Information Technology Industry Council
Leading Policy for the Innovation Economy

Written Testimony to the United States International Trade Commission

Investigation No. 332-514 Hearing
China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy

Presented by:
John Neuffer, Vice President for Global Policy
Information Technology Industry Council (ITI)

June 15, 2010

The Importance of the Chinese Market

The Information Technology Industry Council (ITI) deeply appreciates the opportunity to provide testimony on this important topic. We applaud the U.S. International Trade Commission for undertaking this investigation. ITI puts a great deal of focus on the range of China issues, including China's indigenous innovation policies, which are both challenging and troubling. I would add that ITI, along with the Software & Information Industry Association, also represented on this panel, are parent associations of the United States Information Technology Office (USITO) in Beijing. USITO has stood out as a leader in helping us and others address the wide array of China issues before the business community, including indigenous innovation.

China is a very important market to our member companies. Hundreds of thousands of American jobs in high tech are directly tied to robust business with China. Last year, U.S. exports to China were nearly $70 billion dollars, up four-fold from a decade ago. Some of the largest beneficiaries of that trade are workers and businesses, many of them small businesses, who manufacture electrical machinery and equipment or develop software. If we are ever going to be able to achieve President Obama's ambitious goal of doubling exports in five years, the United States will need to have fair trade with and open access to markets in China.

Moreover, the lion's share of research and development -- intellectual property, know-how, technical design -- that goes into products manufactured by U.S. companies in China are developed here by American scientists, engineers and workers.

We welcome China's efforts to create more innovative companies and to promote the development of innovative capabilities. Our companies have decades of experience building and creating innovative products throughout the world, with intellectual property rights (IPR) protection being at the core of spurring innovation.

The Problematic Face of "Innovation" in China

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

Many of our difficulties in China manifest themselves in the government procurement arena, though our problems with China's approach to innovation extend far beyond this realm. It is difficult to get a good fix on how big the Chinese procurement market actually is, given the complexities of government procurement at the local level and the vast and diverse array of State-Owned Enterprises. China's Ministry of Finance reports that the central government procured $88 billion in goods and service in 2008, and it's a growing market. That $88 billion is three times the number in 2003. Significantly, it includes a substantial portion of IT sales in China. For example, the market research firm IDC asserts that public procurement of personal computer (PC) sales in China accounted for 14 percent of the Chinese PC market in 2009.

China's State Council formalized its indigenous innovation initiative in 2006 with the *Medium- and Long-Term National Plan for Science and Technology*. The policy's chief aim is to give a leg up to domestic producers by compelling government agencies to adopt rules and regulations favoring products that use Chinese-developed ideas and technologies. The problem is, such polices more often than not do this at the expense of foreign players who have worked for

decades in partnership with China to promote growth and prosperity and deliver the most innovative products to the people of China. This puts at risk all past and future investments that our companies have made in that market.

While China's innovation polices have been a major source of concern for some years now, they came into bold relief when the Chinese government set down new rules last November to establish a national catalog of products to receive significant preferences for government procurement. Among the many problematic criteria for eligibility were stipulations that products contain intellectual property developed and owned in China, and that associated trademarks be originally registered in China. This was an unprecedented use of domestic IP as a condition of market access and was a scheme that made it nearly impossible for American companies to qualify. IP is developed all over the world, not just in one country. The Chinese directive targeted some of our most innovative and competitive manufacturing and services industries, including computers, software, telecommunications and green technology.

Then, in December, several agencies, including the State-Owned Assets Supervision and Administration Commission, announced the government would develop a broader catalog of indigenous innovation products and sectors to gain preferences beyond the procurement realm. In essence, the announcement looked as if China was encouraging its plethora of State-Owned Enterprises to discriminate against U.S. and other foreign enterprises in their purchasing practices, including for commercial purposes.

In addition, there is growing concern with an apparent attempt by China to pursue policies that forthrightly promote import substitution. To wit, the December announcement clearly specified import substitution in its criteria.

Fortunately, in the face of intense criticism from the global community, China has paused a bit and promised to factor in our concerns as it considers how to move forward with its indigenous innovation product accreditation program. In fact, this was a top-priority agenda item for the U.S. government in the recently concluded U.S.-China Strategic and Economic Dialogue

convened in Beijing last month. We will very carefully watch China's next step and continue to engage with the U.S. government on this issue.

China's road to innovation is not through the development of product lists by governments, which risks dampening greater foreign investment in China and discouraging innovative partnerships between Chinese and foreign firms. We see the list approach as neither effective for promoting innovation nor competition. Product lists, by their very nature, are limited, do not accommodate innovative new technologies, and therefore have the opposite of the intended effect on innovation. With all due respect to bureaucrats, we strongly feel they should not be the ones deciding which products are innovative and which ones are not. As our own experiences demonstrate, efforts to separate innovation efforts from the markets and international economy will result in much less productive innovation.

We want to join with our global industry colleagues to emphasize that the challenges posed by China's indigenous innovation policy are not just about these discrete procurement practices. The many policies that encompass China's indigenous innovation drive are structural issues with direct consequences for market access and the ability of American and other foreign firms to compete on a level playing field in China.

Another area we would ask the ITC to investigate is the impact of China's propensity to develop and deploy its own country-specific standards. Several years ago, for example, China endeavored to mandate a homegrown wireless standard called WAPI, despite the existence of a technology widely used around the world known as WiFi. Under the auspices of the U.S.-China Joint Commission on Commerce and Trade (JCCT), China ultimately agreed in 2004 to take steps toward a market-based, technology-neutral approach to the development of next generation wireless standards and to "suspend indefinitely its proposed implementation of WAPI as a mandatory wireless encryption standard."

Undaunted, the Chinese have pushed forward with WAPI anyway and it is now a *de facto* mandated standard enforced by using the handset "type approval process" controlled by the Ministries. To be sure, WiFi handsets are available in China now, but only if WAPI technology is built-in and enabled.

Emboldened, the Chinese may now be looking to do the same thing with PCs and servers by requiring that such equipment sold in the country include a technically unknown and untested "Trusted Cryptography Module" chip -- despite the existence of an internationally developed standard known as TPM, or Trusted Platform Module.

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

In addition to China's problematic approach to standards, companies face manifold rules and regulations that are overlapping, unnecessary and onerous. We see a lot of this in compliance requirements related to safety and other product testing. And there is an increasing trend to impose burdensome testing and certification regulations on information security products that are inconsistent with global norms and requires disclosure of sensitive information that make them unworkable to nearly all foreign players. The far-reaching Multi-Level Protection Scheme, for example, would place completely unworkable testing requirements on nearly all high-tech products going into critical infrastructure systems in China. In fact, the program appears to be aimed in part at putting a large part of the Chinese economy out of competition from foreign providers of goods and services.

In sum, whether through government procurement, standard setting, cyber-security, safety testing, or an unwillingness to enforce laws to protect intellectual property and prevent counterfeiting and piracy, the two common threads running through most of our challenges with China are polices that advantage domestic companies at the expense of foreign firms and that attempt to force the transfer of technologies.

Implementation of these policies are imposing onerous and discriminatory requirements on companies seeking to sell into China, promoting systematic import substitution, and contravening multiple commitments of China's leadership to resist trade and investment protectionism and promote open government procurement policies.

Consequences for the United States

Whether or not China can be knocked off its troublesome indigenous innovation vector has significant implications for the United States, its companies and its workers.

Broadly speaking, China going its own way in an increasingly globally integrated economy threatens to generate massive inefficiencies in the international marketplace. American and other foreign companies are faced with having to develop bifurcated product lines – one to meet China's unique standards and regulatory requirements and another for the rest of the world.

China is now eclipsing Japan as the second-largest economy in the world. Our economic destiny is tied to unfettered access to that market. Healthy U.S.-China bilateral relations require a growing economic relationship based on mutual openness. China's systemic efforts to develop polices that grow their domestic enterprises at the expense of U.S. companies and the intellectual property they develop and deploy is a framework that cannot be, should not be, accepted or accommodated by the United States and other global stakeholders.

Given the stakes involved, we applaud the USITC for conducting this important investigation into understanding the nature of indigenous innovation and the scope of IPR infringement in China. As you undertake this important work, we ask that you not only focus on the commercial implications of problematic policies in the government procurement realm, but also the impact on American companies' ability to sell in that market given China's propensity to develop country-specific standards, its inclination to implement onerous and unnecessary technical regulations, and its unwillingness to strictly enforce laws to protect intellectual property. We applaud your efforts to examine the impact of these policies on the U.S. economy and American jobs, which will be very helpful as we continue to make the case that China's indigenous innovation policies are problematic, veer markedly from global norms, and create significant and troubling market access barriers. We look forward to assisting you in the coming weeks and months as you advance your work. Thank you.

# # #