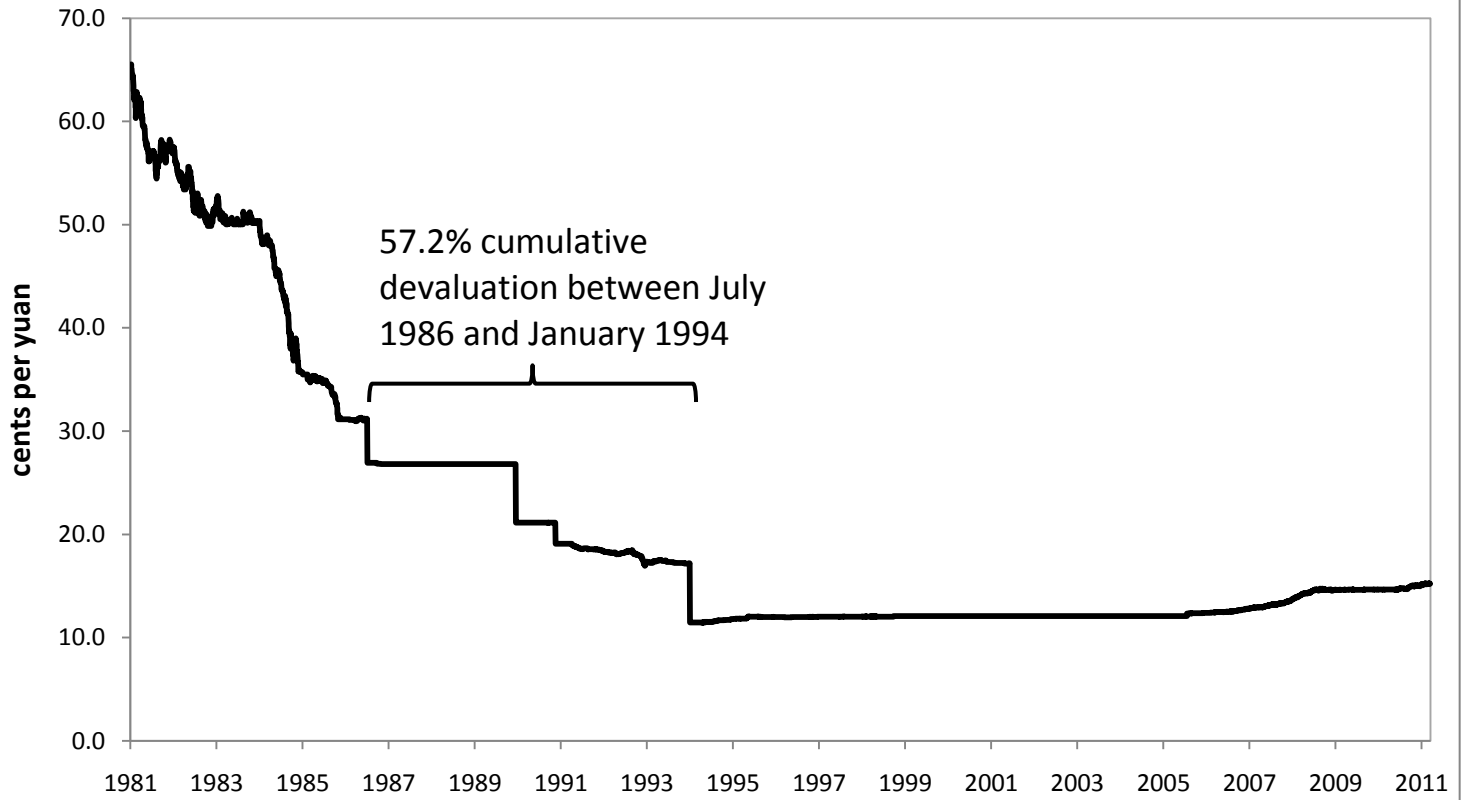
**Table 4: China's World Trade, Total, and by Foreign Invested Enterprises, 2009-2010**

China's world trade, total and by FIE, billions of USD			
	2009	2010	Growth
Exports	1,201.8	1,577.9	31.3%
Imports	1,005.6	1,394.8	38.7%
Trade Balance	196.1	183.1	-6.6%
trade of FIEs	2009	2010	Growth
Exports	672.2	862.3	28.3%
Imports	545.2	738	35.4%
Trade Balance	127.0	124.3	-2.1%
FIE shares of total China	2009	2010	Growth
trade	2009	2010	Growth
Exports	56%	55%	-2.3%
Imports	54%	53%	-2.4%
Trade Balance	65%	68%	4.8%

Source: China, Ministry of Commerce, PRC, <http://english.mofcom.gov.cn/aarticle/statistic/BriefStatistics/201101/20110107386812.html>; Invest in China, PRC, [http://www.fdi.gov.cn/pub/FDI\\_EN/default.html](http://www.fdi.gov.cn/pub/FDI_EN/default.html); Economic Policy Institute.

Figure (2)

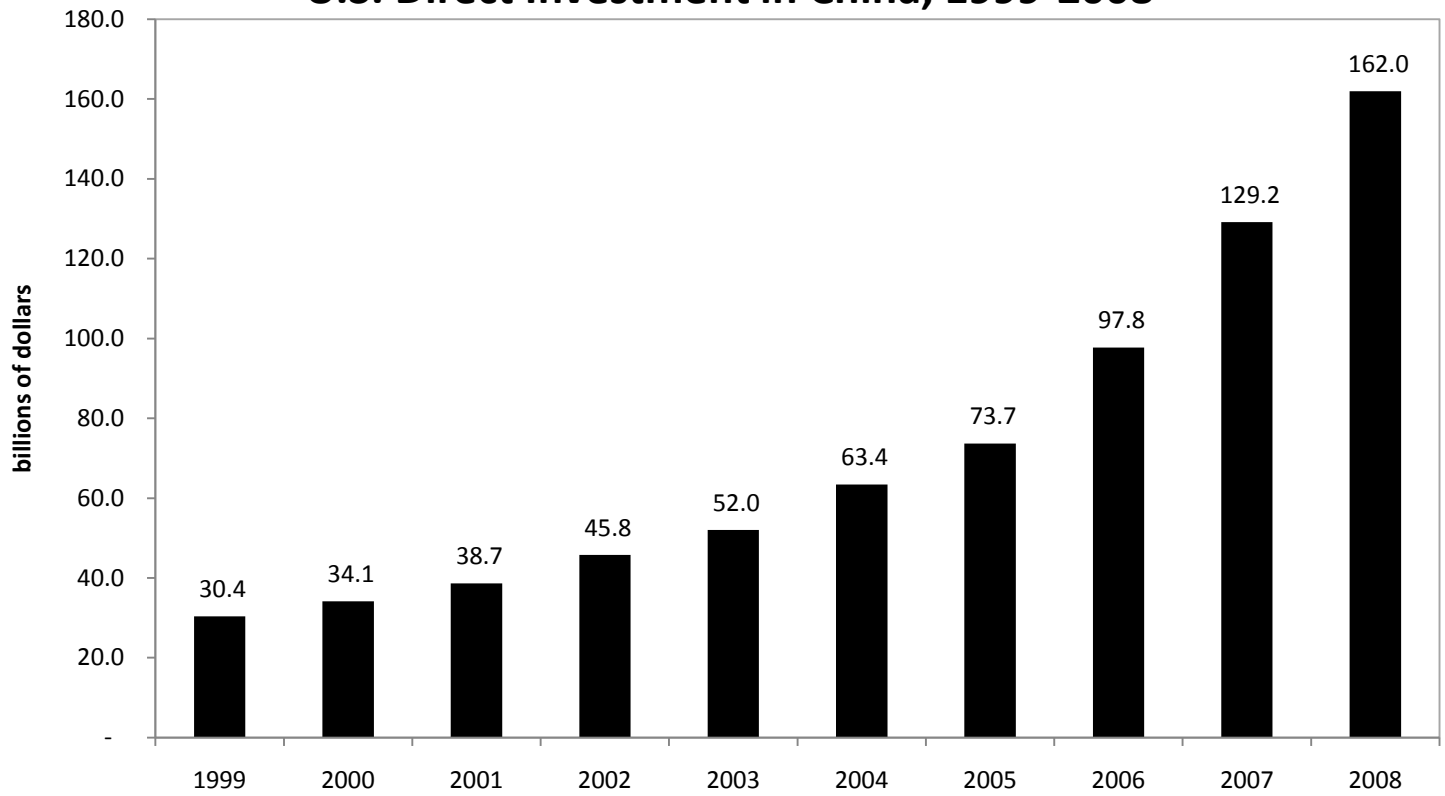
## U.S. dollar-Chinese RMB exchange rate



Source: US Federal Reserve and Economic Policy Institute.

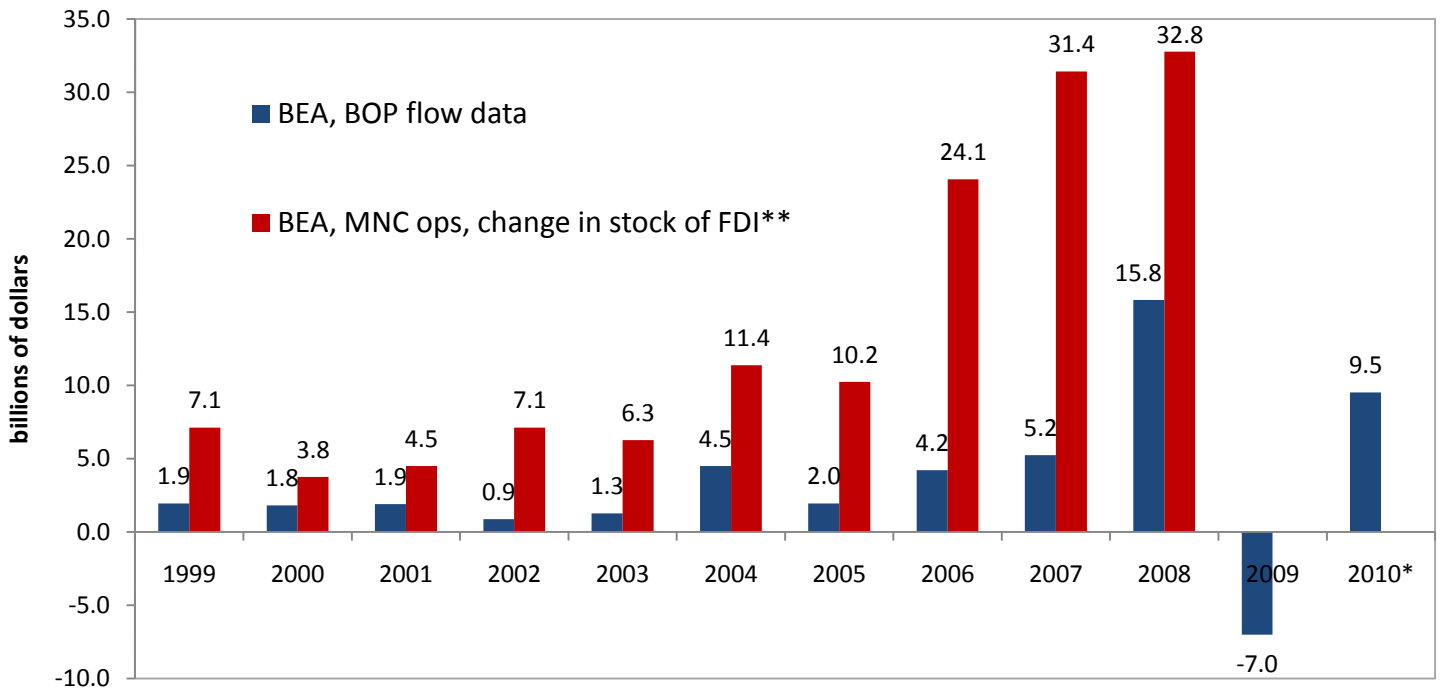
Figure (3)

## U.S. Direct Investment in China, 1999-2008



Source: Bureau of Economic Analysis, "Operations of Multinational Companies, U.S. Direct Investment Abroad," and Economic Policy Institute. See <http://bea.gov/international/index.htm#iip>.

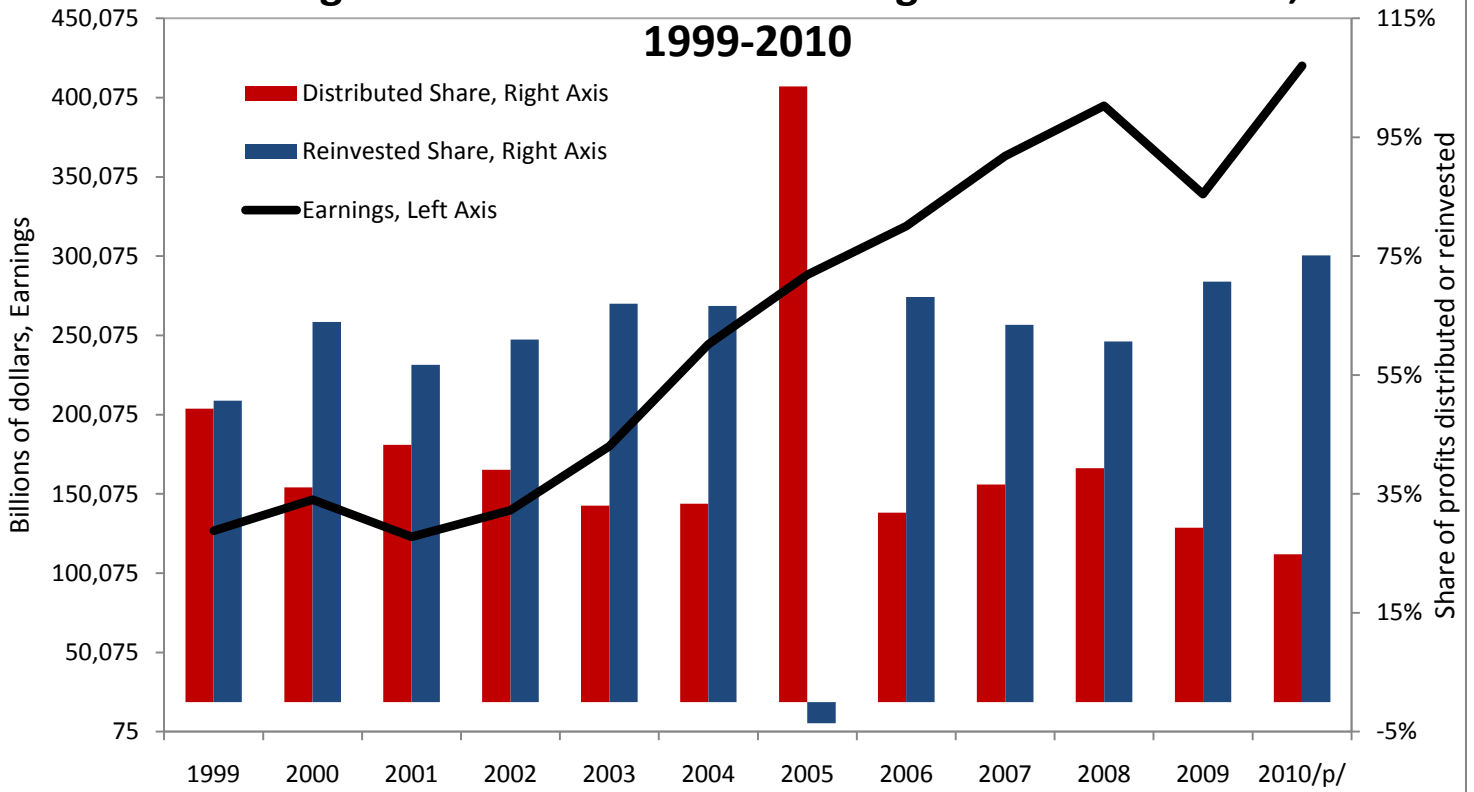
Figure (4) **Contrasting estimates of the flow of new US FDI to China, 1999-2010**



Source: Bureau of Economic Analysis, US International Transactions Accounts Data, and Economic Policy Institute.

\*2010 data is preliminary.  
 \*\*Data not available for 2009-2010

Figure (5) **Earnings from total US FDI: Growing share held abroad, 1999-2010**

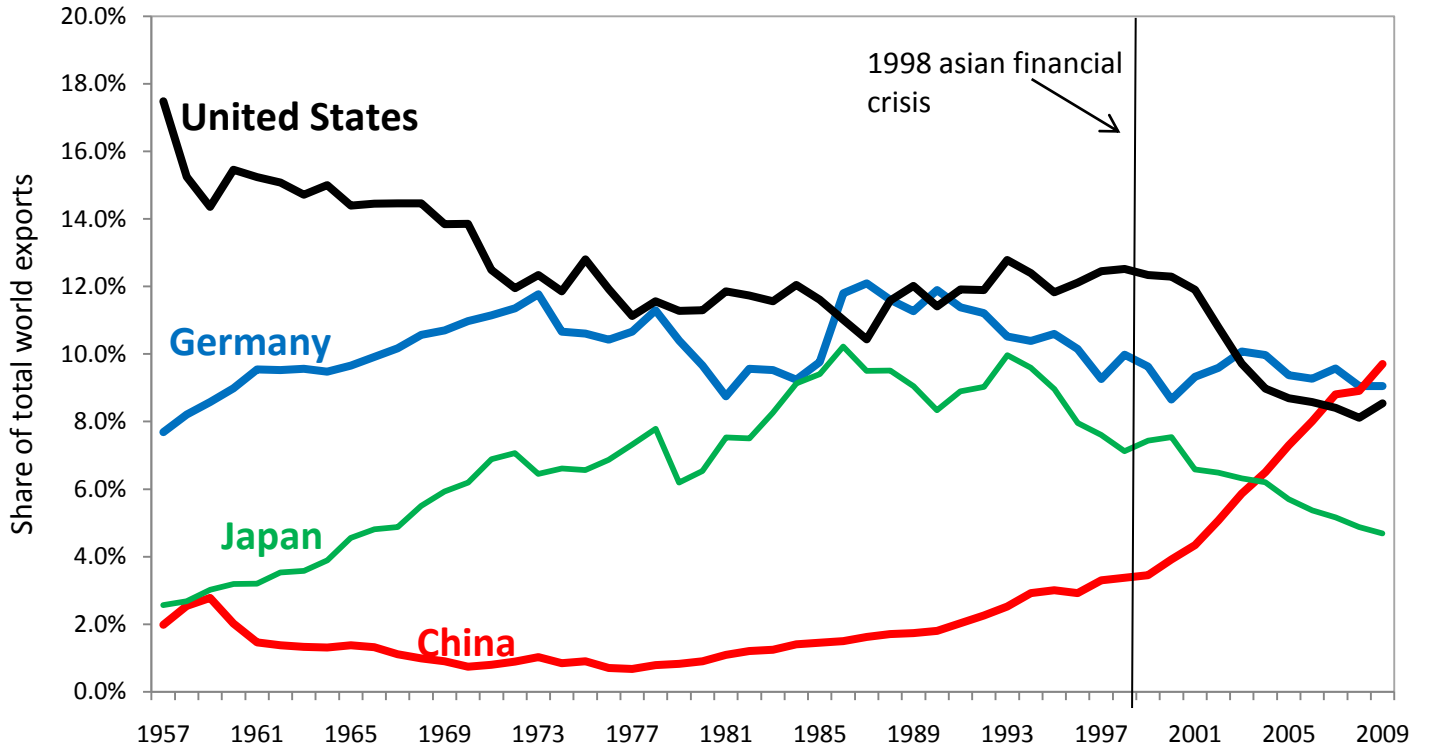


Source: Bureau of Economic Analysis and Economic Policy Institute. Tax holiday: <http://www.slate.com/id/2139782/>.

\*2010 data is preliminary.  
 \*In 2005, there was a one-year tax holiday: corporations could repatriate foreign income at a very reduced tax rate.

Figure (6)

### World export shares by country, 1957-2009



Source: EPI analysis of IMF IFS data.