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Hearing on the Foreign Investment Climate in China

"Soft" Discrimination of US Firms in China

I Introduction

US companies, like other foreign firms, have always faced significant obstacles in China. While many US firms have enjoyed solid profit margins that were often higher than those obtained in other parts of the world, it is worthwhile to remember that the surveys on the basis of which such observations were made have a fundamental flow in the form of "survival bias", meaning that firms who withdrew from the China market and those that decided not to enter the market in the first place because of perceived obstacles, have not been included. Also not included in those surveys are firms who export or try to export to the Chinese market. Still, surveys among US and other foreign firms operating in China have shown consistent profitability for much of the recent decade.

To be fair, many of the failures of US companies in China were of the companies own making. Such failings range from the development of unrealistic expectations which cannot be reasonably met to lack of rigorous preparation, failure to adjust to the idiosyncrasies of the Chinese consumer and employee, to a lack of understanding of changing circumstances in the Chinese and global environments and overreliance on consultancies with their own agenda and biases. In many instances, however, even well prepared US companies were deterred from entry or expansion or suffered below par performance due to a variety of obstacles associated with the Chinese environment, be they lack of robust IPR protection, ambiguous regulations, or a multitude of other factors. While some of those obstacles inflicted harm on foreign and domestic companies alike, foreign companies have usually been more exposed. For instance, while lack of IPR protection has also derailed Chinese companies, it is bound to disproportionally hurt companies that possess advanced technology and knowhow – typically the foreign players.

Outright discrimination of foreign firms also exists. It is apparent, for example, in varied compliance, where a foreign company would be targeted, say, for environmental violations, whereas its domestic competitor, would not. In a network society where relations and connections underpin economic relations and where formal institutions tend to operate by arbitrarily assigned and interpreted rules, this was almost bound to happen.

Ominously, however, there are indications that the environment for US companies in China has taken a turn for the worst. It is increasingly difficult to argue that this deterioration has not been the outcome of discriminatory government strategy but simply the end result of "being in the wrong place at the wrong

time" (e.g., if the government aims to lower prices, market leaders will be targeted, and if those happen to be foreign firms, so be it), though this might have been the case at times. A series of well-publicized raids on US fast food chains is an example: While the companies have admitted wrongdoing, the question remains whether local players receive a similar treatment. The Chinese government insists that the rules apply to everyone but it is not at all clear that this is the case. Foreign firms are reluctant to speak out for fear of reprisal in what has become a key (and sometimes their key) market, so it is difficult to ascertain or challenge the claims. Quite a few US firms have been willing to make unprecedented concessions to uphold their position in the Chinese markets (Hollywood studios come to mind), and are hence not expected to publicly air their complaints or contest their treatment. The bottom line, however, is that foreign companies, including US firms, do not fare as well as they did before.

Within this group of foreign firms, there is no clear indication that US firms are targeted to a greater extent or at a greater frequency than other foreign companies. Notice, for instance, the targeting of German auto firms BMW and Daimler regarding the pricing of their cars and components. Nor were US firms generally subjected to the criticisms and attacks that have plagued Japanese companies during auspicious periods of geopolitical tension that have led some of them to face a sharp drop in sales and led others to divest and withdraw from the China market altogether. The bad news is that, going forward US firms may be more vulnerable than the firms of many other foreign nations, for reasons ranging from the technological intensity of their China subsidiaries, their technology leadership, and their generally greater transparency and openness. Souring relations between China and the US do not help: In much of the Chinese media, the United States is now held the culprit of many of the world ills and is often singled out as the greatest menace to Chinese ambitions. The United States, in this narrative, aims to encircle China and stunt its rise, creating an atmosphere of suspicion and animosity. Some sectors are and will remain more vulnerable than others. For instance, anything having to do with information processing (e.g., web related services, search, social media), is likely to be pressured via the introduction of Chinese standards, enforcement of regulations problematic for US firms (e.g., censorship), and the like.

II Information Sources and Findings

Most US firms are reluctant to go on record and air any complaints about their treatment by the Chinese government (a problem in its own right). In addition to off-the-record conversations, my conclusions are based on anonymous surveys published by foreign Chambers of Commerce in China, where company executives are relatively open about their views on various issues. In addition, my observations are based on interviews with executives in a variety of foreign and domestic companies in China, government officials, academics, and Chinese publications, such as *Quishi*.

In a recent report, the American Chamber of Commerce in Beijing reported "an increasing sense of pessimism among foreign multinational companies in China"; its summary statement: "the environment for many foreign companies has deteriorated." The survey, conducted August 22-28, 2014, reports that 60 percent of respondents said they felt foreign business was now less welcome in China, and that 49 percent believed foreign firms were singled out in recent pricing and anti-corruption campaigns (only 26 percent said they were not). These numbers represent a marked deterioration from the results of a survey taken a little over half a year earlier, in late 2013, when 41 percent of respondents reported they have felt less welcome and 40 percent felt foreign firms were singled out in the Chinese government's campaigns. This is a considerable change in a fairly short time.

Published in February 2014, the 2013-2014 American Chamber - Shanghai report is somewhat less critical, reporting "general optimism" regarding business prospects in China on the part of members. The discrepancy between the Beijing and Shanghai reports can probably be attributed to the date of the survey (note also the deterioration between the two Beijing surveys), but could also be the result of a different composition of member companies (for instance, the Shanghai Chamber notes a rising proportion of small and mid-size US companies among its respondents, such firms are usually less of a target for the Chinese authorities (the US Chambers do not provide breakdown of answers by company size or of other variables, e.g., ownership, location, with the exception of a sectorial summary). Still, the Shanghai survey acknowledges that the percentage of firms planning additional China investments declined from 74 percent in the previous year survey to 65 percent in the current survey.

Yet another survey comes from the US - China Business Council, an organization that consists mostly of large US multinationals who have historically advocated close US -China ties, possibly a product of their greater dependence on the China market (think Boeing, for instance). In a September 2014 report, the Council notes that while "both foreign and domestic companies have been targets of AML (anti monopoly legislation)- related investigations...in recent months foreign companies appear to have faced increasing scrutiny." Data on the proportion of domestic versus foreign firms targeted are lacking. In its characteristically careful style, the Council labels as "unanswered" the question "will China use the AML to protect domestic industry rather than promote free competition?" It notes, however: "in at least some cases so far there are reasons for concern." Indeed, the body of the report contains specific problems plaguing US firms in China, such as a pressure on companies to confess AML violations without due process or "dawn raids" precluding legal representation. Chinese courts often rule in favor of Chinese plaintiffs, as in the case reported by the Council of Huawei versus its licensee, Interdigital (the two eventually agreed on arbitration). It is difficult to imagine such action against Huawei itself, which could well be considered a monopoly in its own right. The Council's report states that Chinese government agencies "have considerable leeway to select investigation targets and carry out the investigations." It also says: "some high profile cases appear to reflect broader Chinese industrial policy concerns on intellectual property standards, and the protection of domestic industries, as opposed to the interests of fair competition."

The European Chamber's survey provides a broader perspective since it covers a great variety of foreign companies and tends to be somewhat more direct in its observations. The report is explicit about the decline in financial performance of European companies in China, including a decline in profit margin below global averages for the first time in the ten-year history of the survey and a precipitous drop of 33 percent in companies seeing China as their top investment destination. While some of the reasons for the change are such things as rising costs, the survey points out that "European companies still perceive themselves to be discriminated against in the Chinese marketplace. It is estimated that European companies that are members of the European Chamber missed out on EUR 21.3 billion in revenues in FY 2013 due to market access and regulatory barriers." It also notes that "over half of European companies (55%) perceive foreign-invested enterprises to receive unfavorable treatment compared to domestic enterprises, whereas only 11% perceive the opposite to be true." The European Survey also has an important table that is absent from US surveys, showing member's perceptions concerning the competitive advantage of different types of firms. This table shows very clearly that the challenge to foreign players does *not* come from private Chinese companies, as is often believed, but rather from SOEs, who are doing better on advantages they were already strong in, such as access to financing and government relations as well as on capabilities that traditionally have been weak in those firms, such as

marketing and the attraction of talent. This implies that SOEs are becoming more fierce competitors for the foreign company.

A separate survey by the German Chamber of Commerce in a China shows more caution though perceptions vary by sector. The United Kingdom's Chamber 2013 report (based on 2012 data) shows a rough doubling in the percentage of companies making a loss in China (21% as compared to 11% the previous year). Companies who have reduced or cancelled their plans for China investments noted "un-level playing field relative to Chinese competitors" among other reasons for their decisions. Finally, the preliminary results from an ongoing survey of Nordic companies show that preference from domestic Chinese companies is having serious repercussions at a considerably higher rate that those reported for US companies in the aforementioned surveys.

III Reasons for The Discrimination of Foreign Players

The reasons for the increased discrimination of foreign firms in China are many, but here is a list of what I see as some of the primary drivers:

1. *The Continuous dominance of foreign firms is inconsistent with China's strategic intent:* China is determined to reach and sustain a global leadership position, especially in sectors designated as "strategic" and "pillar", including the building of "global champions". Due to their dominant position in many segments, foreign firms often stand in the way. As other means (e.g., preferential financing for local players) have often proved insufficient or difficult to defend in international forums such as the WTO, "soft" discrimination becomes a step to be considered.

2. *Decline in the bargaining power of foreign firms:* The bargaining power of US firms, like other foreign companies, typically declines over time, the result of the growing importance of the China market and the critical knowhow already transferred to Chinese firms. Under those circumstances, the expectation is that US firms who are discriminated will not raise much opposition, at least not formally and publicly.

3. *A new, more assertive leadership team in China*: The current Chinese leadership is considerably more aggressive in asserting its vision of a globally dominant role for China, and more determined to keep foreign players at bay. Commensurately, compared to previous leaders, President XI seems to be more confident and less worried about antagonizing foreign players and or confronting their national governments.

4. *A perception that the US administration is weak and distracted:* In private conversations, Chinese officials make no secret of their view that if China were to take on a more assertive line, now would be a good time. The perception is that the US government is distracted by a variety of global issues as well as challenged and split at home, and in particular seeks to avoid confrontation at almost any cost. The takeaway is that the US is unlikely to undertake retaliatory measures at least as long as discrimination remains "soft" and doesn't make US leaders "lose face."

5. *Legitimate concerns of monopoly power and its impact on higher prices:* The current Chinese leadership is more sensitive than its predecessors to public sentiment and is concerned with the social ramifications of higher prices. The millions of Chinese going abroad are often dismayed to

see that various goods, including Made in China products, are priced significantly lower in foreign markets than at home. In sectors where foreign players dominate, such as private automobiles, this translates into a pressure on foreign players. Domestic Chinese makers will almost always price their products considerably below those of foreign manufacturers, so “anti monopoly” steps will keep foreign firms at a disadvantage without proclaiming formal discrimination.

6. *The increased targeting of the domestic market, where domestic players do better:* A byproduct of the (slow) transition of China from an export driven economy to one supported by domestic consumption, combines with the desire of foreign firms to sell in that market (“in China for China”) is a conflict between the two groups of domestic and foreign firms. The Chinese government, already concerned with the considerable dominance of foreign multinationals in its export market, does not wish to see a similar pattern in the domestic market.

7. *Security concerns (or excuses):* China was always obsessed with security concerns and if anything the obsession is greater today. Foreign companies are almost always suspected of colluding with their home governments and of caring little about China’s needs and priorities. Keeping foreign companies out or limiting their opportunities in China is viewed as a natural defense of national interests.

8. *Inability to use tariff barriers leads to preference for non-tariff or “soft” barriers:* Current agreement to which China is a signatory prevent the country from erecting formal barriers such as tariffs, quotas, foreign ownership limitations and mandatory technology transfers. This leaves “soft”, not-tariff barriers as the main vehicle, and the Chinese have become quite adept at using it.

9. *Corruption*: Corruption is a serious problem in China (Transparency International shows a deterioration in China’s rankings on corruption perceptions for 2014). It serves as a discriminatory obstacle to foreign firms who are losing business because of refusal to engage in corrupt practices and especially to US firms whose Foreign Corrupt Act is amongst the highest barriers as far as scope and enforcement. So far, there is no indication that China’s recent crackdown on corruption targets foreign firms in particular, though foreign firms such as GSK have been entangled and as a general rule foreign players have less access to the relationship networks that can save someone from prosecution.

10. *Disappointment with the performance of domestic players in various sectors:* Automobiles would be a good example, where the government’s ambitions of creating a number (three to four) of Chinese “global champions” have failed to materialize with no change in sight. Foreign firms continue to dominate the private car segment especially but not only at the upmarket level, and one way to change the course is to make China sales less lucrative for those manufacturers. That this will reduce prices both instantly (for a new vehicle) and down the road (for spare parts) is an added bonus. Incidentally, the price of “aftermarket” parts is much higher than that of newly installed components in most world markets, and the only way this has been somewhat tempered is by the supply of substitute parts. One therefore has to wonder what is behind the crackdown.

11. *Transition to "next stage" strategy where China incrementally shifts from "catching up" to a leadership position:* The upgrading of capabilities for domestic players is a key goal in that

endeavor, and one way to do that is to create a more supportive environment for those at the expense of foreign competitors.

12. *A desire to utilize the domestic market as a stepping-stone for international expansion, where geopolitics combines with economic goals:* To achieve its goals around the world in places like Africa and Latin America, China needs to strengthen its domestic companies in fields where it is not yet competitive (think automobiles versus infrastructure). This supports discrimination of foreign players as a way to extract more concessions especially in the realm of technology transfer that can then be used to underpin global expansion.

13. *A slowdown in the Chinese economy:* The lower growth in China and the decline in real estate values, as sector in which many Chinese companies are invested, are creating pressures on companies, whether state owned, private, or township enterprises (in which many local governments are invested). One way to improve the profitability of those companies is by squeezing out foreign competitors.

IV The means by Which Discrimination Takes Place

1. Various laws and regulations supposedly universal, of which anti-monopoly legislation is one example, which happen to result in a disproportional adverse impact on the foreign companies rather then their domestic competitors.

2. Various charges, such as dumping, where China is turning the table on countries that have used it to block Chinese imports, and that can be used as a bargaining chip in various trade disputes now and in the future.

3. Standards that are unevenly enforced, as in the case of food labeling and tainting, are likely not only to cause immediate damage, but, even more importantly, harm the reputation of foreign companies and erode the public perception that goods made by them are safer and superior in quality.

4. Discriminatory compliance with a variety of laws and regulations, including labor-related provisions that are disproportionally used against foreign players.

5. Forcing indigenous standards, e.g., in software and operational systems that keep foreign players out of the market or dramatically increase their cost and price them out.

6. Control of distribution channels, typically those that are in state hands, which prevents foreign players for reaching significant market segments, especially those owned or controlled by central or local government.

7. Imposition of policies such as censorship that forces US companies to “pay to play” or “bow to play”, that is, sacrifices fundamental culture and principles. See Google’s search and more recently its G-mail service for an example. Most US companies are not in a position to lose the China market as part of a showdown.

8. Lack of transparency – a perennial problem in China that harms foreign companies more because those companies lack access to personal and informal channels based on family, region or school, which can serve as a substitute, and because of the power transfer to government decision makers.

V How can US companies protect their interests?

1. US companies can do a better job of assessing rising competition on the part of Chinese firms but they cannot do it alone, so US government must play a role.

2. The US government should pressure China to recognize certification by its own agencies, e.g., FDA, which will open more markets for US firms and reduce their cost and time to market. The problem is that China will likely demand mutual recognition that may not be feasible at this stage.

3. Assisting US firms with better protection not only of IPR but also of knowhow in general is urgently needed, as knowhow remains the most important competitive advantage of US companies.

4. Exercising closer scrutiny of Chinese firms in the US and in other markets to assure reciprocity and tip back the bargaining power equation.

5. Developing and maintaining international coordination with European, Japanese and other foreign governments, among others, to develop a unified response to discrimination of foreign companies to counteract a "divide and conquer" options on the Chinese side.

6. Making the domestic changes necessary to make American firms strong and more agile competitors, from changes in corporate taxation to supporting research and development.