

Is China Playing By the Rules? Free Trade, Fair Trade, and WTO Compliance
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Statement of
Public Policy Semiconductor Industry Association
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Chairman Leach, Chairman Hagel, distinguished Commission members, the Semiconductor Industry Association (SIA) is pleased to testify today regarding China's compliance with its WTO commitments. The SIA represents the \$70 billion U.S. semiconductor industry. U.S. semiconductor firms are leading global competitors, commanding 50 percent of world market share.

China represents a large and growing market for semiconductors and other information technology products. In fact, semiconductors are the second largest U.S. export to China. Over the past decade, SIA was a strong supporter of legislation to provide Permanent Normal Trade Relations with China as part of China's entry into the WTO, and SIA is pleased that the Chinese government has taken a number of positive steps in implementing its WTO obligations. However, several areas will require continued efforts by the Chinese government in order to fulfill the commitments made under WTO accession. My comments today will only elaborate on those issues of special relevance to American semiconductor producers, including China's value added tax rebates for domestically produced chips, semiconductor intellectual property, transparency, and local content.

CHINA MARKET

In 2001 the Asia Pacific region, driven primarily by growth in China, surpassed the U.S. as the largest semiconductor market in the world. In terms of demand, in 1997, the U.S. represented 33 percent of the world market, while the Asia Pacific region represented 22 percent. Five years later, in 2002, the Asia Pacific share had grown to 36 percent, compared to the U.S. share of 22 percent - a reversal of positions. By 2005, the U.S. is projected to be the smallest of the four regional markets,^[1] representing only 18 percent of the world, less than half of the 40 percent share that the Asia Pacific market is projected to represent. The growth of the Asia Pacific market has been driven by the growth in China. China's \$18 billion integrated circuit market represented 15 percent of total world demand in 2002, up from 7 percent of the world in 2000.

China's semiconductor market growth is occurring within the context of significant growth in China's computer and telecommunications markets. China is now the world's largest mobile phone market, and second largest personal computer market.

Currently domestic Chinese production, including foreign owned facilities in China, meets only about 15 to 20 percent of its market demand, with the remaining 80 to 85 percent met by imports. The Chinese government's Tenth Five Year Plan, covering 2001-2005, has an ambitious target to ensure that by 2005 "60 percent of IT products should be home grown," and that China shall "gradually design and develop its own IC products, (including [central processing units])."

SIA's EFFORTS IN CHINA

SIA has been encouraging an open trade environment in China for over a decade. SIA has sent delegations to China since the early 1990's to meet directly with Chinese government and industry officials to discuss **the benefits of market liberalization to China's economic growth and to U.S.-China relations**. SIA provided advice to the U.S. government on the WTO accession issues of importance to the semiconductor industry and,

as noted earlier, was an active supporter of legislation to allow Permanent Normal Trade Relations with China.

Based on SIA's interactions with senior Chinese government officials, we believe that there is a **genuine commitment expressed by all Chinese officials to full and faithful execution of China's WTO obligations.**

SIA was pleased that China became a signatory of the WTO's Information Technology Agreement (ITA) in April 2003, committing to eliminate tariffs on a range of information technology products. SIA has long supported the elimination of semiconductor tariffs, beginning with the suspension of U.S. tariffs in 1985, because tariffs increase costs to consumers and thus impede the ability of consumers to take advantage of semiconductor technology. SIA was an early supporter of the ITA, and China's joining this agreement was a high priority because of the consumer benefits that would flow from the elimination of tariffs on semiconductors, computers, telecommunications equipment, and semiconductor manufacturing equipment. **The elimination of China's 6 to 12 percent semiconductor tariffs in January 2002, contributed to a reduction in smuggling and** resulting shift to legitimate import channels, better positioning U.S. companies to take advantage of trading rights when they are fully phased in at the end of 2004 (three years after accession). SIA was pleased that China was able to resolve the "end use" certification issue that had initially prevented its formal participation in the ITA. China had imposed "end use" certification requirements on 15 ITA products, that were inconsistent with the ITA, and would have created a dangerous precedent, especially as we sought to expand the ITA to additional countries. SIA is pleased that China is now a full participant in the ITA, and we appreciate the efforts of USTR that led to this result.

VALUE-ADDED TAX

China imposes a value-added tax (VAT) of 17% on sales of all imported and domestically-produced semiconductors and integrated circuits. However, current Chinese government policy provides for a rebate of the amount of the VAT burden in excess of 6% for integrated circuits manufactured within China (and the amount of the VAT burden in excess of 3% for integrated circuit designs developed in China).^[2] **This discrimination against imported semiconductors through the VAT rebate is inconsistent with China's WTO obligations.**

Reduction of the semiconductor VAT should apply to all semiconductors and integrated circuits sold in China (whether domestically-produced or imported). Application of the VAT reduction to all companies would allow China to come into compliance with its WTO obligations to refrain from discrimination against imports while maintaining its commitments to investors in domestic facilities of a reduced VAT rate.

GATT Article III (on "National Treatment") establishes a general prohibition against a WTO member engaging in activity that discriminates in favor of domestic products at the expense of imported products. Specifically, paragraph 2 of this article states that a WTO member cannot impose taxes on imported products that are greater than those imposed on domestic products. By rebating the amount of the VAT burden over 3% or 6% for local products, while continuing to impose the full 17% VAT on imported semiconductors, the current policy violates this basic GATT/WTO obligation.

Prior GATT decisions clearly establish that it is a violation of the national treatment principle to grant a tax credit or rebate to certain domestic manufacturers of a product while charging the full tax rate to similar foreign-manufactured products. This is true even if the tax credit or rebate is intended to provide a subsidy to local producers. While China does provide the benefits to both domestic and foreign-owned facilities in China, the different treatment of domestic and imported products is a violation of its national treatment commitment. Any tax imposed on imported goods must be collected in a non-discriminatory manner.

The best solution for U.S. export interests and the development of China's information technology market is for the PRC to reduce or eliminate the VAT rate for all semiconductors and integrated circuits, regardless of origin.

As noted above, China joined the Information Technology Agreement (ITA) and has eliminated all tariffs on semiconductors in 2002 and will eliminate tariffs on other information technology products in the near future. The same public policy reasons that caused China to decide to eliminate its tariffs on semiconductors apply with equal force to a decision to lower the VAT rate. A substantial portion of the growth of the American economy has been attributed to information technology and the productivity enhancements made possible by advances in semiconductor technology and production. Just as it was in China's interest to eliminate all import tariffs on semiconductors, significant reduction in the VAT rate imposed on all semiconductors would contribute to the growth of the Chinese IT market and would benefit the Chinese economy in general. In addition, reports indicate that China's elimination of semiconductor tariffs (formerly 6-12%) has succeeded in reducing smuggling of semiconductors into China. As the high VAT rate on semiconductors provides an incentive for smuggling, this runs counter to the high priority the Chinese government has placed on eliminating illegal entry of goods.

Although it is not designed to do so, the high VAT rate imposed on semiconductors imposes significant costs on Chinese electronics producers on exports from China. While China ostensibly rebates the VAT on semiconductors and other electronics components when the finished product containing the inputs is exported, many exporters from China have been unable to receive the full amount of the rebate officially due to them because provincial and local authorities may refuse to rebate VAT charges collected by another jurisdiction within China.

There have been several noteworthy developments on the VAT rebate issue this year. **First, there is the growing recognition in Washington as well as in other world capitals that China's VAT rebate program is a violation of the WTO.** In March, **32 Members of the U.S. House of Representatives** sent a letter to Ambassador Zoellick stating "We believe China should eliminate the VAT for all semiconductors regardless of origin and we encourage you to continue to press for a speedy resolution of this violation." In June, **21 U.S. Senators** sent Amb. Zoellick a letter stating "We urge you to continue to vigorously insist that China lower its VAT on semiconductor imports to abide by its World Trade Organization (WTO) commitments..." Many of you on the Commission signed these letters, and we appreciate the continued support of Congress on this issue.

In May, the World Semiconductor Council (WSC) issued a joint statement critical of China's VAT rebate program. The WSC is composed of CEOs from companies representing the European Semiconductor Industry Association (EECA-ESIA), Japan Electronics and Information Technology Industries Association (JEITA), Korea Semiconductor Industry Association (KSIA), Semiconductor Industry Association (SIA), and Taiwan Semiconductor Industry Association (TSIA). The WSC stated:

"... under China's current application of its Value Added Tax (VAT), a VAT of 17% is applied to all semiconductors, but companies designing and manufacturing semiconductors in China are eligible to receive a substantial rebate of the VAT paid on those semiconductors. This reduces the effective VAT burden on domestically designed and produced semiconductors to only 3%. Discrimination has the effect of limiting market access, distorting patterns of trade and investment, and negates the benefits China promised to provide when it joined the WTO. The WSC calls for China to lower its VAT rate to 3% for all semiconductors, regardless of origin."

A second key development is USTR's formal inquiries to the Chinese on this subject. Coupled with the interest on Capitol Hill and the WSC, USTR's request that China address the VAT rebate problem has attracted the attention of Chinese government officials. **As a result of this attention, China has formed a**

research group to re-examine the VAT issue. In SIA's recent meetings in China, we sensed a willingness in some quarters to explore alternatives with the U.S., but in other quarters, continued skepticism that changes were necessary. The U.S. government must continue to insist that China quickly come into compliance with GATT article III.

Lowering the VAT for both domestically produced and imported semiconductors would be a non-discriminatory policy that is in China's interest for all the reasons set forth above. Non-discriminatory application of the VAT rebate for all semiconductors would allow Chinese electronics producers to obtain the most advanced technology available worldwide at the most competitive prices, benefiting Chinese consumers and the entire Chinese economy, as well as encouraging growth in China's IT sector.

INTELLECTUAL PROPERTY PROTECTION

SIA would like to underscore the importance of China's full compliance with its commitments to improve intellectual property (IP) protection. This is critical not only to U.S. firms doing business in China, but also in China's self interest, as it will encourage the high technology foreign investment China seeks in order to promote the development of its economy while simultaneously encouraging local entrepreneurs to engage in innovation.

Before discussing the issue of enforcement, let me begin by congratulating China for its success in resolving one issue related to its semiconductor layout design protection law. In March 2001, China's State Council passed Regulation on Integrated Circuit Layout Design Protection, which took effect October 1, 2001. Last year, a senior official of the Ministry of Information Industry made comments indicating that China's new law did not cover discrete semiconductors. SIA objected to this interpretation because the WTO TRIPs agreement is clear that discretos, which are products with only one active element, are to be protected. We are pleased to report that, in a response to a question posed by the United States, China affirmed before the Council for Trade-Related Aspects of Intellectual Property Rights that "With respect to discrete mentioned in the question in particular, if it complies with provisions of Article 2 and Article 4 of the Regulations on the Protection of Layout Designs of Integrated Circuits, it can be protected through applying for registration of layout-design."^[3] **We believe that this resolves the discretos issue, and again express our appreciation the USTR and Chinese government for their efforts to bring this question to a satisfactory conclusion.**

SIA would like to highlight the need for strengthened IP enforcement. IP protection is important not only in China, but in all markets around the globe. The **World Semiconductor Joint 2003 Statement**, referenced above, emphasized the need for strong intellectual property protection around the world, stating:

*"Semiconductor makers must invest a very high percentage of sales in R&D, and the intellectual property that results is the lifeblood of the company. Failure to adequately protect intellectual property is very damaging to the semiconductor industry. There are an increasing number of instances of counterfeiting of IC's and other semiconductors. One form of counterfeiting is the unauthorized direct optical copying of the chip, and reproduction of a mask work (layout design/topography) based on the optical copying, and then fabrication of a semiconductor based on this mask work and sale under a different company's name. Another form of counterfeiting involves reverse engineering a company's chip, and then producing a physically identical chip and selling it without authorization under the original company's name and trademark. **Both types of counterfeiting must be quickly addressed and stopped.**"*

The World Semiconductor Council is now working on a proposal to establish fast track consultative mechanisms to encourage enforcement actions to counter IP violations, and to encourage manufacturers to develop policies to prevent their inadvertently making semiconductors that violate a third party's IP. We are hopeful that this proposal will be adopted in all semiconductor producing regions around the world.

SIA is aware of numerous reports of IP violations in China. In one typical case, an SIA member company found that Chinese firms were making identical copies of its chips and data sheets, and selling it under the Chinese company's name. Under TRIPs, reverse engineering a chip to design an original and better product is allowed under the layout design laws. However in this case the chips were essentially photocopies of the U.S. design, which we know because the pirate included the U.S. company's part number etched in a submask level and unused circuits that the U.S. firm had placed on the chip to reserve space for future product development. The Chinese firms that engage in piracy are typically thinly-capitalized companies that contract the manufacture of the copied chips to foundries that can afford to make the necessary capital expenditures.

China's court system is still developing, and U.S. firms are concerned about the fairness of its procedures. For example, we understand that only "legitimate" purchases are actionable. These rules put an unreasonable burden on U.S. firms who cannot hire a private investigator to purchase the counterfeits, but must instead find purchasers of the counterfeit product and convince those purchasers to sign a statement that they bought the counterfeit goods. China also has administrative enforcement mechanisms, but these are largely untested.

In the aforementioned letter signed by 32 House members, the Representatives stressed that "the improved laws China put in place to protect IP are useless unless they are supported by transparent, standardized and predictable court procedures that make the judicial system accessible... **We must continue to demand that China immediately upgrade its IP enforcement mechanisms so that foreign semiconductor companies have certainty their products are protected in this emerging market.**" The letter signed by 21 Senators to Ambassador Zoellick stated "We encourage you to continue to press for strengthened enforcement to bolster the credibility of [the IP] laws, and to **explore with your Chinese counterparts alternative solutions such as fast track investigations of alleged piracy.**" Given its importance to both U.S. producers and China's economic development, SIA urges USTR and the Chinese government to continue to make IP enforcement a high priority issue.

TRANSPARENCY

Several commitments in the final protocol of accession are expected to improve transparency in China's administrative rule-making. For example, China has agreed that only those trade-related measures that are published and readily available will be enforced. China has also agreed to make information on trade-related measures available to WTO members upon request before those measures are implemented or enforced.

Additionally, **China has committed to establish or designate an official journal for the publication of all trade-related measures and to provide a reasonable period of time for comment to the appropriate authorities before measures are implemented.** China is considering providing this information in English in order to provide transparency to the international business community, and to post the information on the web. These are important steps in improving transparency. SIA urges China to fully implement these measures.

LOCALIZATION

There had been localization requirements for parts and materials for products made in China which, while not technically legal requirements, imposed serious restrictions on firms' ability to utilize imported parts. Firms had been required to file localization plans with their foreign investment application. The Chinese government also audited foreign firms to determine local content. What constitutes local content can be subject to many definitions. For example, importation via a Chinese distributor can qualify a part as "local." Chinese sectoral industrial policies also contain local content requirements. Prior to its accession to the WTO, China had imposed local content requirements on products containing semiconductors.

In our discussions with Chinese officials, there was a recognition that these policies are inconsistent with China's WTO obligations and would be repealed in time. **SIA again calls for the immediate repeal of all local content policies as required by the terms of the WTO accession agreement.**

During the China WTO accession negotiations, the Chinese government confirmed that **China would ensure that all state-owned and state-invested enterprises would make purchases and sales solely on commercial considerations**, e.g. price, quality, marketability, availability, and that the enterprises of other WTO members would have an adequate opportunity to compete for sales to these enterprises on a non-discriminatory basis. In addition, the Chinese government committed that it would not influence commercial decisions on the part of state-owned or state-invested enterprises. Adherence to these commitments will be critical for China's development because it will ensure that Chinese electronics firms are able to purchase the most competitive chips free from political interference. Given the market access problems that the U.S. historically faced in other semiconductor markets, it is also critical to U.S. export interests that China's state-invested enterprises purchase solely on a commercial basis.

CONCLUSION

China is a large and fast growing market. The economics of our industry dictate that U.S. firms, to remain competitive, must be able to compete on a fair and open basis for sales in China. For this reason, we are very encouraged by China's efforts to implement its WTO commitments, but we are concerned over the remaining existence of barriers and impediments to trade in China. While the challenge of promoting economic development in a country the size of China is immense, we are encouraged by China's progress and are hopeful that China will lower its VAT for all semiconductors, vigorously enforce its IP laws, eliminate its local content requirements, and improve transparency.

SIA thanks the Commission for the opportunity to testify today. We look forward to continuing to work with the U.S. government on these important issues.

[1] The four regions are North America (primarily the U.S.), Europe, Japan and Asia Pacific.

[2] State Council Document Number 18, June 2000

[3] Council for Trade-Related Aspects of Intellectual Property Rights; Responses from China to the Questions posed by Australia, the European Communities and their member States, Japan and the United States; IP/C/W/374 10 September 2002; Page 43.