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I. INTRODUCTION

While all bilateral trade and investment relationships have varying degrees of complexity, the trade and investment relationship between the United States and China is perhaps the most complex and dynamic in the world. This complexity arises from economic issues, given the size of the U.S. and Chinese economies and recent global economic turbulence, and from multiple security-related issues, including those caused by divergent national defense goals. The rise of Chinese military might and the dawn of a potential new economic paradigm, as the Beijing model of state-led and sponsored growth challenges the "Washington consensus," add further issues to this dynamic relationship.

Given these complexities, it is fitting that this Commission explore the issues raised by the bilateral trade and investment relationship between the United States and China. How these issues are handled by each country individually, bilaterally and multilaterally, will have long-term ramifications for global growth and stability, as well as for each country's role in global leadership.

In addressing the topic of this panel, namely U.S.–China bilateral investment issues, this testimony will focus on three views being raised by a growing number of U.S. industries, lawmakers and government officials that underscore the increasing friction in the bilateral relationship. Specifically, these views are:

- China must address potential economic distortions and national security concerns arising from its system of state-supported and state-led economic growth in order for the United States and other nations to continue to fully support and promote global and domestic open investment policies;

- The United States should consider the implementation of additional international and domestic policies and laws to address potential inadequacies in its current investment regime that may not ensure fair competition for its industries, vis-à-vis their Chinese counterparts, domestically and abroad; and

- The United States and China should build stronger rules-based investment platforms, including through a bilateral investment treaty, in order to provide greater stability to the U.S.-China bilateral relationship and global markets.

II. CHALLENGES TO MAINTAINING OPEN INVESTMENT POLICIES AND PRACTICE

Multiple administrations, both Democrat and Republican, have placed a singular importance on maintaining the long-standing U.S. policy of open investment. They have done so because inbound and outbound international investment have been and continue to be fundamental pillars of U.S. prosperity and growth.[1]

Maintaining open investment policies in the United States, and pressing for such policies abroad, helps ensure that U.S. businesses have better opportunities to open foreign markets to U.S. products and services. The resulting long-term benefits include the expansion of export platforms, stronger rules-based systems abroad, and formal and informal channels to achieve broader political objectives.

Nonetheless, there are growing concerns that China's state-sponsored economic model is undermining some aspects of our open investment policy and practice, as private actors increasingly lose market share to state-owned enterprises ("SOEs") [2] and state supported enterprises ("SSEs") in U.S. and global markets. These concerns are shared by an array of U.S. industries, as well as those from other nations. The result, as discussed below, is that a broad coalition of U.S. industries have reached consensus in seeking new disciplines to address these issues.

A. China's State-Sponsored Economic Model Raises Economic and Security Concerns

China's state-sponsored economic model, and its use of SOEs and SSEs, are increasingly raising economic and security concerns around the globe. These concerns have resulted, at times, in significant bilateral investment friction between the United States and China, with political and economic consequences.

The U.S. Government has had recent experience addressing the issue of state involvement in global economic activity via sovereign wealth funds ("SWFs").[3] While SWFs are in principle long-term investors, these investment vehicles raise legitimate policy concerns – namely that they could take market actions based on state interests rather than economic considerations. The immediate concerns raised by SWFs were addressed, in part, through the Santiago Principles.[4] This was a broad agreement by the

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[1] Research shows that foreign-owned firms in the United States employ over 5.3 million Americans, with approximately 2 million of those jobs in the manufacturing sector. These firms account for nearly 21 percent of U.S. exports, and reinvest over $93 billion annually into their U.S. operations. *See* Organization for International Investment website at http://www.ofii.org/resources/insourcing-facts.html.

[2] SOEs can be defined as enterprises where the state has significant control, through full, majority, or significant minority ownership.

[3] SWFs can be defined as government investment funds, funded by foreign currency reserves but managed separately from official currency reserves.

[4] *See* International Working Group of Sovereign Wealth Funds, *Generally Accepted Principles and Practices ("GAPP")—Santiago Principles*, available at http://www.iwg-swf.org/pubs/gapplist.htm.

SWFs to make investment decisions based solely on commercial grounds, incorporate greater information disclosure, implement strong governance structures, compete fairly with private sector entities, and respect host-country investment and regulatory rules. While the agreement on these principles was helpful, and informative to the current policy discussions on SOEs and SSEs, abiding by them is voluntary.

At the time the U.S. Government was working through the issue of SWFs, there was a realization that a much more difficult issue – addressing SOEs as market actors – would eventually need to be considered. Many of the policy concerns raised by SOEs are similar to those raised by SWFs.

1. Economic Challenges Raised by State-Owned Enterprises

The potential adverse economic effects of SOE participation in the global marketplace are well documented. For example, the Organization for Economic Cooperation and Development ("OECD") has released a number of reports detailing the rise of SOE investment abroad and the related anti-competitive effects and market distortions that may result, both in the SOEs' home markets and in markets around the world.[5]

SOE investments have also caused political controversies. While there have been a number of Chinese SOE and SSE investments in the United States that have not raised issues,[6] other investments have raised serious political concerns. Some of these include: CNOOC's attempted purchase of Unocal in 2005, Huawei's attempted acquisitions of 3Com and 3Leaf, and the proposed investment by Anshan Steel.[7]

The core arguments against many of these investments have been that the Chinese entities do not operate on commercial terms equivalent to private companies, and that they could choose to make investment and corporate decisions based on strategic rather than market-based considerations. Further, subsidies and other privileges bestowed on SOEs and SSEs raise concerns that these entities may have a nearly unlimited capacity to compete. Indeed, Chinese SOEs often receive substantial subsidies from the Chinese

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5 *State-Owned Enterprises: Trade Effects and Policy Implications – An Interim Report*, OECD, TAD/TC/WP(2012)10 (May 18, 2012); *Competitive Neutrality in the Presence of State Owned Enterprises*, OECD, DAF/CA/PRIV(2010)1 (Apr. 2, 2010) ("April 2010 OECD Paper on Corporate Neutrality and SOEs").

6 These investments include the Aviation Industry Corporation of China's investment into Cirrus Aircraft, the Chinese National Offshore Oil Company's ("CNOOC") $2 billion worth of investments in shale lease holdings in the United States, and the recent purchase of AMC Entertainment Holdings by the Dalian Wanda Group.

7 In May 2010, the Chinese SOE, Anshan Iron and Steel Group ("Anshan"), announced that it would form a joint venture with the Steel Development Co. ("SDC") of Amory, Mississippi to build up to five new steel plants in the United States. In response to the announcement, a bipartisan group of fifty Congressmen requested that the Secretary of the Treasury investigate the transaction.

government, allowing them to operate and survive regardless of the economic conditions or their market behavior.[8]

As a result of these and other investments, there is a growing perception that SOEs and SSEs are competing unfairly and crowding out U.S. private investment. These entities are also having an adverse effect on private Chinese industries, causing potential market distortions in China as well as abroad.

2. Reciprocal Market Access Issues

China's constraints on foreign investment have also been a considerable source of trade friction. Its policies make it difficult for many foreign companies to invest and operate in China and raise the issue of lack of reciprocal access to the Chinese market by U.S. and other firms. Indeed, many U.S. companies complain that the Chinese market, and policies such as "indigenous innovation," do not allow for investment opportunities equivalent to those granted to Chinese companies in the United States.

For example, China recently established a "security review system" for mergers and acquisitions of Chinese domestic enterprises by foreign investors. This new tool, which the Chinese government could potentially use to restrict foreign investment, is in addition to the myriad existing laws and regulations governing foreign investment (such as the Foreign Investment Industries Guiding Catalogue, and investment reviews overseen by the Ministry of Commerce, the State Development and Reform Commission, and other Chinese ministries).

The Office of the United States Trade Representative ("USTR") has found that "China has added a variety of restrictions on investment that appear designed to shield inefficient or monopolistic Chinese enterprises from foreign competition."[9] For example, China continues to impose technology transfer requirements as a condition of foreign investment in many Chinese sectors, despite its WTO commitment not to do so.[10] China continues to exercise control over technology transfers in its review of joint venture applications, as well as in the government's involvement in contract negotiations between Chinese SOEs and foreign investors.[11]

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[8] For a further discussion of the potential economic distortions caused by SOEs' operation and investment in the marketplace, see testimony of Timothy C. Brightbill (Feb. 15, 2012), available at http://www.uscc.gov/hearings/2012hearings/written_testimonies/hr12_02_15.php.

[9] *See* United States Trade Representative, *2011 Report to Congress on China's WTO Compliance* (Dec. 2011) ("USTR Report on China's WTO Compliance") at 68.

[10] *See* WTO Working Party Report on the Accession of China at ¶ 203 ("The allocation, permission or rights for investment will not be conditional upon performance requirements set by national or sub-national authorities or subject to secondary industrial compensation including specified types or volumes of business opportunities, the use of local inputs or the transfer of technology").

[11] *See, e.g.*, *Regulations for the Implementation of the Law on Sino-foreign Equity Joint Ventures* (2001) at Chapter VI, available at http://www.fdi.gov.cn/pub/FDI_EN/Laws/law_en_info.jsp?docid=51062.

This lack of investment reciprocity has led to questions on why the United States should continue to allow Chinese companies, including SOEs, to avail themselves of our market – with the potential distortions that could result from such investment – at the same time that U.S. firms face significant restrictions in the Chinese market.

3. National Security Concerns Posed by SOEs and SSEs

The growing presence of Chinese SOEs and SSEs as investors in global and U.S. markets also raises multiple national security considerations. For example, governments and companies are increasingly vulnerable to cyber security threats that affect core economic and national security matters. These matters involve the protection of critical infrastructure and technology, commercial markets and supply chains, as well as governmental programs involving economic, military, and foreign policy objectives. These vulnerabilities are especially concerning given the high level of economic and military dependency on digital infrastructure and technology.

Because of these concerns, it should be no surprise that the protection of the U.S. information system, and U.S. supply chains, would be a core concern for U.S. policy makers, and that investments by Chinese SOEs and SSE in such systems could raise both policy and political concerns.[12]

Currently, the United States addresses these and other national security concerns arising from foreign investment mainly through the Committee on Foreign Investment in the United States (CFIUS). Among other factors, CFIUS is required to address whether the foreign entity is government controlled, and to determine whether the foreign entity would take actions based on government policies, goals and objectives rather than commercial considerations. However, and as discussed below, CFIUS has limited jurisdiction that does not extend to greenfield investments (start-ups), and there are few, if any, mechanisms other than CFIUS that can address national security concerns arising from foreign investment. These limitations are, in many ways, by design and have been long-standing features of CFIUS and U.S. open investment policy. However, given the growing involvement of SOEs and SSEs in the marketplace, these limitations are coming under increasing scrutiny, especially with the growth of cyber security as a core national security concern.

III. POLICY CONSIDERATIONS TO ADDRESS INVESTMENT ISSUES RAISED BY SOEs AND SSEs

The United States should consider new policies to address the challenges posed by the expansion of SOEs and SSEs as actors in global markets. The need for such policies is particularly heightened given the limitations of U.S. mechanisms to address such challenges.

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12 *See* U.S. House of Representatives, The Permanent Select Committee on Intelligence, *Rogers and Ruppersberger Intensify Investigation of Huawei and ZTE* (June 13, 2012), available at http://intelligence.house.gov/press-release/rogers-and-ruppersberger-intensify-investigation-huawei-and-zte.

A principal feature of the U.S. economic system is an appropriate, but limited, role for government in the private sector. Government prevents monopolies, regulates in other necessary ways, and helps ensure a level playing field for businesses, but generally assumes a limited role. Thus, it seems counterintuitive to many that our government would allow foreign government-owned businesses to operate freely within our own borders without creating mechanisms to deal with potential anticompetitive behavior.

A heavy hand by the government would likely run counter to the long-standing history of U.S. open investment. Addressing the issue of SOE and SSE competition is also difficult. Indeed, the United States itself has SOEs and SWFs that operate domestically and invest abroad (though, for the most part, the United States does not have entities that would be considered SOEs operating abroad). Thus, having a system in any way similar to China's, with multiple investment screening mechanisms, including for greenfield investments, may not be appropriate.

Other countries have implemented mechanisms that address SOE investment, including Canada's "net benefit" test and Australia's principle of "competitive neutrality."[13] However, there are currently no adequate tools to address potential competitive distortions arising from SOE participation in global markets, and U.S. laws can be viewed as generally inadequate.

As a result, members from a broad base of U.S. businesses have been working with the U.S. government to address these issues in the context of the Trans-Pacific Partnership ("TPP") Agreement. These efforts include establishing new and binding commitments in the TPP Agreement to effectively address the potential anti-competitive effects stemming from SOE investment. Many are seeking commitments that would generally: (1) require that SOEs investing or operating in the markets of other signatories act based on commercial considerations; (2) ensure that SOEs do not receive subsidies or financing or other benefits from their governments that unfairly advantage them with respect to investments abroad; (3) include a reporting/monitoring and information request mechanism; and (4) provide for a dispute settlement mechanism that is part of the broader agreement mechanism.

While China is not a party to the TPP Agreement, it covers a number of countries in which the state plays a growing role in commercial activity. Importantly, the TPP Agreement will set a precedent for new trade agreements, including any future agreements that could include China as a party.

Other potential steps being considered to address the increasing involvement of Chinese SOEs in the U.S. and global markets include the following:

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[13] The Australian Government introduced a "competitive neutrality" policy in 1995, with the goal of removing market distortions caused by state-owned businesses. Canada has both a national security review as well as a "net benefit" review, which ensures that foreign investment will be a "net benefit" to Canada.

- Negotiate an OECD agreement that establishes and enforces guidelines or "best practices" to ensure that SOEs operate based on commercial considerations. The arrangement could be modeled after the Santiago Principles and the guidelines themselves could be similar to the OECD "Guidelines on Corporate Governance of SOEs." ("OECD Guidelines")

- Address the issue of SOEs through the World Trade Organization ("WTO").

- Enter into additional free trade agreements, and other bilateral and multilateral agreements, that include strong SOE disciplines.

- Ensure that SOEs are included as part of China's commitments upon joining the WTO Government Procurement Agreement.

- Address potential anti-competitive effects of SOEs through a bilateral investment treaty with China, as discussed below.

Lastly, the United States could consider a narrowly tailored review mechanism for inbound investments by SOEs and SSEs (perhaps just those in non-market economies). Such a review could be in the form of an economic benefit test (similar to Canada's test) or could ensure that the SOEs/SSEs are abiding by an established set of rules (*e.g.*, the OECD Guidelines). The review could be designed to ensure that SOEs and SSEs investing and/or operating in the United States act solely based on commercial considerations and that such SOEs do not receive subsidies or other benefits from their home government that provide them unfair advantages over their U.S. competitors.

IV. BUILDING SHARED INVESTMENT RULES THROUGH A BILATERAL INVESTMENT TREATY

One means by which the United States encourages open bilateral investment with foreign countries is through the negotiation of bilateral investment treaties ("BITs"), and a BIT between the U.S.-China could serve as an important way to strengthen, and regulate as necessary, investment between the two countries. BITs provide binding legal rules, which are intended to promote and protect investment in foreign countries (especially where investor rights are not already protected through existing agreements), to encourage market-oriented policies that treat private investment in a transparent and non-discriminatory manner, and to promote U.S. exports.[14]

In April 2012, the United States completed the first review and revision since 2004 of the model BIT.[15] The three-year review process resulted in several changes to the model

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[14] *See* Office of the United States Trade Representative, *Bilateral Investment Treaties*, http://www.ustr.gov/trade-agreements/bilateral-investment-treaties.

[15] *See* Office of the United States Trade Representative, *United States Concludes Review of Model Bilateral Investment Treaty* (Apr. 20, 2012), available at http://www.ustr.gov/about-us/press-office/press-releases/2012/april/united-states-concludes-review-model-bilateral-inves.

BIT, although the overall goal of "providing strong investor protections and preserving the government's ability to regulate in the public interest" was maintained.[16]

Notably, the model BIT's disciplines apply to an SOE "when it exercises any regulatory, administrative, or other governmental authority delegated to it" by that country's government.[17] The 2012 revisions to the model BIT include a footnote added to clarify when governmental authority has been "delegated" – through "a legislative grant, and a government order, directive or other action transferring to the state enterprise or other person, or authorizing the exercise by the state enterprise or other person of, governmental authority."[18]

In the face of increasing encouragement from the U.S. business community and some U.S. lawmakers,[19] the United States has recently announced its decision to resume BIT negotiations with China.[20] The conclusion of a U.S.-China BIT is widely viewed as an opportunity to form a stronger, rules-based investment platform between the United States and China. At the same time, a BIT would allow the United States to address many of the concerns U.S. businesses confront when attempting to invest in China and could address many of the broader issues posed by Chinese SOE investment.

However, while the revised model BIT serves as a strong basis on which to begin negotiations with China, the unique considerations posed by the U.S.-China relationship requires that the two countries do not simply adopt the model treaty in full. Because the model BIT was drafted to serve as the basis for U.S. BIT negotiations with any foreign country, it does not effectively address many China-specific investment-related concerns. In particular, the model BIT, even as revised, does not appear to adequately reflect the prominence of SOEs and SSEs in the Chinese economy, and the effect this has on China's overall investment environment and on U.S. companies' access to and participation in the Chinese market. In order to ensure a level playing field for U.S. investors and Chinese private enterprises one of the main goals any U.S.-China BIT should include disciplines on SOE and SSE behavior in the marketplace.

Provided that the model treaty is tailored to reflect the unique challenges posed by China's investment environment and state-led economy, a U.S.-China BIT can serve as

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16 Office of the United States Trade Representative, *Fact Sheet: Model Bilateral Investment Treaty* (Apr. 20, 2012), available at http://www.ustr.gov/about-us/press-office/fact-sheets/2012/april/model-bilateral-investment-treaty.

17 2012 U.S. Model Bilateral Investment Treaty (available from http://www.ustr.gov/about-us/press-office/press-releases/2012/april/united-states-concludes-review-model-bilateral-inves) at Art. 2.2(a).

18 2012 U.S. Model Bilateral Investment Treaty at Art. 2, n. 8.

19 *See, e.g.*, Doug Palmer, *U.S. lawmaker urges investment treaty pact with China*, Reuters (Apr. 26, 2012).

20 *See* Charlene Barshefsky, Gary Born, Benjamin A. Powell, Suzanne A. Spears, David J. Ross, *United States to Resume Bilateral Investment Treaty Negotiations on the Basis of a Revised Model Treaty* (May 15, 2012) ("On May 4, 2012 the U.S. and China announced their intention to schedule a 7th round of talks on a BIT"); Hu Yuanyuan, *Sino-US investment treaty talks to resume*, China Daily (Apr. 29, 2012).

an effective mechanism through which the United States and China can build shared, rules- and market-based investment policies for the mutual benefit of both countries and their investors.

V. CONCLUSION

The United States and China have extremely important roles to play in establishing global economic stability and the direction of the global economic system. There is great opportunity as well as great peril should both nations take confrontational positions, especially where it concerns trade and investment relations.

In order to avoid such controversies, both nations need to consider making systemic adaptations that build stronger rules of engagement and understanding. In order for the U.S. to continue to sustain its long-standing open investment policy, China must address the real and perceived economic distortions and national security concerns arising from its system of state-supported and state-led economic growth. The United States, in turn, should consider carefully whether to implement additional international and domestic policies and laws to address issues of fair competition, notably in the context of investment.

Working together to build clear rules of the road, through platforms such as a BIT, will in the long run provide greater trust and stability within the U.S.-China bilateral relationship and will strengthen global markets.