THE US-CHINA BUSINESS COUNCIL
美中贸易全国委员会

1818 N Street, NW, Suite 200, Washington, DC 20036
Tel: 202-429-0340 | Fax: 202-775-2476 | E-mail: info@uschina.org | www.uschina.org

Results of the 2006 USCBC Member Priorities Survey

US Companies Gain in China, Still Face Hurdles

August 30, 2006

Each year the US-China Business Council (USCBC) surveys its members to better understand their perspective on the operating and investment climate in China, as well as China's progress in implementing its World Trade Organization (WTO) commitments. Among the key findings this year:

The results counter several common misperceptions about US companies operating in China.

- Eighty-one percent of companies say that their Chinese operations are profitable, a significant increase from a US government survey in 1999. And more than half say that profitability rates for their China operations meet or exceed their company's global profit margins.
- Most US investment in China is in 100 percent US-owned enterprises, not joint ventures with Chinese partners. This trend has developed steadily with China's market openings; nearly 75 percent of new investment is now in wholly foreign-owned enterprises.
- USCBC companies primarily invest in China to serve the Chinese domestic market, not export back to the United States. Fifty-seven percent of the respondents said that their main investment objective was to access the China market. Only 18 percent invest in China as an export platform to the US market. The remainder export to other countries in Asia or elsewhere around the globe.

The survey reveals several successes in the operating environment.

- Ninety-seven percent of respondents are optimistic or somewhat optimistic about prospects for their China business over the next five years.
- US companies are building their sales presence in China by implementing newly granted distribution rights—a key market opening measure and top USCBC priority in 2005.
- China's WTO-mandated market openings have clearly benefited American companies. Over 80 percent of respondents cite China's WTO entry as meaningful to their business. US exports to China have more than doubled since China's WTO entry in 2001—growing faster than any major US export market.

The results reveal significant remaining operating barriers and identify WTO obligations that China has not yet met.

- The top operating concern this year is not a policy issue—it is human resources. The shortage of experienced and skilled local executive talent, especially in middle management ranks, is a persistent and growing problem for US companies.
- Intellectual property rights enforcement is a top issue, but getting business licenses and approvals has emerged as a more immediate concern. Companies run into licensing issues as they seek to act on WTO openings in sectors such as construction, financial services, distribution, and product licenses.
- Downward pressure on margins may be developing, as competition from Chinese companies investing in excess capacity is cited as a growing problem.
- Other top issues include inadequate regulatory transparency, China's product and technology standards setting process, and the restrictive US visa policies for business visitors.

The full report of survey responses follows.

Importance of China to Worldwide Operations

For the second year, USCBC's annual survey has asked companies to gauge the importance of China in comparison to their global operations. The priority that US companies place on China and the resources they plan to dedicate to growing their businesses there indicate not only the extent of US companies' stake in the continued development of China's economy, but also the depth and importance of the bilateral trade and economic relationship.

China as a business priority

The survey asked respondents to assess how important China is to their companies' global operations. Eighty-seven percent of respondents said China was at or near the top of their companies' priorities—up from 71 percent in 2005 (see Figure 1).

Resource commitment to China

Companies continue to expand their resource commitment to China, as reflected in investment, executive time, expenditures, staffing, etc. (see Figure 2). Three-quarters of the respondents indicated they would boost their resources in China in the coming year, about the same as last year. Another 20 percent indicated that their companies' resources in China would be unchanged. Only 2 percent of companies said they would cut their resource commitments in the coming year.

Financial results from China operations

To assess how US companies are faring in China, the 2006 survey began with a simple question: Are your company's China operations profitable? Eighty-one percent of respondents said they were profitable, and 19 percent indicated they were not (see Figure 3). Though USCBC has not polled its members on this subject before, the question was posed in a 1999 US Department of State survey of US companies invested in China. At that time, only 57 percent of companies reported that their China operations were profitable.[1]

Almost 70 percent of respondents indicated in this year's survey that their companies' China revenues rose in 2005; 80 percent expect increases in 2006 (see Figures 4 and 5). Just 10 percent indicated that their revenues were flat in 2005 and expected their 2006 results to be the same. Only 5 percent of companies reported a decline in 2005 revenue, and only 1 percent expected 2006 revenue to fall.

Companies' profit growth also improved in 2005 over 2004. More than half of the respondents said their China operations' profitability improved over the previous year, up from 44 percent in last

Figure 1: China's Prominence in Overall Company Strategy

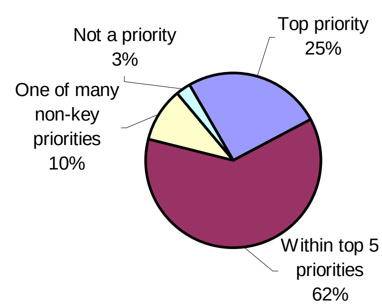


Figure 2: Company Resource Commitment to China in Next 12 Months

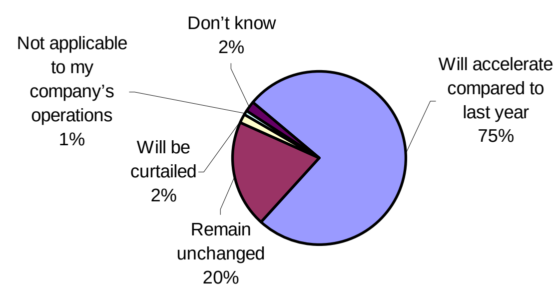
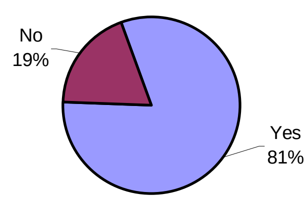


Figure 3: Are Your Company's China Operations Profitable?



[1] US Department of State. 1999 Investment Climate Statement, Bureau of Economic and Business Affairs, 1999.

year's survey (see Figure 6). Another 22 percent said profits were essentially unchanged, about equal to last year's finding of 23 percent. Only 8 percent of respondents reported that their companies' China operations were less profitable in 2005 than in 2004, down from 13 percent in last year's survey.

The survey also asked companies to assess their profitability rates in China compared with the company's rate overall. Nearly 60 percent of respondents indicated their China-based operations were as profitable or more profitable than the company as a whole in 2005, down slightly from last year's combined response of 62 percent (see Figure 7). Nearly one-quarter indicated that their China profitability rate was lower than the company as a whole in 2006, up from 18 percent in 2005. While one year does not make a trend, these changes could be due to margin pressures resulting from growing competition and excess capacity in China (see item 4 on page 5) and bear watching in the coming year.

Finally, the survey asked respondents to describe their five-year outlook for doing business in China. Almost all respondents view their companies' medium-term future in China positively: an overwhelming 97 percent were optimistic or somewhat optimistic (see Figure 8). The score is an improvement over last year's already impressively optimistic combined score of 94 percent.

Figure 4: Revenue from China in 2005 vs. 2004

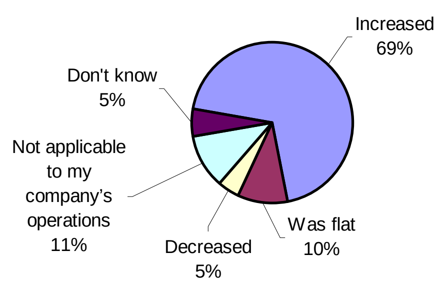


Figure 5: 2006 Revenues Are Expected to...

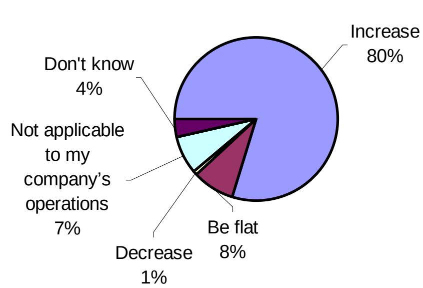
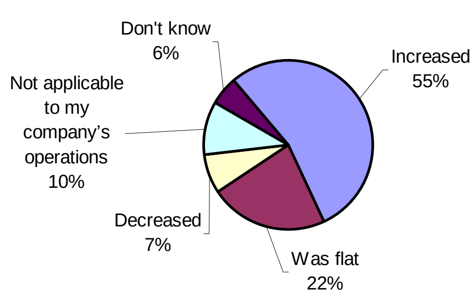


Figure 6: Profitability from China in 2005 vs. 2004



Objectives in China

The survey asked respondents to indicate their companies' main reason for being in China: to serve the local market, to export to the United States, or to export to other countries. Multiple responses were accepted. More than half of the survey respondents, 57 percent, indicated they were doing business in China to access or serve the Chinese market (see Figure 9). Another 22 percent said they use China as an export platform for Asia and the rest of the world. Only 18 percent of companies indicated their China operations were set up to export to the US market. This indicates that as the Chinese economy develops and opens to foreign participation, it is providing more opportunities for US companies to serve China's market.

Top Operating Issues in China

Since China's entry into the World Trade Organization (WTO) in 2001, USCBC has regularly asked its members to identify their top operating issues in China. The ranking of concerns has shifted frequently as some are resolved and new problems emerge. Many of the issues, such as regulatory matters and license approvals, are now all the more important because they interfere with foreign companies' ability to compete in China.

As in past years, the survey asked respondents to rank the top five issues of importance to their companies in China. Respondents were then asked to assess the progress that China has made in addressing those issues in the past year. The results are listed below and ranked in order of importance (see Figure 10).

1. Human resources

In 2006, USCBC members for the first time ranked a non-regulatory matter as their top operating issue in China: recruiting and retaining qualified workers. In China's rapidly growing economy, demand for talented workers is outstripping supply, resulting in significant challenges for companies. More than half of the respondents indicated that recruiting and retaining employees had become more difficult over the past year or that new problems had arisen. In particular, companies have difficulty filling mid-level management positions. Even though the pool of these types of employees in China is at its highest ever, the unbridled pace of economic growth has meant that companies—both foreign and Chinese—are trying to attract the same local talent. This competition is driving up wages and increasing the rate of turnover among Chinese middle managers. The problem is particularly acute in the top-tier cities of Shanghai and Beijing, where management turnover levels regularly approach 15 percent or higher annually. Wages for employees with specialized skill sets, notably in areas such as sourcing and procurement, logistics, and finance and accounting, are climbing rapidly. In 2005, human resources ranked as the fourth-most important concern.

Figure 7: Profitability Rate of China Operations vs. Company as a Whole

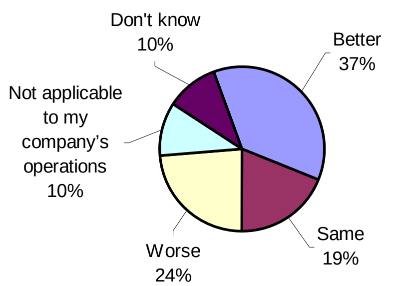


Figure 8: Five-Year Outlook for Your Company's Business in China

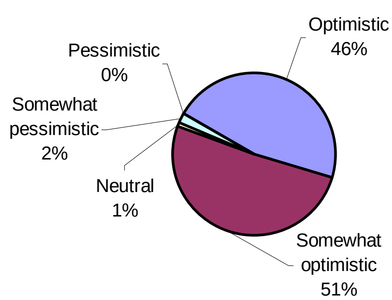
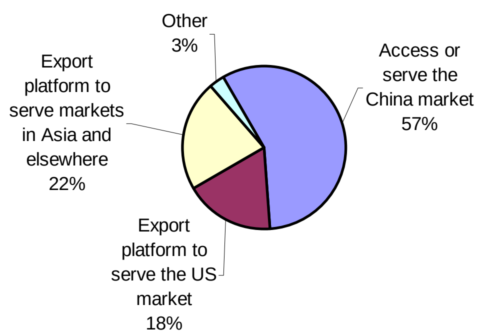


Figure 9: Objectives in China



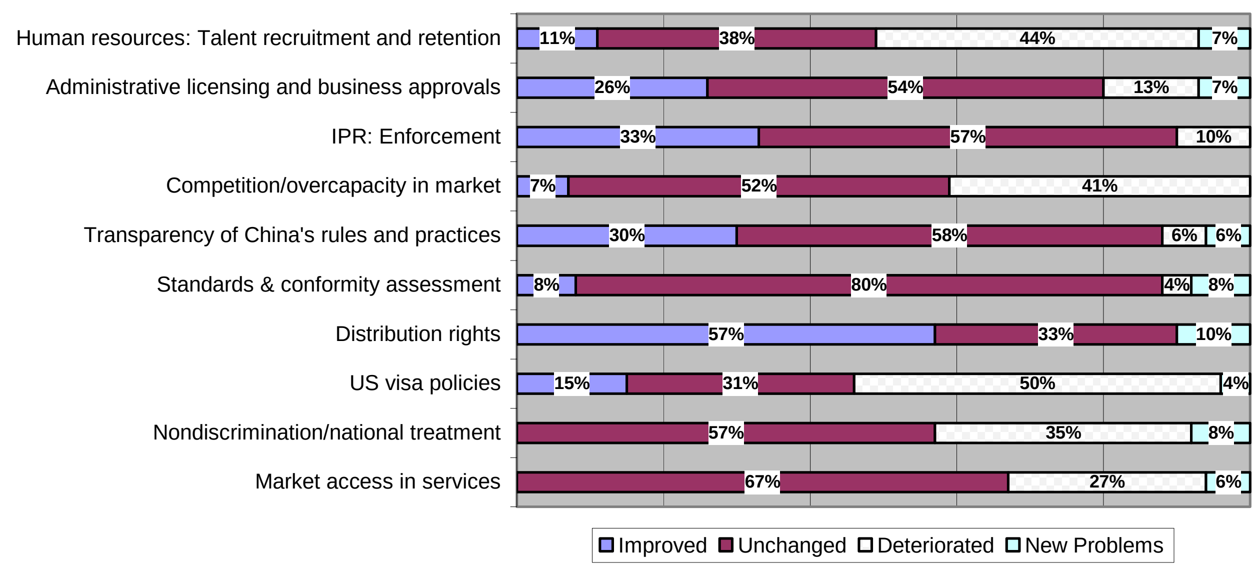
2. Administrative licensing and business approvals

Securing administrative licenses and business approvals ranked as companies' second-most important issue. Although respondents in previous surveys had not listed this issue in the top 10, the challenges in navigating China's licensing and regulatory procedures are widespread and have existed for years. These issues have risen in importance as sector openings mandated by China's WTO entry have reached their implementation dates. A wide range of business sectors in China are affected—particularly direct selling, distribution, construction, financial services, and pharmaceuticals. In addition to difficulties obtaining licenses and approvals, companies report nontransparent application procedures for establishing foreign-invested enterprise liaison offices and difficulties obtaining automatic import licenses, product safety licenses, certifications, and registrations. More than half of the respondents indicated their problems in this area were unchanged in the previous year, though 26 percent noted some progress.

3. Intellectual property rights enforcement

Intellectual property rights (IPR) enforcement was ranked as the third-most important operating issue. This long-term problem has appeared in USCBC members' top 10 issues consistently for the past four years, varying in rank depending on the urgency of other issues ranked around it. IPR

Figure 10: Degree of Progress on Top 10 Concerns of USCBC Members



protection's dip in this year's rankings may reflect the greater immediate concerns confronted on the human resources and licensing fronts. It may also reflect the business community's view that the PRC central government now acknowledges the importance of IPR enforcement and is taking steps to address it, although problems remain in the implementation of laws at the provincial and local levels. For the second straight year, most respondents (57 percent) reported that China's IPR enforcement had remained unchanged, though 33 percent reported some progress. The remaining 10 percent of respondents said enforcement had deteriorated. These results are slightly better than 2005, when 59 percent of respondents reported no change in China's IPR enforcement, 26 percent noted some improvement, and 11 percent indicated deterioration in enforcement.

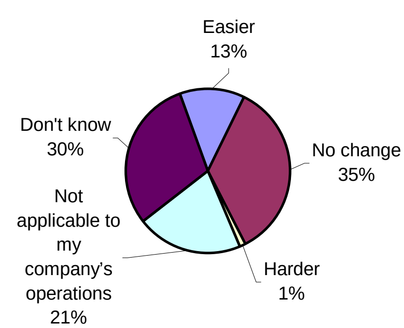
The survey further asked respondents about specific legal changes that China has made in the past year. In April 2006, China issued new rules for transferring IPR cases for criminal prosecution. Thirty-five percent of survey respondents indicated that these rules, plus the Supreme People's Court's 2004 judicial interpretation on IPR, had not improved the prospects for criminal prosecution of IPR violations (see Figure 11). Thirteen percent of companies noted that it was easier to effect criminal prosecutions. Another 30 percent indicated it was too early to assess the new rules.

The legal framework for IPR—as distinct from enforcement of those laws—ranked among the top 10 concerns in 2003, 2004, and 2005, but fell to 11th place in the 2006 survey, reflecting the continuing build-up of IPR regulations. Enforcement of those regulations, however, will likely remain among the top priorities for companies doing business in China for the foreseeable future.

4. Competition and overcapacity

Respondents ranked competition and overcapacity in the market, another non-regulatory issue and a new entrant to the top issues list, as their fourth-most serious operating challenge. Fifty-two percent of respondents assessed the situation as unchanged since 2005, but just over 40 percent said the situation had worsened in the past year. Over-

Figure 11: Transferring IPR Cases for Criminal Enforcement



capacity is occurring in a wide range of sectors, from construction and autos to steel and cement. It is fueled to a great extent by China's unreformed financial sector. Because Chinese enterprises generally do not make dividend payments and lack attractive investment options, Chinese enterprises tend to reinvest a large portion of their retained earnings in new production facilities; easy credit often adds to the expansion of production capacity. As their productive capacity rapidly increases, often without regard to reasonable market forecasts, Chinese companies in these sectors are driving down prices through oversupply. As Chinese companies continue to move further up the value chain and diversify into new product lines, US companies are increasingly concerned that they will face domestic competitors' financing expansion on non-market-based terms. This prospect is one reason why China's unfinished financial reforms are critical to sustainable economic growth and to ensuring a competitive "level playing field."

5. Transparency

Transparency remains a top problem for company operations in China. In general, transparency refers to the availability of necessary information to evaluate the costs and opportunities of doing business in a market. In practice, that means an open regulatory system, in which rules are published for comment before their implementation, and modifications are factored into rules before they are finalized. It also means that the government decision-making process is reasonably open and accessible.

Transparency ranked fifth in importance in 2006 and has made the top 10 every year that USCBC has surveyed its members. Moreover, many of the challenges companies face in securing administrative licenses and business approvals—this year's second-most important issue—stem from the limited transparency of China's regulatory bodies. Almost 60 percent of those surveyed in 2006 said no progress had been made in improving transparency over the past year. Another 12 percent noted deterioration or new problems since 2005, including persistent problems with inadequate public comment periods on proposed rules and regulations that have been implemented but never published.

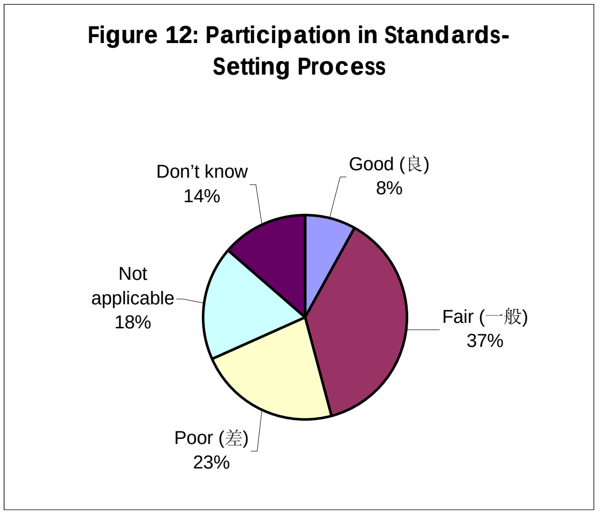
This year could be a watershed for transparency, as the PRC State Council issued a notice in March requiring all laws and regulations affecting trade in goods, services, intellectual property, or foreign exchange to be published in the Ministry of Commerce (MOFCOM) Gazette, similar to the US Federal Register. Implementation of this rule would provide a welcome increase in transparency for most sectors doing business in China. The need for more opportunities for businesses to comment on proposed regulations before they are finalized remains, however.

Companies also face problems in complying with ambiguous laws and regulations. For example, this year China stopped permitting foreign-invested enterprises to set up liaison offices, which foreign companies have used to expand throughout China. Central authorities asserted that foreign-invested enterprises could continue to maintain their existing networks of such offices on an unlicensed basis. Without a business license, however, these offices immediately ran into difficulties in signing office space leases, contracting employees, and even understanding the permitted scope of business activities. Interpretation of these and other regulations is often left to the discretion of local or provincial authorities, leading to conflicting interpretations across China and uncertainty and a continual latent risk of non-compliance for US companies.

6. Standards setting

The setting of China's product and technology standards remains among the top 10 operating issues for companies in China, ranking sixth for the second year in a row. The ability to get information on these processes and to participate in and influence standards setting is a central part of navigating any market. In China, that ability is frequently impeded because of an opaque standards process and the use of unique domestic standards that put foreign companies at a disadvantage. Only 8 percent of respondents noted improvements in the standards issue, while 12 percent identified deterioration or new problems since last year. Most respondents reported no changes. This issue may grow in importance over the next few years, as the PRC government launches a new initiative to promote "independent innovation" by domestic companies that may lead to more standards-related conflicts, such as competing wireless encryption standards.

The survey also asked respondents about their ability to participate in China's standards-setting process. Only 8 percent of respondents



described their ability to participate in standards setting as "good" (良) (see Figure 12). Thirty-eight percent evaluated their participation as "fair," (一般) indicating that they have some difficulty getting information on the processes and that they are occasionally included in standards setting. Nearly a quarter view the standards-setting process as "poor" (差), noting that they are excluded from the process.

7. Distribution rights

In an example of a positive development for businesses in China, distribution rights—a top issue for USCBC advocacy in China and arguably the most important of China's WTO entry obligations—dropped from first and second place in 2004 and 2005, respectively, to seventh place in 2006. "Distribution rights" refers to a foreign company's right to sell in China product it imports or sources from affiliated or third parties; previously, foreign companies were required to use domestic import-export agents and distributors for such imported products. Fifty-seven percent of respondents said the implementation of distribution rights had improved in the past year, reflecting the resolution of licensing issues. Another 33 percent said the situation was the same as in 2005, and 10 percent identified new problems. MOFCOM's decision to delegate approval authority to provincial-level authorities for most applications for distribution rights has sped up the application process, while the continuing emergence of the foreign-invested commercial enterprise (FICE) model as a viable trading and distribution platform for foreign companies has also improved the situation.

8. US visas

Securing US visas for PRC-national employees, partners, and customers ranked eighth in importance in this year's survey—the only US domestic policy issue in the top 10. Half of this year's respondents reported deterioration in their ability to obtain visas, and another 4 percent noted new problems. About one-third viewed the visa approval process as unchanged, and only 15 percent said there had been improvements in the past year. The ability to send PRC employees for training in the United States is a key advantage for US companies when recruiting talent, and problems in getting visas is one reason attracting and retaining employees in China has become more difficult in the last year. In addition, delays in visa issuance for customers and partners affect US company competitiveness.

9. National treatment

Non-discrimination and national treatment ranked ninth in the 2006 survey. This is the first time the issue has ranked among the top 10 issues since 2003, when it also ranked ninth. Respondents in various sectors say China has failed to meet the basic WTO requirement of treating foreign companies the same as domestic ones. As with transparency and standards, the lack of national treatment for foreign companies operating in China prevents them from competing on a level playing field in the market. Thirty-five percent said the situation had deteriorated in the past year, while 8 percent noted new problems, such as ambiguous administrative requirements on foreign firms. Respondents also noted local protectionism, which interferes with their ability to engage in the same activities as domestic companies. The problem is reflected in other top 10 issues as well: China's use of domestic standards favors local companies in affected industries. Similarly, in the services sector, insurance regulators appear to be granting licenses to foreign companies on a consecutive basis, allowing new branches to be established one at a time, but approving domestic insurers' new licenses in concurrent groups.

Figure 13: Was China's WTO Entry Relevant to Your Company?

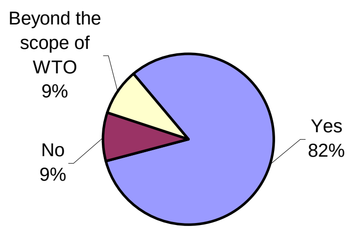
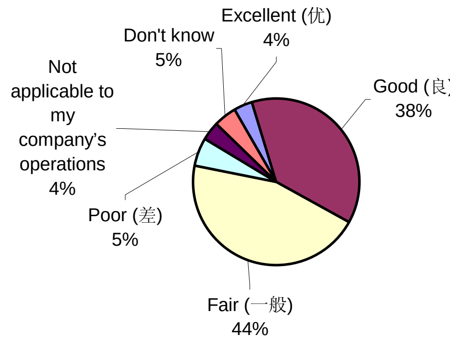


Figure 14: WTO Implementation Grade



10. Market access in services

Rounding out the top 10 issues is market access in services, dropping to tenth from fifth place last year. The successful implementation of distribution rights and progress on other service sector openings likely caused respondents to rank this issue lower on the list of concerns. Nonetheless, 67 percent of companies reported no progress on the issue since 2005, with almost a third reporting deterioration, reflecting the fact that barriers in service sector access still exist. These barriers to services in China include restrictions on foreign law firms operating in China and on Chinese lawyers practicing with foreign law firms; limited access for foreign films; restrictions in the telecom sector; and ownership caps that require partnerships with Chinese companies and limit foreign investment in certain sectors. Many of these barriers were to be removed under the terms of China's WTO accession. However, China's use of regulatory restrictions has prevented foreign companies from realizing the intended market openings.

WTO Impact and Implementation

The 2006 survey again polled companies about the impact of China's WTO entry on their operations in China and their assessment of China's progress in fulfilling its WTO commitments.

General views of WTO entry

This year marks the fifth year of China's membership in the WTO, and many of the mandated market opening commitments have been implemented. Respondents were asked whether China's WTO accession had been relevant to their companies. Eighty-two percent affirmed the importance of WTO market openings, up from 75 percent in 2005 (see Figure 13). The remaining 18 percent were equally divided among respondents who said WTO was not relevant and those whose primary business objectives were outside the scope of China's WTO accession agreement.

Next, respondents were asked to evaluate China's record in implementing its WTO

Table 1: Most Significant WTO Commitment Implemented (%)

Trading/distribution rights	25
Market access	21
Tariff/duty reductions	16
Foreign ownership/investment	10
Financial services market openings	9
Direct sales	3
Express delivery services	3
Government procurement	3
Other	10

Table 2: Most Significant WTO Commitment China Has Failed to Implement (%)

Intellectual property rights	31
Financial services	14
Transparency	12
Local content requirements	5
National treatment	5
Tariff/duty reductions	5
Trading/distribution rights	5
Construction and engineering	3
Direct selling	3
Government procurement	3
Other	14

commitments (see Figure 14). As in 2005, the majority of respondents said China had done a "fair" (一般) (45 percent) or "good"(良) (38 percent) job at implementing its WTO commitments. In last year's survey, 55 percent of respondents gave China a "fair" grade, and 38 percent rated it as "good." Four percent of respondents said China was doing an "excellent" (优) job in implementing its commitments, up from zero in 2005, and a final 5 percent rated China's efforts as "poor" (差), the same as in 2005.

Figure 15: Business Location of Respondents

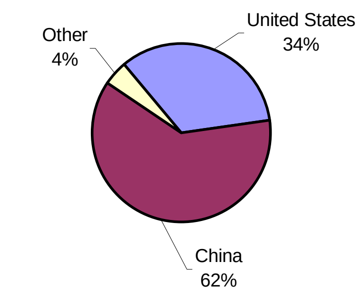


Figure 16: Business Sector

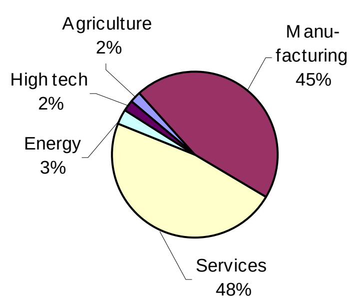
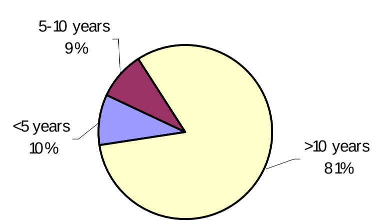


Figure 17: Time in China



Most important WTO commitments

As in 2005, respondents were asked to identify the most important WTO commitment China has implemented (see Table 1). Reflecting progress made since the last survey was conducted, trading and distribution rights were rated as the most significant commitment that China has implemented. Second in importance was market access, followed by tariff reductions and the lifting of foreign ownership and investment restrictions. In 2005, the top-ranked commitments were tariff reductions, financial services, trading and distribution rights, IPR enforcement, and foreign ownership and investment.

Most significant WTO implementation shortfall

Next, the survey asked respondents to identify the issues that China had not implemented in accordance with its WTO accession agreement (see Table 2). Companies cited inadequate enforcement of IPR as their top concern, followed by financial services, where foreign banks, insurance companies, and securities firms still face restrictions in their sector. Rounding out the top five concerns were transparency, local content requirements, and national treatment. In 2005, the top-ranked concerns were trading and distribution rights, IPR enforcement, local content requirements, market access, and WTO commitments whose deadlines for implementation had not yet arrived.

About Respondents' China Operations

Respondents' location

The majority of 2006 survey respondents were based in China (62 percent), (see Figure 15). Another 34 percent were based in the United States, and the remaining respondents were based in Hong Kong, Japan, or Singapore (4 percent).

Respondents' business sector

Reflecting the diversity of USCBC's membership, respondents hailed from a variety of sectors and were evenly split between manufacturing and services, with the balance made up of energy, agriculture, and high-tech companies (see Figure 16). Such diversity indicates that China's economic development and WTO-mandated market openings are attracting all manner of US products and services.

Experience in China

The great majority (81 percent) of 2006 survey respondents have more than 10 years of operating experience in China. The more time companies spend in China, the more seasoned becomes their understanding of the operating environment and the more valuable become the results of this survey (see Figure 17).

Employees in China

USCBC companies continue to expand their workforces as they grow their businesses in China. Eight percent of respondents employ more than 10,000 workers in China, up from 5 percent in 2005 (see Figure 18). Twenty-eight percent have between 1,000 and 10,000 employees, up from 23 percent last year. Still, nearly two-thirds of respondents employ fewer than 1,000 workers in China, down from 70 percent in 2005 but nonetheless reflecting that companies are still in the early stages of building their businesses in the country.

Figure 18: Direct Employees in China

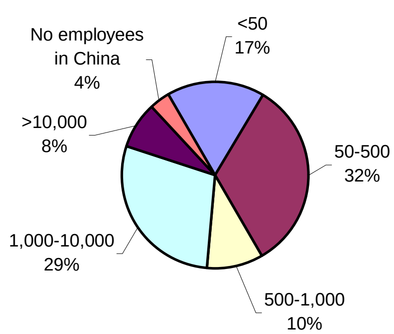
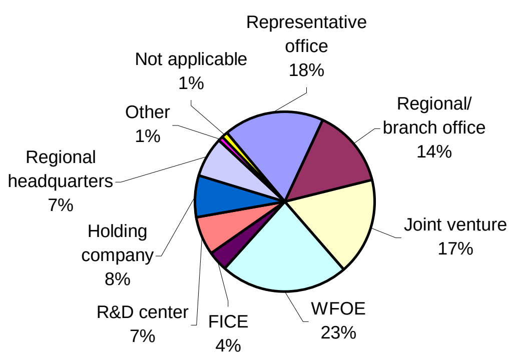


Figure 19: Legal Vehicle



Legal vehicle for China operations

US companies are taking advantage of the increasing variety of options for structuring their operations in China as the country opens its economy further to foreign participation. To gauge this development, the 2006 survey asked respondents about the types of legal entities their companies have in China. This is the second year that USCBC has surveyed this aspect of respondents' operations, and multiple responses were accepted (see Figure 19).

The top legal vehicles were consistent with the 2005 results: 100 percent foreign-owned companies (known as wholly foreign-owned enterprises, or WFOEs), representative offices, and joint ventures (JVs). An additional option in this year's survey, the regional or branch office, ranked fourth. Other investment vehicles include holding companies, regional headquarters, research and development centers, and FICEs.

As in past years, WFOEs are the most popular option, where permitted by PRC regulations. In 2000, WFOEs surpassed JVs as the most popular investment vehicle in China. WFOEs accounted for 73 percent of approved projects in China in 2005, outpacing approved JVs at a rate of 3 to 1. As China continues to open more sectors of its economy to full foreign ownership, the shift from JVs to WFOEs will likely continue.

The US-China Business Council (USCBC, www.uschina.org) is the leading organization of US companies engaged in business with the People's Republic of China. Founded in 1973, the USCBC provides extensive China-focused information, advisory and advocacy services, and events, to roughly 250 US corporations operating within the United States and throughout Asia.