THIRD WAY

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The TPP: Who Will Set the Trade Rules for Asia?

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Asian import markets are set to expand to almost $10 trillion by 2020. The economic benefits for the rest of the world could be staggering, but it depends on who writes the rules for trade. At this moment, America and like-minded Asia-Pacific countries are negotiating an agreement to set high-standard trade rules. China—now the largest economy in Asia—is penning its own trade rules and seeking signatory nations. The $10-trillion Asian market is the most obvious prize for this competition, but these competing agreements could also set the tone for the rest of the developing world. Will they choose the U.S. model or the China model for growth?

Asia has experienced remarkable economic growth since the 1990s; goods imports into 12 leading Asia-Pacific economies grew from $1.77 trillion in 2000 to $4.37 trillion in 2010. [1] Yet during this time, the U.S. share of this market fell 43%, representing the biggest decline of any major trading partner with Asia. Imports by these same 12 Asia-Pacific economies are expected to reach $9.63 trillion by 2020. [2] If the U.S. were to reclaim our historical share of these markets, it would increase U.S. exports by almost $600 billion in 2020 alone—supporting over 3 million jobs. [3] Is this possible? It all depends on the rules for trade.

At this moment, the United States and like-minded countries are seeking to win a high-standard trade agreement that will ensure Asian markets will be open and transparent, and adopt mature labor, environmental, and regulatory standards.

As America and like-minded countries negotiate the Trans-Pacific Partnership agreement (TPP), across the Pacific Ocean, China has a different vision of the right way to do business—and is racing to get there first. In May 2013, China participated in the first round of negotiations on its own regional trade agreement in Asia, the Regional Comprehensive Economic Partnership (RCEP). The RCEP

includes all of the TPP countries (except the United States, Chile, and Peru) along with India, South Korea, and several smaller countries.

In this paper, we look at three key elements of China's domestic economic system: exclusion; favoritism; and lower standards for labor and corruption. We examine how they shape China's approach to international trade rules and describe why China's rules would harm U.S. exporters and investors. We also discuss how the U.S. approach would get things right. The choice is up to Congress: are they going to let the United States lead in Asia with high standards for the region...or will they let China set the rules for how business is done?

1. Transparency or Exclusion?

Chinese trade policy closes off markets through hidden discrimination and tricky rules. Foreign exporters, investors, and service providers are routinely kept at bay through screening mechanisms, mandatory joint ventures, requirements to transfer proprietary technologies, and outright bans. In addition, the government often administers regulations in an opaque, discriminatory manner and designs industry standards to favor Chinese companies. In contrast, the United States features transparent, open markets where all businesses know the rules. China's approach would mean that U.S. businesses would be susceptible to discrimination and complete market uncertainty.

Investment

China often protects its domestic enterprises from competition by restricting foreign direct investment (FDI).[4] They do this by using screening mechanisms to maintain close control over who gets in: every investment into the country must be reviewed. Chinese government officials have discretion over the outcome of the review,[5] and restrict entry "on an ad hoc basis."[6] China's trade rules offer no protection against government discrimination during this approval process.

> *China was rated the most restrictive country for foreign direct investment out of 57 reviewed by the OECD—worse than Saudi Arabia and Indonesia.* [7]

Key industries in China are explicitly off limits to foreign trade and investment in order to restrict competition. For example, foreign manufacturers of automobiles and auto parts can only do business in China through minority-share joint ventures with Chinese companies [8] —unless they want to face 25% tariffs on imported vehicles. [9] In addition, China's regulations create unduly high "thresholds for entry" into key services sectors like banking, [10] energy, [11] telecommunications, [12] electronic payments, [13] insurance, [14] express delivery, [15] legal services, [16] and online services. [17] Because investment restrictions are extensive at home, China's trade agreements operate on a "positive list" format, where only the industries on that country's list are open for foreign participation. Unsurprisingly, sectors in which foreign businesses are competitive do not tend to make the list.

U.S. trade agreements, on the other hand, support an open market for investment. They explicitly provide protections for investors that are seeking to establish their investments. [18] They also operate on a "negative list" format: all industries are open for investment unless exceptions are listed. [19] The United States takes limited, narrow exceptions and presses its negotiating partners to do the same. Even in excepted areas, governments still have to provide fair and equitable treatment to foreign investors. [20]

Regulatory Discrimination

Laws and regulations are created in an opaque way in China. Trade-related measures are routinely implemented without advance publication [21] —despite China's World Trade Organization commitments to publish draft laws in advance —and they are often constructed to give China flexibility in

applying them.[22] To maintain this system of smoke and mirrors, Chinese trade agreements do not require governments to give businesses the opportunity to comment on new rules and regulations that might affect international trade.[23]

Enforcement is even more problematic. According to a survey of American companies that do business in China, the Chinese government is often stricter with foreign companies in enforcing the rules.[24] Foreign companies also have a harder time than domestic companies in obtaining administrative licenses to sell their products in China,[25] and may face discrimination and bribe requests from Chinese officials during the licensing process.[26]

Unlike China, the United States makes laws and regulations in the light of day. Draft legislation in Congress is posted on the Internet for the world to see. The Administrative Procedure Act requires U.S. regulatory agencies to provide the public with at least 30 days to comment on proposed rules and ensures that the final rule cannot become effective until at least 30 days from its publication.[27] U.S. trade agreements require similar openness from trading partners regarding proposed rules,[28] administrative procedures,[29] and the development of standards and technical regulations.[30]

Why does it matter?

Closed industries and discriminatory licensing cut U.S. businesses out of China. Even if they get in, opaque regulations leave American companies uncertain and scrambling to comply. Selective enforcement burdens them with scrutiny and delays that their domestic competitors do not face. If China sets the rules for Asia, governments across the region could reverse years of progress toward openness and transparency. U.S. companies would, in turn, face exclusionary economic climates in which they would struggle to export and invest competitively. And then there would be no going back.

2. Fairness or Favoritism?

China helps its state-owned enterprises (SOEs) and domestic companies through preferential treatment. In addition, local and national authorities in China inconsistently enforce anti-trust laws, [31] often using the law to restrict competition rather than to encourage it. [32] On the other side of the Pacific, the United States works hard to ensure that market power is balanced with fairness and open competition. China's trade rules would mean that U.S. businesses might not be able to compete with favored companies throughout Asia.

SOEs Have it Made

SOEs dominance of the Chinese economy was waning in the 1990s [33] as the government sold off many SOEs and allowed the growth of private enterprises. Since 2006, however, the government has re-emphasized state-led capitalism and has "formally set aside the core of the economy for SOEs." [34] Reforms have merged and consolidated SOEs to form bigger, stronger companies [35] in key industries. For example, Sinopec and the China National Petroleum Corporation dominate China's oil market, holding 77% of refining capacity and 80% of retail fuel sales. [36] In telecommunications, China Mobile has over 60% of China's mobile phone market. [37] These bulked-up national champions are among the largest companies in the world—and the government has encouraged them to expand abroad. [38]

To keep SOEs in the lead, China gives them benefits that are hard to beat: loans at below-market rates, easy license approvals, lower taxes, cheap utilities, cheap or free land, sweetheart deals on government contracts, and direct financial subsidies. [39] If foreign competition threatens despite these advantages, SOEs can often rely on the government to help them fend off competitors through regulatory favoritism. Larger SOEs often have more power than government Ministries because their chairmen are appointed directly by the powerful Central Committee of the Communist Party of China (CCCPC). [40] Moreover, it is not

clear whether China's anti-trust laws even apply to SOEs; they may be immune from prosecution. [41]

Freed from competition through carefully-constructed trade barriers, some SOEs use their market power to dominate domestic industries. With artificially-inflated revenues at home, SOEs can afford to "expand overseas more aggressively" than U.S. or Chinese private companies. [42] In 2011, SOEs accounted for 80% of China's $60 billion of outward foreign direct investment. [43] At the other end of the spectrum, other SOEs are "parochial, poorly performing companies" that only stay afloat due to generous loans and subsidies [44] ; these companies distort competition and drain public resources.

China's trade agreements ignore SOEs: they simply do not mention them. SOEs have a "disproportionately strong voice in FTA negotiations," [45] so they are interested in ensuring that China's trade rules allow the government to give out favors. Regarding anti-trust laws, China's trade rules do not require countries to have adequate laws and penalties and instead give countries flexibility to pursue anti-trust enforcement selectively. [46]

In the TPP, the United States is seeking strong standards in this area by setting groundbreaking rules to address fair competition with SOEs. [47] The U.S. proposal for TPP text on SOEs has not been made public, but may seek to create "'competitive neutrality' between state-owned enterprises... and private sector companies" [48] by limiting governments' capacity for favoritism. In addition, U.S. trade agreements typically set minimum standards for competition laws and authorities [49] along with provisions for transparency regarding enforcement and anti-trust exemptions or immunities. [50]

Private Enterprises Also Favored

Domestic enterprises in China also get preferential treatment. According to the US-China Business Council, the Chinese private sector receives advantages in loans, licensing, taxes,

government contracts, regulatory treatment, and other key areas.[51] In legal services, for example, foreign law firms are not allowed to accompany clients to meetings with government officials in China—only Chinese firms are allowed to do this.[52] In other sectors, China has a record of trying to force foreign entities to transfer their intellectual property to Chinese entities, or to force them to create intellectual property in China, in order to access the Chinese market.[53]

When new industries emerge, China wants to make sure that domestic companies dominate. The government sometimes makes foreign market entry conditional on transferring proprietary technology to domestic companies[54] —which is then theirs to reproduce. In other cases, incentives are enough: as China focused on developing a domestic electric vehicle industry in 2009, it created barriers and benefits that favored domestic companies over foreign manufacturers,[55] including "forced technology transfer."[56]

China's trade rules are built to support this preferential treatment, and they allow ample space for governments to favor domestic private companies. On the other hand, U.S. trade agreements offer robust 'national treatment' requirements that establish a level playing field—and offer remedies for discriminatory treatment. In addition, for over a decade, U.S. trade agreements have included provisions requiring trading partners to strengthen intellectual property rights to bring them closer to U.S standards, and to prohibit technology transfer requirements.[57]

Why does it matter?

The global trend toward relaxing state control over domestic economies has reversed in the 2000s.[58] Developing economies are increasingly eyeing China's economic approach—especially regarding SOEs and government favoritism.[59] China's trade rules would encourage governments to subsidize and protect their domestic firms at the expense of open markets and fair competition. If key sectors in Japan, India, Indonesia, and Thailand were reserved

for favored domestic companies, U.S. businesses would not be able to keep up.

> **21st Century issues: Supply chains, SMEs, e-commerce**
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> *Trade agreements are not only about removing tariffs and establishing protections. They also typically include trade facilitation provisions that can bring greater efficiencies to global markets by decreasing the cost and time needed to get goods across borders. The TPP seeks to go beyond basic trade facilitation to develop cooperation on supply chain facilitation; simplified trade for small- and medium-sized enterprises (SMEs); and e-commerce regulations. By smoothing the flow of international trade and by empowering SMEs, the TPP can truly be a "21st -Century" trade agreement.*

3. High or Low Standards for Labor and Corruption?

Chinese environmental problems are well documented—from 16,000 dead pigs in Shanghai rivers to hazardous air pollution throughout the country.[60] The environment is not the only area in which China's standards lag: China deals with labor and corruption by sweeping those difficult issues under the rug. China's laws are often not up to international standards, and implementation and enforcement are inconsistent at best—and politically selective at worst. In contrast, the United States mandates good working conditions, outlaws bribery, and seeks to raise the bar for trading partners on these and other critical issues. China's approach would mean that Asian companies would not need to aim high, thus leaving U.S. companies in the dust for doing the right thing.

Labor

China's labor conditions often do not meet basic global norms. [61] China does not allow workers the freedom of association, as independent unions are banned. [62] Strikes are also banned. The All-China Federation of Trade Unions (ACFTU), which is controlled by Communist Party, is the only organization that can legally represent workers' interests. The main purpose of the ACFTU and its local branches is to "prevent work stoppages," [63] which leaves them "generally ineffective" [64] in genuinely representing workers' rights.

In areas where China's laws match global norms, enforcement lags perilously behind. Worker safety laws are "inadequately enforced" because China does not devote enough resources enforcing them. [65] For example, employing children under 16 is illegal in China, but children can often be found working in electronics manufacturing and numerous other sectors. [66] Laws against forced prison labor are also not effectively enforced. [67]

Chinese companies often promote poor enforcement. To avoid complying with labor laws, domestic companies routinely leverage privileged relationships with government officials and commonly engage in double bookkeeping. [68] The 2007 Labor Contract Law has made strides in increasing formal employment, [69] but China has a long way to go on labor issues.

China rarely wants to talk about labor standards in diplomatic conversations—and certainly does not include anything meaningful about labor in its trade agreements. [70] In contrast, the United States requires trading partners to "adopt and maintain" labor laws and practices that meet international norms, avoid making exceptions on implementation that impact trade or investment, and provide fair access to—and fair treatment in—labor tribunals. [71]

Corruption

China also has a serious corruption problem. A culture of corruption has taken root wherein "people who have good connections…grease the palm of the [government] officials

to get things done."[72] Domestic businesses often resort to bribery to ensure their success in investing, acquiring land, getting licenses, and avoiding compliance with the law. The government is known to award contracts based on bribery rather than on commercial criteria.[73] Corruption is particularly entrenched at the local and regional levels.

The Chinese government agrees that corruption is "one of the most serious problems the country faces," which may threaten the Communist Party's long-term viability.[74] As such, China is trying hard to push back against corruption. In 2011, China updated its laws on combatting business bribery of foreign public officials to match international standards. China says that over 660,000 officials have been punished for corruption from 2008 to 2013,[75] and much of that was before President Xi Jinping and Premier Li Xi Keqiang led a drive against corrupt public officials in 2013.

Despite recent efforts, enforcement is lacking. Implementation of foreign bribery laws and contract bidding regulations has been cloaked in mystery.[76] Powerful officials and entities, including SOEs, act "with impunity"[77] as courts are unable to enforce corruption judgments against them. The Party selectively chooses which public officials to punish—often on the basis of political tussles within the Party—and is especially reluctant to punish the highest ranks of Party leaders, unless there is a power sturggle within the Communist Party.[78]

Unsurprisingly, China's trade agreements do not address corruption and bribery. In contrast, the United States makes anti-corruption provisions an important part of its trade agreements. Trading partners are obligated to "adopt and maintain" criminal laws against soliciting bribes as well as offering or giving bribes to domestic or foreign officials.[79] They are also obligated to establish "appropriate penalties" and enforcement mechanisms.[80] The United States also presses trading partners to improve enforcement per their commitments to multilateral anti-corruption

agreements in the United Nations and Organization for Economic Cooperation and Development.

Why does it matter?

Chinese companies that avoid complying with labor laws cut back on costs because they do not pay adequate wages, create safe work environments, provide overtime, or contribute to social insurance. Under China's lax trade rules on labor issues, less-developed Asian countries may have limited incentives to align their own practices with international norms. U.S. companies that follow the rules would have trouble competing with local companies across Asia that do not.

Corruption is a significant problem in China and in other key Asian markets. Many countries, including Japan, have weak anti-corruption authorities or poor enforcement records. [81] Companies that bribe local officials in these countries are likely to beat out companies that do not bribe. Due to strong Department of Justice efforts to enforce the Foreign Corrupt Practices Act, [82] U.S. companies are unlikely to bribe while doing business abroad. Under China's trade rules, U.S. companies could struggle to compete in Asia even when they offer a better service at a better price.

Conclusion

China's business model is a huge threat to U.S. businesses and should be a huge warning for U.S. policymakers. China's use of discrimination, opacity, and arbitrary and unpredictable business regulations keeps its companies competitive at home—and China's trade rules reflect and promote this approach abroad. If the rest of Asia buys in, U.S. exporters could be left out in the competitive cold, which would mean fewer U.S. exports, dampened U.S. growth, and slower job creation here in America.

But this does not have to be our destiny. By supporting the TPP, policymakers can set the rules in Asia so that the U.S. economy can benefit and thrive. Through the TPP, Congress can establish rules that encourage open markets,

competition, clear and just laws, and fair enforcement. Under these rules, U.S. businesses and workers can succeed based on the quality of their products and services, thereby fueling U.S. economic growth.

Who will get there first, and who will set the rules? Negotiations on the Regional Comprehensive Economic Partnership (RCEP)—China's trade agreement for Asia—are scheduled to conclude in 2015. If Congress does not move forward on TPP fast enough, the United States may lose the race.

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