

Executive Position Paper

On the eve of a generational leadership transition, China holds a historic opportunity to raise its economy to a new level. To achieve this, a prompt and fundamental shift is required to carry out necessary economic rebalancing. China's state-led investment development model has supported growth over the last 30 years, but is by design unequal and no longer sustainable. The last decade of stalled and piecemeal reform during prevailing advantageous economic conditions maintained strong growth but failed to create the supporting institutional framework required to sustain China's development.

China possesses the necessary ingredients, including the technology and physical infrastructure bases, as well as the human capital, to make this shift. However, reforms to substantively reduce state involvement in the business environment and to give full play to market principles are needed to unleash the entrepreneurial potential of China's private industry.

The 12th Five-Year Plan recognised this need for change, but meaningful implementation has been lacking. With signs of over-investment and poor productivity returns already perceptible and with China's demographic dividend coming to an end, these changes are now urgently required not only for China, but also for global economic growth.¹ As the next five years will be critical, China's leadership transition provides an ideal opportunity for these bold steps to be taken.

At its core, this process must serve to create the conditions whereby the drivers of innovation, productivity and efficiency will prevail. Rebalancing the economic growth model requires equal access for all companies, whether private or state-owned or whether Chinese or foreign-invested, not only to markets, but also to procurement, technology innovation, treatment under the law and to finance and subsidies.

This *Position Paper* aims to contribute by providing constructive recommendations on some of the required changes to bring about this process of economic rebalancing and the upgrading of China's business and regulatory environment.

China's unequal state-led growth model...

...led to a prolonged period of sustained growth

China's state-led economic growth model has been well-suited to sustain massive growth and catch up in the transition from a low to middle-income economy.² China has become the world's second-largest economy just 30 years after opening up. Its development has lifted hundreds of millions of people out of poverty, raised life expectancy, increased real wages, boosted the value of the Renminbi and raised vast foreign reserves. However, this model is unequal by design, favouring large-scale state-owned enterprises (SOEs) over most private domestic companies and foreign-invested enterprises (FIEs).

¹ *A loss not to worry about*, China Daily, 2011: http://www.chinadaily.com.cn/thinktank/2011-02/19/content_12043372.htm

² According to the World Bank classification, China is an 'upper middle-income economy' with complex development needs: <http://wdronline.worldbank.org/worldbank/a/incomelevel> & <http://data.worldbank.org/country/china>

The state-led economic model is predicated on growth driven mainly by the manufacture of low-end exports, investment and by the technology upgrading that comes mainly from the absorption of foreign investment. So long as China enjoyed a sizeable trade surplus, attracted significant amounts of foreign direct investment (FDI), maintained a closed capital account and retained a high savings rate, funds were available to be injected into investment projects.

It was possible for the state to guide and control this development as state-owned banks channeled investment largely to SOEs to carry out state-identified projects. The availability of physical infrastructure and technology upgrading projects with easy productivity returns on investment gave huge impetus to growth, but has led to an over-reliance upon the contribution of fixed capital formation to gross domestic product (GDP) growth.

As a result of the structure of China's economy, an interests system has developed that leads to further inequality and favourable treatment. SOEs receive regulatory and procurement advantages, abundant supplies of cheap energy and raw materials, as well as favourable administrative price controls. Along with the technology transfer that has been demanded for foreign enterprises' access to the market, these conditions have allowed for large-scale state-led development and the formation of companies with giant economies of scale that can compete with low prices. At the same time, a financial system has developed to both support and prop up this model, in particular through controlled interest rates on deposits and loans that have effectively allowed household savings to fund SOEs through cheap financing and other forms of subsidies to the detriment of domestic demand and consumption.

Most private-owned enterprises -- in particular small and medium-sized enterprises (SMEs) -- are provided less access than SOEs and discriminated against in the Chinese marketplace. This is most marked in restricted or outright closed market access conditions in various sectors, most notably in administrative monopoly public goods sectors and in strategic or pillar industries; and by a lack of access to financing that has led to evidence of large-scale risky shadow banking with capital often provided by SOEs.

Foreign-invested enterprises suffer from the same examples of unequal treatment as private domestic companies, but are additionally restricted market access in an even greater number of sectors owing to joint venture and licensing requirements as well as claims to national security, causing massive asymmetry in market access conditions for FIEs between the EU and China. Recent Chinese government pronouncements aim to encourage more private investment in sectors currently dominated by state-owned entities, but concerns persist that the government's definition of 'private capital' only covers capital from domestic private enterprises, not capital from partly or wholly foreign-invested companies.³ Foreign-invested enterprises are also frequently forced to transfer technology in return for market access, are less able to qualify for subsidies, R&D funds and public procurement contracts, and are frequently unable to even take part in standards-drafting processes.⁴

...but is no longer feasible to support a second prolonged period of sustained growth.

The underlying factors that allowed this model to function are quickly diminishing. The supply of cheap

³ The Chinese term for 'private capital' used in the official documents is *minjian ziben* (民间资本). The European Chamber requested a meeting with MOFCOM's Foreign Investment Administration Department to discuss the Chinese government's recent guidelines on encouraging private investment, but was told that a meeting could not be granted on this topic as such pronouncements to encourage private investment (*minjian ziben*) are 'completely unconnected' with foreign investment.

⁴ In the Executive Summary of the *Position Paper 2011-2012*, the European Chamber provided 10 major examples of discriminatory concerns. Although 8 of these 10 concerns still persist, the European Chamber welcomes the removal of equity restrictions on foreign investment for e-vehicle components in the release of the Foreign Investment Catalogue, as well as the approval of long-awaited Interim Computer Reservation Systems regulations that will allow some market access for foreign CRS providers.

and young labour is declining as China is quickly losing its demographic dividend and calls for a better distribution of the fruits of its 30 years of impressive growth are driving increases in the wages of China's workers. There is steep downward pressure on China's trade surplus due to thinning external demand from the downturn in the world's major markets and increasing internal consumption. The global economic crisis has also contributed to a decline in foreign direct investment as greater caution is being exercised in weighing up returns on investment in a speedily maturing marketplace that lacks a corresponding maturation of the regulatory and market access environment for private and foreign enterprises.

As these supporting factors disappear, the current economic growth model has begun to show its deficiencies. The inequality which served growth so well during catch up is leading to inefficiency, low-productivity and a lack of innovation.

Due to an over-reliance on the contribution of state-controlled investment to GDP, many sectors favoured under the current model are exhibiting over-capacity and signs of bubbles. Inefficient utilisation of capital has led to significant debt and contingent liabilities both at the local level and of SOEs and it is questionable whether the favorable treatment that many SOEs have enjoyed, in particular those in administrative monopoly sectors, has prepared them to speedily adapt and innovate in parallel to the maturation of the marketplace. Industrial and manufacturing growth is also slowing. Following the stimulus package of 2008 that was heavily channeled to SOEs, China is no longer ready to face risks of high inflation and to sustain waste and risk vastly increasing debt and the ratio of non-performing loans through a continued reliance upon state-led investment.

Some consolidated SOEs, in particular those in sectors more open to competition, have developed strong corporate management structures and modern business approaches and are thus able to compete globally in terms of quality and branding. Nevertheless, once favourably provided costs and subsidies are factored into estimations, Chinese central-level SOEs are still on average estimated to produce negative returns on equity,⁵ and total factor profitability growth of SOEs has been just a fraction of private industry since opening up.⁶ As further pressures on total factor productivity will result from overcapitalisation and reaching the technology frontier, a continued over-reliance on fixed-asset investment will lead to slowed growth and will thus jeopardise China's opportunity to avoid the middle-income trap and attain developed market status.

A speedy rebalancing and a new model suited to prevailing macro-economic conditions that puts economic efficiency ahead of growth is required.

The required growth model for a second period of sustained growth...

...has been identified

China still has great resources to stimulate growth. There is massive potential for new growth to come from further productivity gains from industrial upgrading, relocation of manufacturing to central and western regions, stimulating domestic consumption, developing the tertiary sector and advanced technology manufacturing, as well as from competing in global marketplaces through overseas investment. At the same time, there is a continued need for investment projects, including in social housing, the development of healthcare and education facilities, as well as urbanisation and corresponding infrastructure development that poses both great opportunities and challenges for China's development.

⁵ *The Nature, Performance and Reform of State-owned Enterprises*, The Unirule Institute of Economics

⁶ *China 2030: Building a Modern, Harmonious, and Creative High-Income Society*, the World Bank and the Development Research Center of the State Council, the People's Republic of China

Reform and opening up was identified as the driving force of the 12th Five-Year Plan to rebalance the economy more towards domestic consumption, industrial upgrading and more services-led value-added and sustainable growth.

China in many important regards is well-positioned to realise this new economic growth model that is needed to transition into a high income society. The many years of investment spending have led to the development of high-quality physical infrastructure and strong industrial technology. Most important is human capital. China has improved its educational base, including in sciences and engineering, during the process of development. Given the right conditions, China's private industry would be well able to fully unleash its entrepreneurial and innovative potential.

...but necessary reforms are not happening.

Incremental and piecemeal reforms must give way to urgent and comprehensive reform. This requires altering the status quo and must therefore touch upon the vested interests of those that benefit most from the state-led investment model and address the structural conditions that lead to the favourable treatment that SOEs have long enjoyed. As Vice Premier Li Keqiang stated, reform and opening up must 'continue to lead the way in removing the institutional obstacles that hamper the shift of the growth model'.⁷ The state must retreat, and the private must advance.

To rebalance the economy, rising costs need to be offset to drive income and consumption growth. As deindustrialisation is needed at the lowest-end of the value chain due to increased labour costs, there must be an accompanying generation of high value-added products and services. Innovation is the key to this process and competition is critical to innovation.

Time is of the essence and European companies can be a catalyst to accelerate this process. European industry has committed to China and is willing to further invest, but in times of economic difficulty and constrained markets, the need for equitable treatment that provides fair opportunity for sustainable returns on investment becomes a much greater consideration when weighing up investments. The advanced, high-tech and green technologies and services of European companies not only provide better choice and value for Chinese consumers, European industry investment also leads to a willing transfer of skills, technologies and processes to Chinese companies. Most importantly, however, is the enhancement of international competition in the Chinese marketplace.

Equal access is required.

China needs to create the conditions whereby the most innovative, productive and efficient companies will prevail. At its core, this requires providing equal conditions to all actors, whether state-owned or private, or whether Chinese or foreign-invested.

In order to rebalance the economy and bring about the new growth model, **China should provide equal access to:**

- 1. Markets**
- 2. Procurement**
- 3. Treatment Under the Law**
- 4. Financing and Subsidies**
- 5. Technology Innovation**

⁷ Li Keqiang's Speech at the Opening Ceremony of the Boao Forum, http://english.gov.cn/2012-04/03/content_2106213_2.htm

1. Access to Markets

Market access has long been the major concern of European business in China. China is identified by the Organisation for Economic Co-operation and Development (OECD) as having the most restrictive regime for foreign investment in all of the G20.⁸ Access barriers still exist to China's expanding internal marketplace and Chinese companies increasingly compete on a level footing in the European marketplace. This growing asymmetry makes the importance of fair market access in China even more critical.

Approximately one half of European Chamber member companies asserted that they lost out on business opportunities due to market access and regulatory barriers in the annual *Business Confidence Survey 2012*. Market access barriers in China are various in form and include wholly protected sectors, limits on equity ownership that necessitate joint venture models of operation and forced technology transfer, licensing requirements to enter sectors that FIEs cannot attain, frequent restrictions due to claims of national security, as well as less direct or more opaque market access barriers including standardisation practices and public procurement practices.⁹

China's approach to foreign investment is conceived in a fundamentally anachronistic and outdated mindset. Rather than commencing from the premise that foreign investment and healthy competition in an open marketplace brings positive impacts in and of itself, China places conditionality on the opening of markets to foreign investment. This is reflected in the piecemeal opening of markets and control of foreign investment in the 'Foreign Investment Industrial Guidance Catalogue'. The Catalogue retains a fundamental distinction between domestically-invested and foreign-invested industry and attempts to prescriptively lay out conditions for the acceptance of foreign investment only where it is perceived to serve clear industrial policies. As China aims to rebalance its economy and move up the value chain, in order to realise the greater benefits that foreign investment and healthy competition in the marketplace can bring, the Catalogue should be recognised as obsolete and abolished.

Equal market access and national treatment for FIEs would produce healthy competition, which would in turn drive productivity, innovation, economic efficiency and an optimised utilisation of capital. Equal market access would also allow the Chinese consumer to benefit from the best and most value-for-money advanced and green products and services available on the global marketplace. It would bring greater levels of capital, tax and jobs through FDI and private investment; as well as a transfer of leading skills, technologies and processes. Through bringing more transparency it would also lessen the risk of corruption. Other benefits of increased market access include increases in safety and quality standards, improvements to environmental conditions and reductions in CO₂ emissions, as well as boosting domestic consumption in China.

Market access is most heavily restricted in sectors that can be argued to be supplying public goods and in other strategic and pillar industries that are often characterised by administrative monopolies. Due to favourable treatment and a lack of real accountability, SOEs in these industries operate outside normal market conditions without strong incentives to be productive, efficient and innovative. It is in these sectors where there is frequently waste, over-capacity, under-utilisation of capital and debt. In these conditions, the argument that protected SOEs are best suited to serving public interests does not hold true.

⁸ The OECD FDI Regulatory Restrictiveness Index (FDI Index), www.oecd.org/investment/index. The FDI Index measures statutory restrictions on foreign direct investment in 55 countries, including all OECD and G20 countries. China is ranked as having the most restrictive FDI climate of all the 55 countries, further demonstrating the asymmetry in access conditions between the EU and China.

⁹ The Working Group chapters in this *Position Paper* include a number of Key Recommendations that are related to market access issues for European companies. These issues are spread throughout various industries and have been denoted in this year's *Position Paper* by a red flag. Of the 210 Key Recommendations and Sub-Key Recommendations developed in the Working Group papers, 45 are perceived to be clearly related to market access.

China's own experience shows the clear benefits that can be brought by privatisation and increasing competition in most SOE-dominated sectors. Increasing competition would not only give play to the great potential of China's private industry, it would also force more SOEs to upgrade their governance structures, improve transparency, become more globally competitive and provide better, more innovative and cheaper products and services.

The benefits of increasing private investment into monopoly sectors have been recognised by the Chinese government in policies such as the '36 Clauses for the Non-State Owned Economy'¹⁰ and other recent pronouncements from various government bodies.¹¹ However it will not be possible to attract substantial private investment into SOEs and SOE projects until true and equal competition between SOEs and private – including foreign-industry is realised in these administrative monopoly sectors and favourable treatment for SOEs is addressed. Returns on private investment into SOEs and SOE projects can only be realised if SOEs are stimulated to become more productive and efficient.

Strategic and pillar sectors to open to greater market access need to be identified. Both the increased efficiency of state capital utilisation as well as the private capital investment injections that would be brought by such opening would support the public interest and increase government fiscal budgets. This would help sustain growth through relatively high investment spending over the next few years, in particular in urbanisation and related infrastructure areas, and allow greater funds to be invested into public goods areas that would support and boost consumption, like healthcare and education.

To bring about equal market access, China should develop an action plan to identify steps for market opening, as well as work with partners such as European Union authorities to identify key market access barriers. The announced negotiation of a Bilateral Investment Agreement with the EU presents an opportunity to actively open sectors to equal competition and to reduce existing asymmetries.

2. Equal Access to Public Procurement

The European Chamber estimated in the *Public Procurement in China* study, that China's public procurement market is worth approximately 20% of China's GDP.¹² Based on this calculation method, it is estimated that the size of the public procurement market in 2011 was approximately EUR 1.05 trillion.¹³

Despite the European public procurement market being very open to Chinese companies, the Chinese public procurement market is largely out of bounds for foreign companies. This is mostly owing to China's very limited definition of government procurement in China's 'Government Procurement Law' (GPL), which does not include the vast proportion of public procurement projects tendered by public entities and SOEs that are of public interest and/or use public funds. Most infrastructure and public works projects are included under the 'Tendering and Bidding Law' (BL) and FIEs are routinely excluded from participation. For those contracts still accessible, FIEs continue to be discriminated against under both the GPL and BL.

China promised in its WTO Accession Protocol to join the Government Procurement Agreement 'as soon as possible' after WTO accession. However, nearly 11 years following China's entry, China has yet to

10 The '36 clauses for the Non-State Owned Economy' were first issued in February of 2005 to promote private enterprises through various policies and by providing them with equal market entry opportunities with their state-owned counterparts. The document was revised in 2010 to help boost private investment in state-dominated sectors.

11 Including the State Council, the National Development and Reform Commission, the Ministry of Railways, the China Securities Regulatory Commission and the China Banking Regulatory Commission

12 *Public Procurement Study: European Business Experiences Competing for Public Contracts in China* <http://www.europeanchamber.com.cn/en/chamber-publications>

13 According to the National Bureau of Statistics of China, the gross domestic product (GDP) of China was CNY 47.2 trillion in 2011, http://www.stats.gov.cn/english/newsandcomingevents/t20120117_402779577.htm. The conversion rate used was based on the average exchange rate for 2011 from the China Foreign Exchange Trade System, <http://www.chinamoney.com.cn/fe/Channel/17383>

submit an offer which comes close to being acceptable in terms of scope and thresholds. In November 2011, China submitted a third offer to the WTO. Although a minor improvement on the second offer, coverage is still highly disappointing and does not reflect the public procurement reality that the vast proportion of China's public procurement is carried out at local levels and through projects implemented by SOEs and financed with public money. The total coverage of China's most recent GPA offer is estimated to be a tiny fraction of China's total public procurement market.¹⁴ This is asymmetrical to the practice in the EU where approximately 85% of the EU's public procurement market is opened in the GPA to third countries; and in practice even more.

China still has room for a large number of investment projects, in particular in urbanisation-related infrastructure areas in western and central regions, in the construction of social housing and in the development of healthcare and education facilities. As productivity returns on investment become much more difficult, China has a clear interest to speedily enact reforms in the public procurement process to open up infrastructure projects to all players and to attract private investment to mitigate local government contingent liability risks.

Consumers stand to benefit the most from transparent public procurement opened to all players. Increased competition in the public procurement marketplace provides greater choice and quality at lower total life-cycle cost. A more efficient allocation of public capital and the attraction of private capital into public projects would save Chinese taxpayers billions of Euros per year that could instead be invested in social welfare schemes and other public goods that would support domestic consumption spending. Furthermore, transparent and equal public procurement improves open governance and inhibits waste through decreasing the potential for corruption and by opening the project identification process to greater scrutiny for its benefit and likely returns on equity.

China will undertake a massive process of urbanisation in the coming years. The scale of rural-to-urban migration will bring many opportunities to China, as well as challenges. European industry has the experience, technology and know-how to support the overall sustainability of China's urbanisation course, but is currently restricted the access required to help tackle the real issues that China faces across various urbanisation-related fields, including energy, utilities, transport and construction.

To improve public procurement, the Chinese government should issue a comprehensive GPA offer that includes local governments and SOE projects financed with state money. Policy-makers should encourage more public-private partnerships, ensure transparency throughout the bidding and reward processes, give equal treatment to all bidders irrespective of their capital or ownership structure and total life-cycle cost, rather than merely price and quality, should be considered the ultimate selection criterion.

¹⁴ The European Chamber estimates that the scope of government procurement under the GPL covers just 12% of China's total public procurement market, with the remaining 88% falling under the BL. As the GPA offer generally mirrors the scope of the GPL, yet its coverage is further limited to mostly central level government agencies, the total coverage of the GPA can be estimated to be just a small fraction of the 12% of China's total public procurement market that is covered by the GPL. See the Public Procurement Working Group Position Paper. The EU's definition of public procurement, which is opened to bidding, is therefore equivalent to the scope of China's GPL plus BL.



Asymmetry in Market Access and Public Procurement

Whether China will overcome its many vested interests to increase market access in key sectors is the question at the heart of the EU-China relationship.

China has demonstrated that in basically all sectors of the economy it is now able to compete with mature multinational companies, including in mature global markets like the EU. Chinese industry is no longer regarded as a bastion of low-end manufacturing; in many advanced and high-tech sectors it is regarded as the most dangerous competitor for European companies.

This rise in competitiveness is largely due to the technology transfer that has been brought into China through investments made by foreign companies based on prospects of a fair and equitable marketplace in China. It has also been bolstered by practices not in line with China's WTO commitments, including discriminatory subsidies, remaining export quotas, licensing difficulties and equity restrictions that China argued were necessary to protect domestic industries upon opening. These have together led to the formation of companies with massive economies of scale and an ability to compete with low prices.

Chinese companies are also increasingly looking to invest in Europe to acquire brands and technology.¹⁵ The European Chamber, as a proponent of freer trade and investment, welcomes this increase in Chinese investment into Europe so long as similar access is granted in China. However, it is this point of asymmetry that is the major sticking point for EU-China relations.

Europe remains resiliently open during the crisis. Chinese companies are increasingly entering markets in Europe that European enterprises are not allowed to access in China; and are showing their capabilities to bid for major participation in infrastructure projects in Europe, while such procurement markets in China remain out of bounds to European industry.

Open markets should be viewed as two-way streets, and systematic market access restrictions and discriminatory treatment issues continuously heap pressure on governments to tackle these problems. It is in no-one's interest for this pressure to lead to a closing of markets.

The potential benefits of an open EU-China economic relationship are enormous. Mutual opening of markets would bring about increased competition and would lead to increased efficiencies and innovation and greater economic development, ultimately to the benefit of the consumers.

3. Access to Treatment Under the Law

The development of China's legal and regulatory system has been a significant element of China's reform since 1978. It has also been a decisive factor behind China's impressive economic performance. However, while the past decade has witnessed strong economic growth, China failed to capitalise on the favourable economic environment by implementing reforms to establish greater rule of law, which is imperative for rebalancing, building a harmonious society, promoting private industry and for breeding innovation.

Calls for strengthening rule of law and regulatory transparency in China's business environment have grown stronger over the last year. In the annual *Business Confidence Survey*, European Chamber

¹⁵ Chinese annual outbound direct investment to Europe tripled from 2006 to 2009 and tripled again in 2011 to \$10 billion (EUR 7.18 billion). Moreover, it is expected that Chinese direct investment to Europe could amount to \$250 billion to \$500 billion (EUR 179.5 billion to EUR 359 billion) over the next ten years. *China Invests in Europe: Patterns, Impacts and Policy Implications*. Rhodium Group, Thilo Hanemann and Daniel H. Rosen, June 2012. The conversion rate used was based on the average exchange rate for 2011 from the China Foreign Exchange Trade System, <http://www.chinamoney.com.cn/fe/Channel/17383>

members have identified 'discretionary enforcement of broadly drafted laws and regulations' for five consecutive years as being the utmost obstacle to China's future economic performance;¹⁶ and increasing 'rule of law/transparent policy-making and implementation' as being potentially the most significant driver of China's economy in the future.

Predictability in the enforcement of the legal system is essential for a stable business environment in a modern economy. As the Chinese economy inevitably moves towards even greater market economy principles, the need for a robust and predictable legal environment to serve fair market-based competition and wider societal interests becomes stronger. Impetus to strengthening rule of law and transparency in the legal system is the only way to ensure that all types of businesses comply with laws, which *ipso facto* serve China's broader interests.

The possibility for the state to intervene in the economy, owing mainly to a lack of power and independence of the judiciary, has led to a situation in China whereby the interests of the legal system at local levels have become intertwined with the economic interests of the major participants in China's state-led economic model that compete against rule of law.

Strengthening rule of law in all aspects of business will serve to protect fair competition by ensuring that all companies operate within the same legal environment. Only under these conditions will it be possible to ensure that the drivers of productivity, efficiency and innovation will win by removing all factors extraneous from the functioning of the market. Strengthening rule of law will also serve to protect societal interests related to business outputs such as environmental protection and product quality and safety; and will help with fostering a greater sense of fairness in society. A predictable, rule-based system is the best way to breed innovation not only because it protects fair competition, but also because it safeguards investments by protecting intellectual property and by ensuring predictability that the same conditions will be met across different locales and sectors.

Transparency and consultation in the legislative process is also necessary to establish a strong, fair and inclusive legal system. Consultations with all affected players and reasonable grace periods to adjust ahead of significant changes enable companies to plan their business development. European business has vast experience in providing input to the drafting of business regulations in the EU and other mature markets and is willing to provide assistance wherever possible to the drafting of relevant Chinese regulations.

Much progress has been made in recent years by Chinese legislative organs to increase the level of fruitful dialogue with European stakeholders; but while the number of consultations has improved in recent years the length of time given for consultation has often not. Of the 67 Chinese government calls for comment that the European Chamber responded to in 2011 and the first half of 2012 (49 in 2011 and 18 in the first half of 2012), the average length of time given for comment was just 24.5 days, with the longest being 51 days and the shortest just six days.¹⁷

16 Since being given as a survey response option in 2008, 'Discretionary Enforcement of Broadly Drafted Laws and Regulations' has been identified by European Chamber members for each of the five consecutive years as the most significant regulatory obstacle when doing business in China. European Chamber's annual *Business Confidence Surveys 2008-2012*. <http://www.europeanchamber.com.cn/en/chamber-publications>

17 The average amount of time (24.52 days) overstates the real average. Firstly, all days are counted in the calculation, not just working days. Also, on many occasions the date the consultation is uploaded to the official government website differs from the date stated in the call on the website. As the European Chamber has not tracked this information, the average length of time calculated is based on the government stated amount of time allotted. However, of the 18 calls for comments responded to in H1 2012, the European Chamber has observed that the upload dates of at least 6 do not correspond to the stated dates, in each occasion providing less time to comment than stated. For example, the commencement date for consultation on the '12th Five-Year Plan Energy-Efficiency Construction Special Plan' released by the Ministry of Housing and Urban-Rural Development is stated as January 9th 2012, with the deadline for comments given as February 7th 2012. For calculation purposes, the European Chamber used the figure of 30 days, when in actuality the consultation was uploaded on February 1st 2012, giving just 7 days.



The European Chamber welcomes the 'Provisional Measures on Soliciting Public Opinion on Laws and Regulations' issued by the Legislative Affairs Office of the State Council in May 2012 which states that the consultation period for draft legislation and regulation should not be less than 30 days. Although still not in alignment with international practice that stipulates at least eight weeks of public consultation,¹⁸ this should be regarded as a step in the right direction so long as all Chinese regulatory organs follow the provisions laid out in the legislation.

4. Access to Finance and Subsidies

China's financial system has developed to support the state-led investment economic model. Despite steady reforms, China's commercial banking system is still tied to the state and China's banks have yet to be incentivised to become the 'real banks' that Deng Xiaoping envisaged.¹⁹

The regulated banking system in China allows the state to direct the flow of capital. At the same time, the banking system is able to issue cheap loans due mainly to low fixed interest rates for savings and borrowing which effectively allows capital deposited mostly in household savings to be transferred in a subsidised form to mainly SOE borrowers.²⁰

During catch-up and the transition from a low to middle-income economy, this model is well-suited to stimulating growth because it allows SOEs to engage in state-identified infrastructure and technology upgrading. However, when productivity returns on investment are not as simple as during catch-up owing to a higher base level of infrastructure and production capacity, this state model of financing becomes unfeasible as it negates proper assessment of credit risk and leads to wasteful capital utilisation. China is now at this stage.

Low interest rates and subsidies make it difficult to determine returns on investment. It is possible for SOEs to report profits, yet much evidence shows that SOEs are actually destroying wealth once the values of repressed rates and other subsidies ultimately coming from the household sector are discounted.²¹ The incentives that have developed around this system also encourage over-investment. The GDP growth and other immediate returns including employment and seeming productivity growth are powerful incentives for local governments that are able with SOEs to influence bank lending at local levels, while transferring risk into debt expiring in the future that banks know will ultimately be rolled over by the state.

China needs to speedily develop and implement plans to allow a liberalisation of interest rates to incentivise efficient capital lending. At its core, Chinese banks need to be forced to properly evaluate investment returns on projects and to direct capital to the drivers of efficiency, productivity and innovation. This would equalise access to finance for domestic private industry, SMEs and FIEs who have been mostly restricted from accessing the cheap subsidised capital from repressed interest rates.²² ²³ A better allocation of capital would stop waste and the build-up of bad debt and would drive value-added growth and innovation, including from SOEs, as well as encourage private investment into China's development

18 The WTO recommends a 60 day (8 weeks 4 days) consultation period for standards: WTO Uruguay Round Agreement, Agreement on Technical Barriers to Trade, Annex 3, Article L. China committed to give "a reasonable period for comment" (Accession Protocol, Part 1, Section 2 (C) 2). From 1 January 2012, the European Commission has given citizens, businesses and non-governmental organisations at least 12 weeks to comment on plans for new policies and legislation, compared to 8 weeks previously, demonstrating an increasing asymmetry in legislative consultation practices between the EU and China. <http://europa.eu/rapid/pressReleasesAction.do?reference=IP/12/1&format=HTML&aged=0&language=EN&guiLanguage=en>

19 *Selected Works of Deng Xiaoping*, Volume III: Corporate and Financial Reforms, People's Daily. <http://cpc.people.com.cn/GB/64184/64185/66612/4488744.html>

20 China Macroeconomic Research Center, Peking University, China: Financial Reform in China: Progresses and Challenges. First Draft: 29 November 2010

21 *The Nature, Performance and Reform of State-owned Enterprises*, The Unirule Institute of Economics

22 Oriental Patron, China Alternative Financing Industry, January 2011

23 In April 2012, Wen Jiabao publicly stated that the monopoly of Chinese state-owned banks needs to be broken up to better serve the financing needs of private companies.

and help redistribute wealth from corporate state entities to the public, thus narrowing income inequality and helping raise domestic consumption levels. A more competitive spread between lending and deposit rates would also incentivise banks to develop non lending-related income and thus enhance their portfolio of activities and their global competitiveness.

In addition to subsidised lending rates, industrial policies lead China to offer a large number of subsidies to industry players in a wide number of sectors that are again disproportionately afforded to SOEs. Subsidies come in many forms and include taxation incentives as well as preferable rent, power and land prices. Although some forms of subsidies may have merit,²⁴ as a proponent of freer, healthy and fair markets, the European Chamber generally discourages the use of subsidies because they serve to distort the market and discriminate against all players that are not recipients, thus reducing the benefits of healthy and fair competition.

As long as such subsidies exist, it is imperative that fair and equal access is granted to all invested enterprises on the basis of national treatment, yet the European Chamber's *Business Confidence Survey 2011* identified access to subsidies as a comparative disadvantage vis-à-vis Chinese domestic firms.^{25 26}

In order to ensure a level playing field in this arena and to assuage potential movements of partner markets to apply countervailing duties, China should publish the amount of all subsidies available, application criteria and the results of which firms are successfully granted access.

5. Access to Technology Innovation

China is nearing the technology frontier. This necessitates a shift to a new development model and a move up the value chain as the productivity returns from acquiring and applying foreign technology diminish. Although China possesses great innovative potential it still lags behind many developed countries in terms of technological innovation, let alone cutting-edge technological innovation.

As explained in this *Position Paper* and as discussed in-depth in the European Chamber's publication on patent quality and its impact on innovation in China,²⁷ a variety of Chinese policies and practices intended to stimulate innovation deserve significant improvement. A shift in policy that would better stimulate technological innovation in China includes, among other issues, making standardisation approaches less discriminatory, improving the IPR protection environment, curtailing forced technology transfer in exchange for market access, opening up more financial innovation incentives to FIEs, and relaxing price controls.

Discriminatory standardisation policies

Discriminatory standardisation policies are one of the most significant issues mentioned in this *Position Paper* in terms of inhibiting the transfer of technology to China and the development of technology in China. China has fallen short of its goals to adopt international standards due to a growing tendency for Chinese national and industry standards to be based on delayed, incomplete or slightly altered internationally established and accepted standards. There is also a worrying tendency to adopt deviating

²⁴ An incubation subsidy in a societal goods sector intended to provide a kick start to the industry would be an example of a subsidy with merit.

²⁵ In this regard, the European Chamber welcomes the recent announcement in April 2012 of the removal of restrictions on foreign-invested enterprises in the application requirements for participation in the Chinese National Significant Science & Technology Projects and 863 Projects by the Ministry of Industry and Information Technology and the Ministry of Science and Technology.

²⁶ <http://www.europeanchamber.com.cn/en/chamber-publications>. China does not publish a list of all the available subsidies and the recipients. As such, the Chamber must rely upon surveyed information that points to subsidies being unevenly and injuriously provided to Chinese domestic companies over foreign-owned enterprises.

²⁷ *Dulling the Cutting-Edge: Unaddressed Patent Quality Barriers and their Impact on Innovation in China*. Prud'homme, Dan (2012), European Union Chamber of Commerce in China. <http://www.europeanchamber.com.cn/en/chamber-publications>

standards, often through discriminatory policies intended to build such standards in an ill-devised attempt to encourage indigenous innovation.

Although China set an adoption rate target for internationally accepted standards of 85% by 2010, this was assessed by Chinese authorities to still be below 80% in 2011.²⁸ As this refers to the rate of adopted international standard clauses in Chinese national standards, the rate of complete adoption of global standards is much lower. By using the most common calculation method,²⁹ the European Chamber estimates the number of national standards that are identical to internationally established and accepted standards to be as low as 40%.

Chinese Standardisation Development Organisations that develop industry and provincial standards routinely discriminate against FIEs, their subsidiaries and joint ventures by barring them from full and effective participation in the standardisation process, including within patent pools. Although these standards are frequently classified as voluntary and thus not required to be notified to the WTO Technical Barriers to Trade Committee, they are often mandated within certification schemes.

The development of diverging standards will, contrary to intentions, actually serve to hinder indigenous innovation as it risks isolating China's research and development and consumers from the benefits of global markets, technologies and networks. Together with creating barriers to the international harmonisation of standards, this will create difficulties for Chinese products to both enter and compete on the global market.

Inadequate IPR protection

An issue of cross-cutting importance, improved IPR protection is essential for stimulating technological innovation in China. In the European Chamber's *Business Confidence Survey 2012*, 81% of respondents rated China's enforcement of IPR laws and regulations as inadequate. Although recent Chinese government IPR campaigns have in many regards improved IPR enforcement, there are still instances of discrimination against FIEs. More importantly, the general IPR environment is still not best conducive to encourage confidence for companies to invest time, effort and resources into innovation. It is important that the Chinese government continue to foster a more predictable, equal and reliable enforcement environment.

Forced technology transfer

On many occasions, unreasonable technology transfer requirements are set as preconditions for any type of access to the Chinese market. Such forced technology transfer is not conducive to technological innovation. Minister of Commerce, Chen Deming's statement in February 2012 that technology transfer should be independently decided by businesses and not be used by the Chinese government as a precondition for market access was therefore welcomed by the European Chamber as a positive development.³⁰ EU industry is frustrated by the raw deals of having to form joint ventures with Chinese companies, in particular SOEs, whereby unreasonable technology licensing requirements are required in return for any type of market access. Such requirements actually work against the development of

²⁸ The target of 85% was included in the Standardisation Administration of China 'Notice on the Reporting of Working Summary for The Adoption of International Standards and Advanced Foreign Standards. In a speech by Mr. Pu Changcheng, Vice Director of AQSIQ on 7th March 2012 it was acknowledged that the adoption rate was still below 80%.

²⁹ The calculation is based on the number of national standards (GB, GB/T, GB/Z) that are listed as an identical adoption (IDT) of a corresponding international standard. Based on information from the Standardisation Administration of China database of national standards, as of December 2011, the total number of national standards total 27,208, of which 10,859 are listed as IDT.

³⁰ *Technology transfer not precondition for market access*, <http://english.peopledaily.com.cn/90778/7725409.html>

innovative indigenous technologies as evidence shows that European cutting-edge innovation-intensive operations do not generally agree to these raw deals and that these policies actually serve to deter enterprises from contributing valuable technological knowledge in Chinese operations.³¹

Discriminatory financial incentives

China has set forth a wide range of financial incentives to boost technological innovation; however some of these are discriminatory or otherwise closed to FIEs. This causes asymmetry in terms of access to technology innovation financial incentives as most initiatives are non-discriminatory in the European Union and are generally open to applications from all companies, including Chinese companies. Such openness is regarded as beneficial for both the EU and China. Europe recognises that innovation and productivity in research is best fostered in an open R&D environment that facilitates collaboration, cooperation and cross-fertilisation of research ideas between a variety of different stakeholders. Innovation programs and R&D funds which are supported by state capital should be open to all companies legally invested in China. This would create the condition for cooperation between Chinese and foreign entities and thus help stimulate innovation and the creation of globally competitive brands and products.

Strict pricing controls

Pricing is important in determining the selection of technologies. Since WTO accession, China has gradually tended to reduce the number of products and services subject to administrative price controls and government guidance pricing. However, the last year has witnessed the imposition of various new price control measures.³² In some of these areas, the controls could have the effect of providing protection to domestic industry, while in others the effect of the price controls could be to price those higher quality and more innovative products, which European products tend to be, out of the marketplace.

Moving ahead

To stimulate innovation, policy focus should serve to provide the market conditions of fair and equal competition and to assist private sector development. FIEs should be recognised as an essential partner and player in the drive to stimulate Chinese indigenous innovation of cutting edge technology, rather than pushing industrial policies that discriminate against FIEs.

European companies are already the largest contributors of technology to China, with 36,730 items of technology worth EUR 100 billion of contract value having already been transferred by September 2011;³³ however, European companies would bring more technology to China and, importantly, develop more technology in China if the business environment was made less discriminatory. With a more business-friendly environment, not only would European technology transfers increase to China-based entities, but China would be further transformed into a place where European companies, in partnership with Chinese entities, would innovate and build new technologies.

³¹ *Dulling the Cutting-Edge: Unaddressed Patent Quality Barriers and their Impact on Innovation in China*. Prud'homme, Dan (2012), European Union Chamber of Commerce in China. <http://www.europeanchamber.com.cn/en/chamber-publications>

³² There has been a tendency towards a greater weighting of price in public procurement tendering in recent years and attempts to control price as part of China's healthcare reform have led to price controls in both the medical devices and pharmaceuticals sectors in recent years. Such measures work against innovation and may impede the introduction of cutting-edge and potentially life-saving technology into the Chinese marketplace.

³³ *Remarks by H.E. Ambassador Song Zhe at the Luncheon Hosted by the European Union Chamber of Commerce in China*, <http://big5.fmprc.gov.cn/gate/big5/www.fmprc.gov.cn/ce/cebe/eng/sthd/t860978.htm> 2011/09/21. The original figure was quoted in USD. The currency conversion rate used was based on the average exchange rate for 2011 from the China Foreign Exchange Trade System, <http://www.chinamoney.com.cn/fe/Channel/17383>.



European Union Policy-Makers Should Develop a Pan-EU Trade and Investment Strategy with China that Places Access at its Core ...³⁴

As China continues to move up the value chain, its industry is becoming in many regards the major competitor of EU companies, not only in China, but also in European and global markets. At the same time, China's internal marketplace has contributed more to global growth in recent years than any other global market. For this reason, and for its sheer size, succeeding in the Chinese marketplace has become more important than ever before. Due to the massive amount of technology and skill transfer that has occurred over the last decade from foreign direct investment, the argument that China still needs to protect some of its industries no longer holds true.

The European Union has long engaged with China under the assumption that China would gradually reciprocate its own liberalisation. The European Chamber believes that the EU is still correct in maintaining that Europe's open investment regime remains the strongest argument to attain similar access abroad. However, as China maintains deep asymmetries by continuing to restrict access in all the areas outlined in this *Executive Position Paper*, Europe must develop an alternative strategy that places market access and China's investment environment at its core and which focuses on concrete achievables as well as joint agreements. China must be engaged to close the relative gap in access rather than allow mounting pressures in member state constituencies to compel the EU to close the gap themselves.

1) ...through Taking Responsibility to Speak with One Voice

While the European Chamber recognises that the European Commission has endeavoured to develop a harmonised trade and investment policy towards China, the effectiveness of EU trade and investment policy continues to be undermined by fragmentation and economic short-termism. It is imperative that the various actors in Europe present an effective, strong and resolute voice to Chinese counterparts.

Member state representatives should firstly engage with European Union officials to together develop a unified and coherent strategy with China that identifies common objectives and priorities. Commencing from the already identified barriers in the Market Access Database, European officials should agree upon a list of priority issues on which to engage and cooperate with China to pursue opening. Recognising that Member states have a responsibility to ensure that all high-level communication with Chinese officials is consistent, such messaging should be considered binding, as should the need for communication with European Commission authorities prior to and following high-level meetings with Chinese officials that could touch upon trade and investment relations.

2) ...through Requiring Compliance to the Rules of the Multilateral Trading System

The benefits of liberalisation and regulatory and standardisation convergence at the multilateral level should continuously be advocated as being of the uppermost importance. China's development would not have been possible were it not for the predictable rules of the WTO. To safeguard the benefits that WTO membership brings to all its signatories, it is necessary that its multilateral trade rules continue to be followed. In this regard the EU, and indeed China, should not hesitate to engage in constructive and specific dialogue and ultimately turn to the WTO to resolve issues where there is evidence of non-compliance, nor be deterred from imposing safeguard measures by potential reflexive countermeasures.

3) ...through Pursuing a Comprehensive Bilateral Investment Agreement with China

The European Chamber welcomes the EU-China Joint Communiqué on the occasion of the EU-China

³⁴ Whilst the recommendations in this paper are primarily aimed at PRC governmental authorities, the European Union Chamber of Commerce in China also offers the below recommendations to European Union authorities and individual European member state authorities.







Summit to work together to pursue a 'rich in substance EU-China investment agreement'. Negotiations offer an opportunity for the second largest economic partnership in the world to both promote and protect investment. Such an agreement must take into account investment realities and must therefore cover market access barriers within a wide range of industry sectors. The European Commission should pursue a comprehensive yet realistic agreement covering both post-establishment and pre-establishment national treatment, which would in the long term be beneficial to the economies of both China and Europe.

4) ...through Identifying and Developing Mutually Beneficial Cooperative Projects to show the Benefits of Access

Europe and China have both recently issued medium-term development strategies. These two strategies are very similar. At the core of both the EU's 2020 Strategy and China's 12th Five-Year Plan is the drive for green and sustainable growth based on an innovative economy. As China aims to rebalance its economy through increasing domestic consumption, relying less on exports and opening its economy, this process will bring the economies of the EU and China closer together and will bring greater synergies and opportunities for cooperation in the business relationship, for example in joint R&D projects.

The EU and China should together identify opportunities for cooperation where the EU can assist China's development path through imparting experience from the lessons of its own development process. The EU-China Partnership on Urbanisation is one such example where cooperation could be massively beneficial for the overall sustainability of China's urbanisation course, while also providing opportunities for EU business in the process. Such partnerships are not only important for their direct benefits to both parties, they can also assist in moulding a more positive image of the EU-China relationship in the eyes of the public.






Table 1: Examples of Improvements in the Business Environment

Working Group	Improvements in the Business Environment over the Last Year
Aviation 	<p>Computer Reservation Systems regulations to allow limited foreign market access: The Civil Aviation Administration of China has approved the long-awaited Interim Computer Reservation Systems (CRS) regulations, which will allow limited market access for foreign CRS providers into 5% of China's market, as a first step. This issue has long been highlighted by the European Chamber as a key market access barrier and so the regulations are greatly welcomed, although concerns are aroused by anti-competitive actions being taken by the incumbent Chinese CRS provider to close the market before it is opened by attempting to sign exclusivity contracts with the top 50 travel agencies that service the very foreign airline CRS market that CAAC is trying to liberalise.</p>
Public Procurement 	<p>De-linking indigenous innovation policy and government procurement: In November 2011, the State Council issued a notice directing all local government entities to remove any mention of linkage between indigenous innovation policy and government procurement incentive measures within regulatory documents and to stop such implementation by 1st December 2011.</p>
Banking & Securities 	<p>Steps towards liberalising the financial services sector: There has been a reasonably substantial level of progress in the financial services sector since the change in leadership of the financial services regulators:</p> <ul style="list-style-type: none"> • An expansion of quotas for Qualified Foreign Institutional Investors • Announcements to increase ownership caps in securities joint ventures and to increase foreign debt quotas. • Permitting greater private lending to SMEs in Wenzhou and making it easier for overseas investment in a pilot project on private financing. • Initiatives to allow greater international use of the Renminbi. • Greater experimentation with the issuance of municipal government bonds
Information Security 	<p>CC-IS information security license granted for the first time to a WFOE: A China Compulsory Certification for Information Security Products (CC-IS) license was granted for the first time to a WFOE in May 2012. In order to gain the CC-IS licence for the smart card, it was firstly necessary to attain an Encryption Testing licence from OSCCA. This also represented the first time an Encryption Testing licence had been granted to a WFOE by OSCCA. This is a strong forward step as it indicates that OSCCA has recognised that the core function of smart cards is not encryption. However, the process for licensing still precludes foreign-invested semiconductor manufacturers from accessing the commercial encryption product marketplace because certification was contingent on a need for the chip used on the smart card to be produced by a Chinese semiconductor manufacturer with embedded Chinese national encryption algorithms.</p>
Insurance 	<p>Opening mandatory third-party liability insurance for motor vehicles to foreign-invested insurance companies: Decision 618 of the State Council in March 2012 announced that the market for mandatory third-party liability insurance for motor vehicles would be opened to foreign-invested insurance companies as of 1st May, 2012. This means that all insurance companies, including foreign insurers, will be allowed to sell mandatory minimum coverage for motor vehicles, which represents more than 70% of the non-life insurance market. As such, the European Chamber looks forward to the release of implementation details.</p>
ICT 	<p>Opening national ICT research projects to foreign enterprise participation: In April 2012, restrictions were removed on foreign-invested enterprise applications to participate in key national ICT research projects, namely the Chinese National Significant Science & Technology Project and the 863 Project. The European Chamber welcomes this and hopes that the removal of restrictions in project application requirements will allow for increased participation of European-invested companies in such projects, ultimately resulting in greater collaboration and productivity in ICT research in China.</p>



 : The red flags denote key recommendations perceived to be clearly market access related

Taxation	<p>Pilot projects to replace the Business Tax with a Value-added Tax: There have been strong movements towards fully replacing the Business Tax with a Value-added Tax that was announced as part of the 12th Five Year Plan. A government-supported VAT reform pilot programme for Shanghai that aims at structurally cutting tax on transportation companies was approved in November 2011. This was followed by an announcement in July 2012 that the pilot programme will be expanded to 10 further provinces and cities between 1st August, 2012 and 31st December 2012. Affected companies will be taken off the Business Tax rolls and are instead required to pay VAT.</p>
Healthcare Equipment	<p>Reducing clinical trial registration requirements for some medical devices: The Notice on the 'Catalogue of Exemption of Submission Clinical Trial Documents for Class II Medical Devices (for trial implementation)' was issued by the SFDA on November 2011. The notice provides the foundation for certain medical device products to obtain exemptions from clinical trials once the regulation is officially issued.</p>
Legal	<p>Increasing transparency and consistency in the legislative consultation process: The State Council Legislative Affairs Office issued provisional measures intended to streamline and improve transparency in the consultation process for draft legislation and regulations and to improve public participation. Article 6 of these 'Provisional Measures on Soliciting Public Opinions on Laws and Regulations' establishes that "public consultation for draft regulations should not be less than 30 days". Although it is still recommended to extend the public consultation period to at least eight weeks in line with international practices, the European Chamber welcomes this as a first step towards standardisation of the consultation system and will monitor how these measures are implemented in practice.</p>
Energy	<p>Pilot projects to replace cost-plus natural gas pricing with a net-back pricing regime: NDRC announced China's plan for a new natural gas pricing regime and started pilot trials in Guangdong and Guangxi provinces. For domestic onshore pipeline gas and imported pipeline gas, traditional cost-plus pricing is replaced by a new regime based on net-back value of natural gas against alternative fuels. Shanghai is chosen as the hub, or reference point, for calculating the net-back value of gas, from where wellhead price (for domestic onshore pipeline gas) and China border price (for imported pipeline gas) is net-backed and the gate price is derived for each province. Based on the two pilots, the new pricing regime will be promoted across the country. Compared to previous gas pricing reforms which only involved small gradual adjustments, this one is a major step forward in streamlining prices along the gas value chain and is in line with the European Chamber's 2010/11 and 2011/12 Position Paper recommendations.</p>

Table 2: Examples of Deteriorations in the Business Environment

Working Group	Deteriorations in the Business Environment over the Last Year
Logistics 	<p>Prohibiting foreign investment in domestic express delivery services for letters: Domestic express delivery services for letters have been added to the prohibited category in the Foreign Investment Catalogue released in December 2011. This places a restriction on the autonomous right of domestic clients and consumers to select services and makes it impossible for foreign express delivery companies to obtain a level playing field. At the same time, although the China Postal Law stipulates that express delivery services for parcels is still open to foreign companies, no foreign company has been granted a national domestic parcel express license since the Law was issued in 2009. These examples of restrictions for both parcel and letter express delivery services go against the long-term development interests of the sector, as well as Chinese efforts to bolster the services sector of the economy.</p>
Public Procurement 	<p>Lack of determination to open government procurement or join the Government Procurement Agreement: More than ten years after joining the WTO, China submitted a second revised GPA offer that was extremely limited in scope and included very little coverage underneath the central level and none at the local or SOE level, which is where the vast proportion of China's public procurement takes place. China is expected to submit another GPA offer in 2012, yet the Ministry of Commerce has stated openly that China is unlikely to join the GPA this year, and the Ministry of Finance has recently issued a statement that central government departments should continue to buy made-in-China products when implementing government procurement policy.</p>
Private Equity 	<p>Disallowance of any money sourced from overseas in private equity funds classified as domestic: The National Development and Reform Commission released a 'reply' in April 2012 to overrule the 'Shanghai Circular 38' which regulated a Qualified Foreign Limited Partner pilot program that had been previously welcomed as a positive development for encouraging foreign investment. Previously, the rules stated that a fund could be classified as being domestic even if up to 5% of the fund's value was sourced from overseas, but 'the reply' stipulates that unless 100% of a private-equity fund's money comes from local sources, it will be treated as a foreign fund and therefore subject to additional scrutiny and obstacles, thus also raising negative implications for the plan to develop Shanghai into an international financial centre.</p>
Pharmaceuticals 	<p>Administrative 'cost plus' price reductions of pharmaceuticals: Since 1998 the National Development and Reform Commission has mandated 28 drug price reductions estimated to have impacted 1,318 types of drugs by an average of 21%. The European Chamber is concerned about the recent acceleration of this trend and the potential elimination of price differentials between innovative and generic drugs. The 'cost-plus' pricing system implemented does not encourage innovation and has a negative impact on drug quality in China, which in turn does not allow the generation of real cost benefits through the reduction of overall drug expenditure and keeping more people out of hospital. The implementation of the 'single reimbursement price' for newly-listed 'National Reimbursement Drug List' drugs would also mean that local generic drugs may be fully reimbursed while originator drugs may be only partially reimbursed, thereby causing an uneven 'playing field' and substantially restricting market access for more innovative European manufacturers.</p>
Healthcare Equipment 	<p>Administrative 'cost plus' price reductions of medical devices: Medical devices continue to be a target of administrative price controls. A tendency to adopt a cost-based approach on pricing and tendering leads to a forced price reduction during the tendering process. The cost-plus approach for medical devices adopted by the National Development and Reform Commission is not in alignment with the development of a market economy and stifles innovation and efficiency. Commoditising devices by ignoring value-based pricing and the associated technical training, services and costs in applying the devices to patients by a wide range of surgical and procedural means will drive out physician and patient choice and stifle innovation and quality. The tendency of using administrative measures that stipulate a maximum mark-up from the import price of foreign enterprises and the ex-factory price of domestic manufacturers will also constitute a market access barrier for European manufacturers, and set obstacles to outstanding domestic companies in further development.</p>

 : The red flags denote key recommendations perceived to be clearly market access related

<p>Standardisation</p> 	<p>Closed or restricted foreign market access in standardisation processes: The participation of foreign-invested enterprises in a number of standards-developing bodies is frequently severely constrained, for example many technical committees, particularly common under the Ministry of Industry and Information Technology, only grant foreign-invested enterprises observer status and therefore no voting rights. In some standardisation activities in sectors including ICT, information security and electromagnetic compatibility, participation is not allowed in any form. This exclusion directly translates to restricted market access for these enterprises as they are faced with extra costs and difficulties in standard conformity. For example, although often introduced to the market as voluntary, many such standards go on to be mandated through certification schemes and have had a tendency to mandate Chinese proprietary technology in certain sectors. This exclusion can therefore also result in potentially reduced customer satisfaction and impediments to innovation.</p>
<p>Automotive</p> 	<p>Non-inclusion of foreign brand automobiles in a draft catalogue for government automobile procurement: In February 2012, the Ministry of Industry and Information Technology issued a draft '2012 Catalogue of Automobiles for Selection as Official Cars for Party and Government Organs', in which all of the 412 prescribed vehicle models are Chinese independent brands. Foreign brands, and foreign brand-vehicles produced in China by Sino-foreign joint venture companies, were not included on the list for selection and thus excluded from this large market.</p>
<p>IPR</p>	<p>Weakened trademark protection: In the last year, there have been two disconcerting developments regarding trademark policy in China. In December 2011, the Supreme People's Court issued an Opinion that legal actions launched by a registered trademark owner against the user of a similar trademark, i.e. an infringer, should be dismissed when the infringer has built a reputation of its own, thus allowing the infringer to continue. This constitutes an encouragement to infringers and raises serious questions as to the compatibility with the Chinese Trademark Law and the TRIPS Agreement. In addition, the 2011 draft revision to the 'Trademark Law' introduces the concept of 'local famous trademarks' in the same article relating to 'well-known trademarks'. Whereas the 'well-known trademark' is a legal concept that provides an exceptional protection in favour of certain reputed trademarks, these 'local famous trademarks' are an 'award' granted by the local Chinese Administration to help Chinese enterprises promote their products/services. Introducing this term in the Trademark Law is therefore a fundamental misconception which confuses protection and promotion.</p>
<p>Private Equity</p>	<p>Uncertainty caused by the security review mechanism for domestic M&A: Vagueness in the provisions of the Ministry of Commerce on 'Implementing a Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors' that came into effect in September 2011 poses a risk that such a mechanism could be used to stop investment using claims of national security. The scope of the review is ambiguous and so leads to uncertainty and poses a risk of uneven implementation as it leaves the decisions of whether a transaction is subject to review or should be terminated up to the discretion of regulators. The late-2011 release on the websites of a number of provinces of a list of 57 sectors for which it is said the review will apply caused further confusion as the list includes some sectors that are in the 'encouraged' section of the Foreign Investment Catalogue and so would not be expected to be subject to the security review mechanism.</p>
<p>Human Resources</p>	<p>Implementation difficulties and continued uncertainties for foreign employee contributions to China's social security system: 'Several Rules for Implementing the New Social Insurance Law', released by the Ministry of Human Resources and Social Security, became effective 15th October, 2011. This date marked the commencement for the contribution of foreigners to the five mandatory social insurance schemes in China. Despite this, a large number of local Human Resources and Social Security Bureaus did not release implementation and registration requirements for many months afterwards, meaning that it was not possible to enjoy social insurance benefits despite being required to pay contributions. In addition, the new policy on social insurance for foreigners remains unclear in many regards, including in terms of rules for accessing pension and unemployment benefits, deadlines for decisions to uphold or refund payments and the taxation of contributions to home-country insurance schemes under bilateral agreements. These have made it difficult for both companies and employees to comply with the new rules.</p>

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