

Chapter 4

Barriers to trade

4.1 China has taken great strides to eliminate barriers to trade, particularly by reducing or removing impediments at the point of entry such as tariffs and quotas on imports. This chapter looks at the progress China has made to assist foreign companies gain access to its markets and considers whether it has been effective. It then examines the measures taken by China to help foreign enterprises conduct business once they have gained entry to the domestic market. It considers the business culture in China and the difficulties encountered by people conducting business there. Finally, the chapter looks at the restrictions that Australia applies to importers and the Chinese view on the imposition of such barriers.

4.2 This chapter is intended to provide a broad overview of the trading and business environment in China. Subsequent chapters discuss specific economic sectors in China of interest to Australia and the trading restrictions applying to particular products.

From planned economy to market economy

4.3 Traditionally, as a centrally planned and controlled economy, China had a high and extensive protection regime. Before the period of reform ushered in by Deng Xiaoping, China was inward looking and generally limited its imports to goods that could not be made or obtained in China.¹ One analyst described the import system:

...in the early years of the reform era China maintained an extraordinarily complex and highly restrictive system of controls including not only the usual policy instruments, such as tariffs, quotas, and licensing requirements, but also an array of other tools. These tools included limiting the number of companies authorized to carry out trade transactions and restricting the range of goods that each of these companies was allowed to trade, import substitution lists, a system of registration for selected imports, and commodity inspection requirements.²

4.4 Since the 1980s, China has gradually relaxed some of its import and export controls. As noted earlier, 1978 marked a significant change in its approach to protection and economic development which is reflected in tariff reforms and initiatives taken to dismantle non-tariff barriers.

1 Wayne M. Morrison, 'China's Economic Conditions', *CRS Issue Brief for Congress*, 21 September 2000, p. 2.

2 Nicholas R. Lardy, Senior Fellow, Institute for International Economics, Washington, D.C., 'Trade Liberalization and its Role in Chinese Economic Growth', prepared for an International Monetary Fund and National Council of Applied Economic Research Conference, New Delhi, 14–16 November 2003, p. 6.

4.5 By the time China entered the WTO in 2001, many of the obstacles to trade had been removed and its approach to foreign imports had changed dramatically. At this time, Vice Minister Long Yongtu described China's progress over the previous fifteen years toward a market economy and of its deepening participation in the process of economic globalisation. He stated:

China has substantially reduced its tariff levels for many times, eliminated over-whelming majority of its non-tariff measures, gradually opened its service sectors, abolished the mandatory plan for imports and exports, eliminated export subsidies, established its market-based pricing mechanism, unified the exchange system, realized the convertibility of RMB under current account in international transactions, unified taxation system and provided national treatment to imported product.³

4.6 Reflecting on the long negotiation period leading to China's accession to the WTO, Mr Long stated that it was an unprecedented challenge for China and the complexity and difficulty of the process was 'beyond the imagination of almost everybody'.⁴ He likened it to 'a "long March" full of arduous difficulties'.⁵

4.7 Its accession to the WTO on 11 December 2001 continued China's transition from a planned economy to a market economy. Since then, it has embarked on a program of sweeping reforms intended to allow the Chinese economy to become integrated fully with the rest of the world. It has adopted an export-oriented strategy to underpin its economic development and has made remarkable progress in dismantling barriers to trade. Mr Yu Yongding from the Chinese Academy of Social Sciences argued that China wanted to integrate its economy gradually with the global economy on 'the basis of comparative advantages'.⁶ He observed:

For many years in the past...China used variety of policies such as multi-tier exchange rates, subsidies, tariffs and various non tariff barriers (NTBs), to encourage exports, protect domestic markets, and maintain foreign exchanges balance. However, following the deepening of China's reform and trade liberalization, all policies that are inconsistent with the WTO rules have been abandoned or in the process of being abandoned. Some of

3 WTO News, Statement by H.E. Vice Minister LONG Yongtu, Head of the Chinese Delegation, at the eighteenth session of the Working Party on China, 'Meeting of the Working Party on Accession of China', 17 September 2001.

4 WTO News, Statement by H.E. Vice Minister LONG Yongtu, Head of the Chinese Delegation, at the eighteenth session of the Working Party on China, 'Meeting of the Working Party on Accession of China', 17 September 2001.

5 "'WTO Negotiation", Tantamount to the "long March": Long Yongtu', *People's Daily*, 30 November 2001.

6 Yu Yongding, Director and Senior Fellow, Institute of World Economics and Politics, Chinese Academy of Social Sciences, 'China's Trade Policy', 31 July 2004, p. 4.

the policies were already abandoned long before China's entry into the WTO.⁷

4.8 China's market is certainly more open to the rest of the world and China has freed up its economy considerably. A number of witnesses were of the view that it is now easier for Australian companies to do business in China.⁸ Even so, significant obstacles, even at the point of entry, inhibit trade. DFAT explained:

Despite China's ongoing efforts to meet its 2001 commitments, many tariff and non-tariff barriers remain and the Chinese business environment can still be challenging for Australian companies. Some significant issues relating to China's economic reform remain a 'work in progress'. For example, the rule of law as it relates to intellectual property rights and contracts is being strengthened but still has some way to go. Once universally understood, applied and enforced, this enhanced legal framework will underpin a more predictable business environment in China.⁹

4.9 The following section looks at the major barriers remaining in China that impede trade.

Tariffs and import quotas

4.10 Tariffs on imported goods are one of the most common and obvious forms of market restrictions. The Australian Industry Group noted that China still imposes significant tariffs on a number of items.¹⁰ On average, China applies considerably higher tariffs on the imports of agricultural products than applied to non-agriculture products and levies relatively high tariffs on textiles, clothing and footwear.¹¹

4.11 Despite China's dependence on overseas suppliers for minerals commodities, it imposes tariff barriers on a number of these products. According to the Minerals Council, the tariffs are not high enough to prevent trade but they are an unnecessary cost borne by exporters. It gave the example of the tariffs on nickel, coal and aluminium which place an additional cost of up to \$50 million annually on Australian minerals companies.¹² It recorded the following tariffs:

- manganese 5.5%
- zinc 3%

7 Yu Yongding, Director and Senior Fellow, Institute of World Economics and Politics, Chinese Academy of Social Sciences, 'China's Trade Policy', 31 July 2004, p. 4.

8 *Submission P24*, p. 12.

9 *Submission P19*, p. 12.

10 *Submission P63*, p. 30.

11 Annual Report by the Director-General, *Overview of Developments in the International Trading Environment*, February 2005, p. 11.

12 *Submission P55*, p. 3.

- coal 3 to 6%
- various copper products 3 to 6%
- aluminium alloys 7%
- lead 3%
- unwrought nickel 3 to 4%¹³

4.12 As noted previously, under the WTO, China agreed to increase market access by reducing tariff rates, removing quotas, dismantling non-tariff barriers and opening up the telecommunications and financial services sectors. It is committed to remove or reduce all tariffs on imported goods mostly by 2004. Tariffs on industrial goods will be reduced to an average of 8.9 per cent with a range from 0 to 47 per cent, with the highest rates applying to photographic film and automobiles and related products. Tariffs on agricultural goods will decrease to an average of 15 per cent with a range from 0 to 65 per cent, with the higher tariffs applying to cereals. It has agreed to limit its subsidies for agricultural production to 8.5 per cent of the value of farm output.¹⁴

4.13 Its average Most Favoured Nation (MFN) rate in 2002 was 12.3 per cent which was half the level in 1996.¹⁵ Even so, by the time its WTO commitments are fully implemented, China's average bound rate will be 9.9 per cent which, according to the report by the Director-General WTO, means that applied rates 'will need to be brought down to at most this level'.¹⁶

4.14 On 1 January 2004, China lowered its average tariff by 0.6 percentage points to 10.4 per cent.¹⁷ The IMF Staff Report for the 2004 Article IV Consultation noted that the implementation of WTO commitments was broadly on track, and, in some cases, ahead of schedule. It stated:

The unweighted average tariff was reduced to 10.4 percent in 2004 from 11.3 percent in 2003 and key commitments with respect to banking services and trade and distribution rights have also moved forward. The authorities are committed to implement agreed reforms and plan to further liberalize trading rights with effect from July 1, six months ahead of schedule...Staff encouraged the authorities to improve the administration of tariff-rate quotas for agriculture, and to address other issues related to WTO compliance. The authorities indicated their willingness to do so, and to

13 *Submission P55*, p. 12.

14 Thomas Rumbaugh and Nicholas Blancher, 'China: International Trade and WTO Accession', *IMF Working Paper*, WP/04/36, March 2004, p. 8.

15 The WTO's 'Most Favoured Nation' (MFN) principle means that every time a country lowers a trade barrier, it must do so for all its trading partners. In other words, each WTO member treats all the other members equally as 'most-favoured' trading partners. World Trade Organization, 'Understanding the WTO', September 2003, p. 11.

16 Annual Report by the Director-General, *Overview of Developments in the International Trading Environment*, February 2005, p. 11.

17 Thomas Rumbaugh and Nicholas Blancher, 'China: International Trade and WTO Accession', *IMF Working Paper*, WP/04/36, March 2004, p. 7.

discuss any issues raised by partner countries through the WTO's dispute resolution procedures, if necessary.¹⁸

4.15 The Chinese government has acknowledged that it still has some way to go in opening up its markets. Premier Wen in the 2005 Report on the Work of the Government stated:

Tariffs need to be reduced to the level we promised when China joined the WTO, most non-tariff measures need to be eliminated, and the service sector needs to be opened wider to foreign competition. We need to respond to these new situations to ensure success in opening up.¹⁹

4.16 The table on the following pages provides detailed figures on the structure of MFN tariffs in China including the final bound rate.

4.17 China also has many quota restrictions that constitute a significant trade barrier.²⁰ Hunt and Hunt Lawyers suggested quotas need to be reduced and phased out over a reasonable period.²¹ China is committed to eliminate import quotas by 2005.²²

4.18 There are also a range of technical barriers to trade that impede or prevent the importation of certain goods into China. RTIO informed the committee that iron ore is listed for compulsory examination upon import. It noted that this quarantine imposition limits the potential for pursuing 'Loading Analysis as Final' which it argued would be 'a mutually beneficial agreement between Chinese steel mills and Australian exporters'.²³ Quarantine barriers of most concern to Australia, however, are the restrictions applying to agricultural products and will be dealt with in detail in the following chapter.

18 Executive Summary, IMF, Staff report for the 2004 Article IV Consultation, prepared by the Staff Representatives for The Article IV Consultation with the People's Republic of China, 6 July 2004, p. 22.

19 *Report on the Work of the Government*, delivered by Premier Wen Jiabao at the Third Session of the 10th National People's Congress, 5 March 2005.

20 *Submission P24*, appendix 2, p. 29.

21 *Submission P24*, appendix 2, p. 29.

22 Thomas Rumbaugh and Nicholas Blancher, 'China: International Trade and WTO Accession', *IMF Working Paper*, WP/04/36, March 2004, p. 7.

23 *Submission P34*, p. 8.

**Table: 4.1 Structure of MFN tariffs in selected developing countries
(Per cent)**

	China			Brazil			India			South Africa		
	1996	2002	F.B. ^a	2000	2004	F.B. ^b	1997/98	2001/02	F.B. ^c	1997	2002	F.B. ^d
Bound tariff^e												
1. Bound tariff lines (% of all tariff lines) ^e	n.a.	100.0	100.0	100.0	100.0	100.0	67.0	73.3	73.3	96.3	96.2	96.3
2. Simple average bound rate	..	12.4	9.9	..	..	30.2	..	..	50.6	..	..	20.9
Agricultural products (HS01-24)	..	17.9	14.5	..	..	35.8	..	..	115.7	..	..	46.8
Industrial products (HS25-97)	..	11.4	9.1	..	..	29.5	..	..	37.7	..	..	18.1
WTO agricultural products	..	18.2	15.2	..	..	35.3	..	..	114.7	..	..	43.5
WTO non-agricultural products	..	11.5	9.0	..	..	29.6	..	..	36.2	..	..	18.1
Textiles and clothing	..	17.6	11.5	..	..	34.7	..	..	29.9	..	..	26.8
3. Tariff quotas (% of all tariff lines)	..	0.8	0.8	..	..	0.0	..	..	..	..	..	3.9
4. Duty free tariff lines (% of all tariff lines)	..	4.3	7.6	..	..	0.7	..	..	0.3	..	..	10.2
5. Non- <i>ad valorem</i> tariffs (% of all tariff lines)	..	0.0	0.0	..	..	0.0	..	..	6.4	..	..	0.0
6. Non- <i>ad valorem</i> tariffs with no AVEs (% of all tariff lines)	..	0.0	0.0	..	..	0.0	..	..	6.4	..	..	0.0
7. Nuisance bound rates (% of all tariff lines) ^f	..	1.9	2.4	..	..	0.0*	..	..	0.0	..	..	0.0
Applied tariff												
8. Simple average applied rate	23.6	12.3	n.a.	13.7	10.4	n.a.	35.3	32.3	n.a.	15.0	11.4	n.a.
Agricultural products (HS01-24)	35.4	18.0	n.a.	12.9	10.4	n.a.	33.8	41.7	n.a.	11.3	11.5	n.a.
Industrial products (HS25-97)	21.7	11.3	n.a.	13.8	10.4	n.a.	35.6	30.8	n.a.	15.4	11.4	n.a.
WTO agricultural n.a. products	33.8	18.2	n.a.	12.6	10.2	n.a.	35.2	40.7	n.a.	9.4	9.6	n.a.
WTO non-agricultural products	22.1	11.3	n.a.	13.8	10.5	n.a.	35.4	31.0	n.a.	15.7	11.6	n.a.

	China			Brazil			India			South Africa		
	1996	2002	F.B. ^a	2000	2004	F.B. ^b	1997/98	2001/02	F.B. ^c	1997	2002	F.B. ^d
Textiles and clothing	32.8	17.5	n.a.	20.3	17.2	n.a.	43.7	31.3	n.a.	35.1	24.4	n.a.
9. Domestic tariff "peaks" (% of all tariff lines) ^g	1.1	1.8	n.a.	0.0	0.6	n.a.	0.2	1.3	n.a.	4.0	3.9	n.a.
10. International tariff "peaks" (% of all tariff lines) ^h	55.2	17.2	n.a.	41.3	26.8	n.a.	90.5	96.8	n.a.	39.4	34.9	n.a.
11. Overall standard deviation of tariff rate	17.4	9.1	n.a.	6.7	7.0	n.a.	14.5	13.0	n.a.	17.8	12.6	n.a.
12. Coefficient of variation of tariff rates	0.7	0.7	n.a.	0.5	0.7	n.a.	0.4	0.4	n.a.	1.2	1.1	n.a.
13. Tariff quotas (% of all tariff lines)	..	0.8	n.a.	0.0	0.0	n.a.	..	..	n.a.	4.2	3.8	n.a.
14. Duty free tariff lines (% of all tariff lines)	1.9	4.8	n.a.	1.5	10.4	n.a.	1.4	1.1	n.a.	42.4	43.4	n.a.
15. Non- <i>ad valorem</i> tariffs (% of all tariff lines)	0.0	0.7	n.a.	0.0	0.0	n.a.	0.2	5.3	n.a.	25.6	25	n.a.
16. Non- <i>ad valorem</i> tariffs with no AVEs (% of all tariff lines)	0.0	0.7	n.a.	0.0	0.0	n.a.	0.2	5.3	n.a.	25.6	25.0	n.a.
17. Nuisance applied rates (% of all tariff lines) ^f	1.0	1.9	n.a.	0.8	15.1	n.a.	0.0	0.0	n.a.	0.2	0.0*	n.a.

.. Not available.

n.a. Not applicable.

* Negligible.

F.B. Final bound.

a Based on 2002 tariff schedule.

b Based on 2004 tariff schedule.

c Based on 2001/02 tariff schedule. Averages do not include lines where different parts of the HS six-digit line were bound at different rates.

d Based on 2001 tariff schedule.

e Calculations are only based on bound tariff lines. Including fully bound and partially bound rates.

f Nuisance rates are those greater than zero, but less than or equal to 2%.

g Domestic tariff peaks are defined as those exceeding three times the overall simple average applied rate (indicator 8).

h International tariff peaks are defined as those exceeding 15%.

Note: Excluding in-quota rates. Calculations exclude specific rates and include the *ad valorem* part for compound and alternate rates.

Source: WTO Secretariat calculations, based on data provided by Members.

4.19 The Australian government strongly advocates the lowering of trade barriers and the end to subsidies. During a recent address to the United Nations, the Prime Minister urged countries to support moves to eliminate all tariffs, subsidies and other barriers to trade.²⁴ Along similar lines, he told a gathering of the Asia Society that the world's richest countries as well as developing nations, such as China, India and Brazil, must show leadership in supporting the WTO objectives. In particular he stated that 'nations share a particular responsibility to rise to the occasion on cutting barriers to agricultural trade'.²⁵

Committee view

4.20 The committee recognises the advances that China has made in removing or reducing tariffs and other barriers at the point of entry. It accepts that these barriers could be lowered further.

Doing business in China

4.21 Gaining access to the Chinese market is but the first step for many Australian companies toward successfully conducting business or trading activities in China. Once they have achieved access, they often confront an array of difficulties. Ms Heather Ridout, Chief Executive, Australian Industry Group, pointed out that often lurking behind the transparent barriers 'are the more murky impediments that can cripple access to the China market'.²⁶ Obstacles range over many aspects of business activity and commercial law.

4.22 The following section separates the main areas of concern for Australian business people doing business in China into distinct topics for closer consideration. It looks firstly at the presence of the Chinese government in the domestic marketplace and the influence it exerts there. In particular, it considers the role of SOEs and corporate governance. It then examines the legal and regulatory framework, the enforcement of legislation, and the involvement of local government in the business affairs of foreign enterprises. It also identifies some of the aspects of the Australian market that the Chinese government regards as impediments to trade.

The influence exerted by the Chinese government in the marketplace

4.23 In China, the private sector continues to expand and displace the public sector as a proportion of industrial output. The emergence of this vibrant private sector that

24 Transcript of the Prime Minister the Hon John Howard, MP, Address to the United Nations, New York, 16 September 2005. See also transcript of the Prime Minister, the Hon John Howard, MP, Address to the Asia Society Lunch, The Asia Society, New York City, 12 September 2005.

25 Transcript of the Prime Minister, the Hon John Howard, MP, Address to the Asia Society Lunch, The Asia Society, New York City, 12 September 2005.

26 Heather Ridout, 'China—Terms of Engagement', the *Sydney Papers*, Summer 2005, p. 50.

is gradually overtaking the role of the government in the Chinese economy is reshaping the business landscape in China. Even so, government control remains firm and its influence still permeates the economy. Undoubtedly, the government remains the leading force in planning China's economy.

State-owned enterprises (SOEs)

4.24 In terms of private business establishment and operation, the Chinese bureaucracy continues to wield tremendous power in the commercial realm.²⁷ Its influence is particularly evident through the activity of state-owned enterprises (SOEs) in the economy. Indeed, much of China's economy is controlled by large SOEs that still have a stranglehold on key sectors in the market. Because SOEs occupy such a commanding position in China's economy, their business and corporate governance practices are important to foreign companies who must deal with these enterprises.²⁸

4.25 Although the SOE sector has undergone significant reform, many commentators maintain that substantial improvement in this sector is yet to be achieved.²⁹ Most concur that the lack of transparency coupled with a poor disclosure regime present major problems for business people dealing with SOEs.³⁰ Mr Graeme Thomson, Principal Graeme Thomson and Associates, noted that 'State trading enterprises are not fully corporatized and separate from the State.'³¹ Taking account of the significance of SOEs in China and the difficulties they pose for foreign enterprises, Ian McCubbin, Partner, Deacons, has advised Australian companies when contracting major projects with SOEs:

...to go beyond the commercial terms to satisfy themselves that the relevant SOE will be permitted to meet its contractual commitments, either at all, or more likely, within the time parameters set by the contracts. What do you do if an SOE fails to meet a contractual deadline? In all probability the SOE is not being capricious, just waiting for Central Government direction. You will respond as most foreign companies do when they are dealing with a major SOE. They do not issue proceedings, regardless of their legal rights.³²

4.26 Numerous witnesses to this inquiry reinforced this view that China needs to improve its corporate governance and to reform its state-owned enterprises. The

27 *Submission P19*, p. 13.

28 *Submission P19*, p. 13.

29 Claustre Bajona and Tianshu Chu, 'China's WTO Accession and its Effect on State-Owned Enterprises', Economic Series, *East-West Center Working Papers*, No. 70, April 2004, p. 2.

30 See for example, Ma Zhengwu, 'Improving Transparency and Standardizing Information: Disclosure is the Social Responsibility of State-owned Enterprises', *DCR/ERI-OECD-2005 Policy Dialogue on Corporate Governance in China*, 19 May 2005, p. 2.

31 Graeme Thomson, Principal Graeme Thomson and Associates, 'Trade Policy Issues', Australia-China Free Trade Agreement Conference, Sydney, 12-13 August 2004, p. 7.

32 Ian McCubbin, Partner, Deacons, 'The legal system and business environment', Australia-China Free Trade Agreement Conference, p. 6.

Australia China Business Council contended that SOEs with their hold over key areas of the economy and, at times, the lack of transparency in their business dealings, have 'the potential to stifle trade and lead to anti-competitive behaviour'.³³ Ms Vivienne Bath, a senior lecturer in law, noted the problems for foreign investors operating in an environment where the government has such a dominant presence in the market. She stated:

...as long as every foreign investor in China has to invest through a foreign investment enterprise, the Ministry of Commerce has a role in approving the investment, reviewing the documents and subsequently approving any change which is made to the documents. I cannot see why that it is necessary now that China has moved away so much from an economy in which state owned enterprises are dominant. Every year the sector of the economy that the state owned companies control gets smaller and the private sector gets bigger.³⁴

4.27 China acknowledges that to facilitate its growing economy it needs to continue its economic restructuring especially the reform of SOEs and corporate governance. Its major priorities for reform are:

- to restructure government bodies and to transform the functions of government;
- to promote State-owned enterprise reform, focusing on corporate governance and share-holding systems; and
- to promote financial reform, which is a critical and often problematic aspect of China's economy.³⁵

4.28 The Chinese government also announced that better management of state owned assets would be a top priority and established a new commission in April 2003 to manage state-owned assets.³⁶ It wants to improve its own performance to ensure that its administration acts in accordance with the law. Premier Wen announced:

We will conscientiously implement the basic policy of governing the country by law and the Program on Performing Official Duties in Accordance with the Law promulgated by the State Council, and speed up work to build a law-based government...we will strengthen the administrative accountability system and investigate and prosecute administrative improprieties in accordance with the law. All departments must strengthen their internal management, actively cooperate with and support auditing offices and supervision departments in the performance of

33 *Submission P40*, p. 17.

34 *Committee Hansard*, 1 August 2005, pp. 91–92. Ms Bath appeared in a private capacity. She is a senior lecturer in law at the Sydney University Faculty of Law and Director of the Centre for Asian and Pacific Law at Sydney University

35 'Premier Wen Jiabao's press conference', 14 March 2005.

36 OECD, Building Partnerships for Progress, 'Policy Dialogue with China'.

their duties in accordance with the law, and conscientiously correct any problems discovered in the process.³⁷

4.29 With the emphasis on improving information disclosure and enhancing transparency for SOEs, the Government is looking for a major shift in corporate culture. Mr Ma Zhengwu, told an OECD conference on corporate governance that:

A fundamental engineering for China to develop market-oriented economy is to establish the good-faith system. SOEs are influential not only to the industry to which they belong and regional economy but also to national economy and are the dominant force for China's economy, as a result, they shall assume the key responsibility in the construction of social good-faith system which is based on transparency and information disclosure and shall play the role of a model to promote the forming of the social good-faith system.³⁸

Corporate governance

4.30 China has stated clearly its intention to reform state-owned enterprises which it regards as a central plank in its economic restructuring. China is also moving to address the general corporate governance problems in the private sector. Ineffective shareholder protection, a poor disclosure regime and conflicts of interest feature as the main weaknesses of current corporate governance practices.³⁹ A recent study found that the corporate governance model adopted in China can be described as 'a control-based model, in which the controlling shareholders (in most cases, the state) employ all kinds of governance mechanism to tightly control the listed firms'. It stated that :

...concentrated ownership structure, management-friendly boards, inadequate financial disclosure, and inactive take-over markets have been the governance norm commonly practiced in China.⁴⁰

4.31 Chinese leaders have made a commitment to improve corporate governance and 'change the operational mechanisms of enterprises to meet the requirements for a modern enterprise system'.⁴¹ They recognise that good corporate governance is central

37 *Report on the Work over the Government*, 15 March 2005.

38 Ma Zhengwu, 'Improving Transparency and Standardizing Information: Disclosure is the Social Responsibility of State-Owned Enterprises', *DRC/ERI-OECD 2005 Policy Dialogue on Corporate Governance in China*, Beijing, 19 May 2005, p. 2. Mr Ma is Chairman and CEO of one of the seven pilot enterprises in which the SASAC is setting up boards.

39 A recent study concluded that 'the protection of shareholder rights is poor, insider trading is rampant, and the listed companies do not take shareholder value maximization as their primary goal, in practice', Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants*, Draft, 9 May 2005, pp. 11–12.

40 Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects, and Institutional Determinants*, Draft, 19 July 2005, p. 2.

41 *Report on the Work of the Government*, delivered by Premier Wen Jiabao at the Third Session of the 10th National People's Congress, 5 March 2005.

to China's development. Despite this recognition, Chinese leaders have faced many difficulties in trying to establish a sound corporate governance regime. In December 2004, Mr Zhou Xiaochuan, Governor of the People's Bank of China, stated that at the very beginning, like primary school students, 'we even disagreed and argued about some of the very fundamental issues'.⁴² Now, the government wants the reforms to proceed 'unwaveringly'.⁴³

4.32 To this end, China has undertaken far reaching reforms to improve corporate governance. For example, it has issued a Code of Corporate Governance for Listed Companies in China based on the OECD Principles of Corporate Governance. In summarising the current situation, Hunt and Hunt Lawyers stated:

Whilst it would not be suggested that bad or improper business practices have been eliminated in China there has been dramatic improvements in terms of transparency, accountability and business ethics and before criticising China it is important to have a balance remembering that even in the most developed economies there are many examples of bad or improper business practices.⁴⁴

4.33 Its submission goes on to state:

The new generation of bureaucrats and business people are keen to capitalise on the economic opportunities in China and to enhance the growth of their own businesses and are keen to partner with foreign business people and contrary to the myths propagated by the media outside China have found most to be honourable and determined to ensure they meet obligations which they undertake.⁴⁵

4.34 Mr Eswar Prasad, Chief, China Division, Asia and Pacific Department, IMF, has written that it was essential for China not just to have a reform plan, but also 'a set of tools that are necessary to meet these reform challenges and to deal with the additional shocks that the economy could face as China's integration with the world economy continues and it becomes more exposed to external influences'.⁴⁶ He believed that a good legal framework, good property rights and sound financial supervision were essential for China's progress.⁴⁷ Mr Albert Keidel, Senior Associate, China Program, Carnegie Endowment for International Peace, also noted that there

42 Zhou Xiaochuan, Governor of the People's Bank of China, 'Improve corporate governance and develop capital market', Speech at the Euromoney 'China Forum: Capital Market and Corporate Governance', Beijing, 1 December 2004, p. 1.

43 *Report on the Work of the Government*, 15 March 2005.

44 *Submission P24*, p. 12.

45 *Submission P24*, p. 13.

46 Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 5.

47 Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 5.

remained in China a serious problem with the management and governance of enterprises not just SOEs. In his view they are opaque. He stated:

...whether state-owned, state-controlled, or private, it's hard to find out what their accounts are like. It's hard to find out what their business plan is.⁴⁸

4.35 Mr Keidel recognised the importance of building a financial system on solid legal and accounting foundations, noting that China is building those institutions but needs to progress a long way towards creating the skill, talent and regulatory structures.⁴⁹ Other commentators agree that China is still lacking 'world-class companies, a well developed banking system and fully functioning capital markets'.⁵⁰

4.36 Poor corporate governance is a sure breeding ground for corruption. A recent OECD study formed the view that despite significant efforts from the CPC and government leaders, corruption remained 'a serious problem for both citizens and businesses, particularly for foreign direct investment'. It acknowledged that this problem posed a significant challenge for China.⁵¹ Indeed, Professor Yan Sun recently asserted that since the beginning of economic reform in China there has been 'a steady rise in the number of Chinese cadre disciplined for abuses, especially at senior levels'. He wrote:

Among the highest officials disciplined for official corruption – those at the deputy governor or minister level and higher – the average take in the 1980s was about \$5,000. Since the 1990s, the average has approached 250,000, or 50 times as much. This surge of corruption has stemmed from a continuing expansion of incentives and opportunities created by economic liberalization.⁵²

4.37 The committee also cites, in particular, the conclusions drawn in a recent OECD Policy Brief on China's governance. It stated:

...corruption is one of the most important problems in China today...More attention should be paid to reviewing areas prone to corruption, eliminating

48 Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 9.

49 Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 12.

50 Dr Stephen Roach, Chief Economist and Managing Director, Morgan Stanley, Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 14.

51 OECD, *China in the Global Economy: Governance in China*, OECD Publishing, Paris, September 2005, p. 127.

52 Yan Sun, Professor of Political Science, City University of New York, Queens College and the Graduate Centre, 'The Corruption, Growth, and Reform: The Chinese Enigma', *Current History*, September 2005, p. 257.

opportunities for corruption and creating conditions conducive to ethical behaviour.⁵³

4.38 A recent conference of the Regional Asian Development Bank and the OECD urged businesses operating in the region 'to act with increasing integrity and put in place effective anti-corruption measures'. It recommended that...

...governments set up and strictly enforce accounting standards to improve transparency of company accounts; strengthen independent external auditing controls to help prevent and detect acts of corruption; and require auditors to report suspicions of bribery to competent authorities.⁵⁴

It also stressed the need to establish ethical and administrative codes of conduct for managing conflicts of interest.⁵⁵

4.39 Witnesses before the committee also highlighted the need for improved corporate governance in China. For example, while identifying the SOE sector as a major problem, Dr Morgan argued that reform needed to encompass the wider corporate world in China:

China has been making positive steps in the reform of corporate governance and the improvement of state owned enterprises, but there is still a long way to go. Whether state owned enterprises are part of the problem or part of the solution, in my view, really does not matter in a sense. What is important is the extent to which China is able to reform governance and bring into play effective market institutions that will ensure some oversight of not only state owned enterprises that are becoming increasingly corporatised but also the emergent private sector, which is quite vibrant but, being entrepreneurial, also has its fair share of cowboys.⁵⁶

4.40 RTIO was of the view that there could be greater transparency in the Chinese marketplace. It cited practices such the failure to produce annual reports, the lack of third party audits, reporting that is not up to international standards and stock market regulations not comparable with international norms as significant shortcomings in corporate governance.⁵⁷ The Australia China Business Council agreed that strong corporate governance and transparency needed to be introduced and enforced in China. This requirement would apply to publicly listed enterprises and also corporate and government-owned entities throughout the country.⁵⁸ It stressed the need for clear

53 OECD, 'China's Governance in Transition', *Policy Brief*, September 2005.

54 'ADB/OECD Anti-corruption Initiative for Asia and the Pacific', 5th regional anti-corruption conference, Beijing, 30 September 2005.

55 'ADB/OECD Anti-corruption Initiative for Asia and the Pacific', 5th regional anti-corruption conference, Beijing, 30 September 2005.

56 S. Morgan, *Committee Hansard*, 27 June 2005, p. 11.

57 *Submission P34*, p. 8.

58 *Submission P40*, p. 16.

accountability, strong corporate governance and unambiguous transparency with all stakeholders including shareholders, employees, customers and suppliers.⁵⁹

Corporate governance—Australia

4.41 The reputations of countries such as Australia and the United States have in recent years been tarnished by a spate of corporate failures. These very public instances of unacceptable or irresponsible corporate conduct by, in some cases, highly respected companies and corporate executives exposed weakness in corporate governance. Both countries responded by introducing laws that would better promote transparency and accountability. They focused in particular on improving disclosure and the avoidance of conflicts of interest. Australia in particular has introduced a substantial body of reforms to ensure that its corporate regulatory framework 'remains effective and helps define world's best practice'.⁶⁰ These reforms range across many aspects of corporate law and Australia's experience in grappling with the complexity of such laws could be of benefit to China. Australia's corporate law economic reform program is continuing to introduce measures to improve corporate governance in Australia.

Committee view

4.42 Corporate governance is now a matter of open public debate in China. The committee commends the initiatives taken by the Chinese government to improve its corporate governance regime. It accepts, however, that implementation will take time and China needs to press ahead with reform to ensure that transparency and accountability underpin corporate conduct in China. The committee accepts that the challenge is not only in formulating legislation but in changing the business culture. The committee believes that Australia, in light of its serious and determined efforts to improve its corporation laws, is well placed to provide a model for and practical assistance to China in its endeavours to develop a better corporate governance regime.

Legal and regulatory framework for foreign enterprises

4.43 As part of its drive for economic reform, the Chinese government, since the 1980s, has turned its attention to the country's legal framework. Indeed, the various agencies empowered to create rules have been busy in formulating laws which have resulted in substantial legislative activity and a proliferation of new laws and regulations. For example, Dr Sarah Biddulph recorded that to June 1999, the National People's Congress, the primary rule-maker, had passed 250 laws and 106 decisions; the state council had passed 830 administrative regulations; local congress had passed

59 *Submission P40*, p. 16.

60 See for example a report by the Parliamentary Joint Committee on Corporations and Financial Services, *CLERP (Audit Reform and Corporate Disclosure) Bill 2003, Part 1 and Part 2*, June 2004.

7,000 local regulations, and finally local government and the ministries and commissions under the state council had passed 30,000 administrative rules.⁶¹

4.44 Legal review and reform have continued. According to the 2003 Report on the Work of the Government, between 1998 and 2003, the State Council made 50 legislative proposals and promulgated 150 administrative statutes. It stated further that:

...the State Council made a sweeping review of the 756 administrative statutes promulgated by the end of 2000, resulting in 71 of them having been nullified and 80 others declared no longer in effect. The agencies under the State Council went over 2,300 foreign-related regulations and related policies, abolishing 830 of them and revising 325 others.⁶²

4.45 A number of commentators accept that China's reform program has greatly assisted and encouraged foreign companies to enter the Chinese market. For example, Hunt and Hunt Lawyers informed the committee that China is 'a much easier environment in which to work'. It used the example of the time taken for foreign businesses to establish a wholly-owned foreign enterprise (WFOE) as indicative of the improvement.

The WFOE concept was unknown in the 1980s, joint ventures were mandatory but now depending on the industry sector in which you seek to operate all requirements for the establishment of your own WFOE in China can be completed in six to eight weeks at a modest cost, including the incorporation of a company and obtaining all relevant government approvals.

In many large Chinese cities the government has recognised to encourage foreign investment there must be a dramatic reduction in the time required and the bureaucratic processes to obtain approvals. In part these processes become easier because authority to make decisions has devolved from Beijing.⁶³

4.46 It also noted that only the very largest investments in sensitive areas now require approval in Beijing and in most cases relevant approvals can be obtained in the city where the foreigner is intending to commence business.⁶⁴ The new laws include 'company law, insolvency laws and laws relating to dispute resolution together with the development of credible arbitration bodies.'⁶⁵

61 *Committee Hansard*, 1 August 2005, p. 94.

62 *Report on the Work of the Government* delivered by Premier Zhu Rongji at the First Session of the 10th National People's Congress, 5 March 2003.

63 *Submission P24*, p. 11.

64 *Submission P24*, p. 11.

65 *Submission P24*, p. 12.

4.47 While acknowledging the improvements made to assist foreign companies to conduct business in China, some witnesses considered that the reform program has created a fairly complex system of national legislation, administrative regulations and local laws in which governments at all levels have a strong presence. Ms Vivienne Bath, senior lecturer in law, commented on what she saw as 'excessive regulation in the form of a proliferation of government legislation at all levels in China in relation to foreign investment, general corporate activity and sector specific regulation'.⁶⁶ The Australia China Business Council, was also critical of the current regulatory framework in China, describing the administrative system in many sectors as 'multi-layered, overlapping and opaque'.⁶⁷ It noted that there are significant regulatory barriers on the 'operation of wholly owned foreign enterprises'.⁶⁸

4.48 In keeping with these findings, Mr Ian Satchwell, ACIL Tasman, identified the bureaucracy as a major impediment for Australian companies. He explained:

For a company to register in China it must specify the area of business in which it intends to operate, and then the company is only allowed to undertake business activities in the specified sectors or fields. If new market opportunities open up it is difficult for the company to move outside its specified scope of services, and that inhibits the easy development of foreign firms, in particular, in China.⁶⁹

4.49 Mr Duncan Calder, KPMG, joined the numerous witnesses who highlighted the problems created by the 'intricacy of different interpretations of procedures and regulations'. He stated:

I hear a lot of evidence of people thinking they have opened the door and understood the law who then find there is another layer of regulation that sits behind that. Things may be approved but they may never happen, because of frustration with delays. There are restrictive regulations in relation to business scope and the registering of capital requirements for foreign investment enterprises that can cause some difficulties there as well.⁷⁰

4.50 The problem goes beyond the complexity and the multi-layering of rules and regulations. Their tendency to discriminate against foreign companies places such businesses at a distinct disadvantage. Evidence presented to this committee documented a wide range of legal impediments confronting Australian companies

66 *Committee Hansard*, 1 August 2005, p. 86.

67 *Submission P40*, p. 15.

68 *Submission P 40*, pp. 17–18.

69 *Committee Hansard*, 1 August 2005, p. 3. Mr Satchwell is an executive member of the board of the ACBC Western Australia and also Executive Director of ACIL Tasman and head of ACIL Tasman's practices in Western Australia and China.

70 *Committee Hansard*, 1 August 2005, p. 3. Mr Calder is a Council Member, Australia China Business Council, Western Australian Branch; and National Chairman, China Business Practice, KPMG.

including the continuing legal and practical demarcation between foreign and Chinese companies operating in China. The Australia China Business Council cited restrictions such as the inability to obtain full import/export licences, strict controls on foreign exchange movements, limitations on inter-company loans and the retention of capital with Chinese domiciled enterprises and concerns with regard to the convertibility of renminbi.⁷¹ Legal firms have found their ability to service clients limited by laws that restrict their ability to hire Chinese lawyers in China and to form joint ventures or economic associations with Chinese law firms.⁷² The mutual recognition of professional qualifications gained outside China also creates impediments.⁷³

4.51 Ms Bath believed that foreign investment enterprises should really just be regarded as another form of private enterprise.⁷⁴ She argued that China should be working towards 'a simpler and less regulated investment regime and the gradual elimination of the foreign domestic distinction'.⁷⁵ Mr Calder would like to see Australian companies have equal treatment in China with Chinese companies.⁷⁶

Committee view

4.52 Foreign businesses operate not only in a regulatory environment where there is a strong government presence and a need for improved corporate governance but also under of system of rules and regulations that are confusing and complex. Even though government agencies at all levels have introduced a raft of legislation since the 1980s, foreign companies find the legal and regulatory environment complex, time-consuming, expensive, uncertain and discriminatory. The experiences of some foreign companies in China have left a lasting impression that conducting business in China can be a risky undertaking.

4.53 Without doubt, many legal obstacles remain in China that impede the attempts by Australian companies to become established and to expand in that country. Although over the last quarter century China has overhauled its legal system, some still regarded the system as inadequate for a country moving into the global market of the 21st century.

4.54 Clearly, any measures taken to streamline the rules and regulations governing foreign business operating in China would greatly assist Australian companies in that country and be an incentive for increased trading activities. The removal of practices

71 *Submission P 40*, pp. 17–18.

72 See for example, Ian Satchwell, *Committee Hansard*, 1 August 2005, p. 3 and Vivienne Bath, *Committee Hansard*, 1 August 2005, pp. 86–87.

73 See for example, Ian Satchwell, *Committee Hansard*, 1 August 2005, pp. 4–8 and Australia China Business Council, *Submission P40*, p. 30. See also chapter 8, paragraphs 8.51–8.54.

74 *Committee Hansard*, 1 August 2005, pp. 91–92.

75 *Committee Hansard*, 1 August 2005, p. 87.

76 *Committee Hansard*, 1 August 2005, p. 3.

that discriminate against foreign companies in China would also encourage Australian firms to conduct business there.

Specific problems in the current legal system

4.55 Inadequacies or failings in the legal system in China are not confined to narrow aspects of the law. Some commentators mentioned bankruptcy laws where, in their view, it is very hard to bring an enterprise to the table to make them pay their debts.⁷⁷ Australian business people also cited returning money to Australia as another significant difficulty. Hunt and Hunt Lawyers noted that one of the main concerns in conducting business in China is 'the ability to repatriate moneys earned' there.⁷⁸ Mr Thomson also noted that 'difficulties still exist in the remission of funds out of China despite the steps taken to achieve the full convertibility of the RMB'.⁷⁹ The committee has chosen two areas of the legal system in China to highlight the problems confronting Australian firms—contract law and intellectual property law.

Contract law

4.56 Mr Ian McCubbin, partner, Deacons, has referred to China's legal and regulatory system as 'relatively embryonic' and likely to restrict free market access.⁸⁰ He noted that contract law was one particular aspect of the legal framework that concerned Australian businesses. He stated:

One of the most commonly asked questions of companies hoping to do business in China is 'Is my contract in China worth the paper it is written on?' My answer to that question is 'it depends what you want the contract to do'. If you are expecting to be able to enforce the 'rules for the engagement of war' clauses in a Court of Law in China, then the answer is probably 'No'. If, on the other hand, you view Chinese contracts as a means of reinforcing your future negotiations, then the documents have a significant role to play. Either way, this is the reality of doing business in China.⁸¹

4.57 The Australia Business Council told the committee that China is gradually adopting a legal system that 'enshrines written contracts with the same sanctity as in Western systems'. It stressed, however, that improvements were still required.⁸² It noted in particular the absence of a tradition of an independent judicial process in

77 Transcript of an IMF Economic Forum, 'China in the Global Economy: Prospects and Challenges', Washington, D.C., 19 October 2004, p. 9.

78 *Submission P24*, appendix 2, p. 30.

79 Graeme Thomson, Principal Graeme Thomson and Associates, 'Trade Policy Issues', Australia–China Free Trade Agreement Conference, Sydney, 12–13 August 2004, p. 7.

80 Ian McCubbin, Partner, Deacons, 'The legal system and business environment', Australia–China Free Trade Agreement Conference, p. 6.

81 Ian McCubbin, Partner, Deacons, 'The legal system and business environment', Australia–China Free Trade Agreement Conference, p. 2.

82 *Submission P40*, p. 16.

China that would allow a party to enforce a written contract. It also observed that in China contracts are often seen as evidence of the parties' intentions at the time of signing and therefore subject to renegotiation.⁸³ Another witness, Dr Davis, also identified the legal framework as a significant problem for foreign countries conducting business in China and again used contracts as an example. He stated:

At the moment, many businesses, when they write contracts with the Chinese, are concerned that many of the Chinese regard them as little more than nice pieces of paper and abrogable at the discretion, usually, of a government official. We are aware of a growing tendency of Western businesses—Australian and others—to put clauses in their contracts which, in effect, say that if there is a dispute then the appropriate forum for this resolution will be the International Chamber of Commerce's International Court of Arbitration. So, quite simply, it stays outside China.

In China, there is also a growing recognition of reputation risk. That is, we cannot keep opting in and out of contracts that we do and do not like just because circumstances change. We cannot walk away from them; if we do, people will cease to contract with us.⁸⁴

4.58 DITR similarly cited the enforcement of contracts as another area of concern for Australian business, stating that 'all of these things are developing in the country'.⁸⁵

Committee view

4.59 Clearly, Australian companies need to be confident that any agreement or arrangement that they enter into with a Chinese party will be honoured and that effective and fair mechanisms are in place to safeguard the interests of all parties who enter into such arrangements.

Intellectual property (IP)

4.60 One of the most contentious areas of commercial law in China is that governing the protection of intellectual property. It was cited by a number of witnesses as a major area of weakness in the legal framework.

4.61 Upon its accession to the WTO, China agreed to overhaul its legal system to ensure the protection of intellectual property rights in line with the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement).⁸⁶ The requirements imposed on China since its accession to the WTO and its acceptance of the TRIPS Agreement have been the main catalysts for reform. Change, however, has

83 *Submission P40*, p. 16.

84 R. Davis, *Committee Hansard*, 29 June 2005, pp. 22–23.

85 *Committee Hansard*, 21 June 2005, p. 53.

86 See for example, United States Trade Representative, *2004 Report to Congress on China's WTO Compliance*, 11 December 2004, p. 5.

been slow and IP remains an area that generates criticism from foreign firms. The *2004 Report to Congress on China's WTO Compliance* found:

China has been much less successful in ensuring effective IPR protection, as IPR enforcement remains problematic. Indeed, counterfeiting and piracy in China are at epidemic levels and cause serious economic harm to U.S. businesses in virtually every sector of the economy.⁸⁷

4.62 The experience of some Australian businesses matches that of a number of American companies.⁸⁸ Mr Ian Heath, Director General of IP Australia, stated recently that 'counterfeiting is rife' across most industrial sectors in China citing, in particular, the pharmaceuticals, chemicals, information technology, consumer goods, electrical equipment and the auto sector. He explained that:

The extent of counterfeiting in China is due to the ingrained culture, the support given to infringers by local officials who genuinely want to support local industries, the lucrative gains to be made, the limited resources and training available to enforcement officials, and the lack of public education regarding the economic and social impact of counterfeiting and piracy.⁸⁹

4.63 DITR told the committee that while there is a law on IP there is also the prevailing practice.⁹⁰ The Australia China Business Council agreed with this view. It argued that the enforcement of intellectual property rights in China was 'a major issue of deep concern to all Australian business'.⁹¹ It found that even where foreign companies have been successful in prosecuting an intellectual property infringement claim in China, the remedies and orders of compensation are likely to be inadequate to cover for the loss suffered by the companies.⁹²

4.64 The Australian Industry Group (AiG) joined many witnesses who complained that China failed to protect intellectual property rights adequately. It told the committee:

TRIPS obliges China to adhere to internationally accepted standards of protection for copyrights and neighbouring rights, trademarks, geographical indications, industrial designs, patents, integrated-circuit layout designs and undisclosed information. The TRIPS Agreement also establishes standards for the enforcement of IP rights in administrative and civil actions, and in

87 United States Trade Representative, *2004 Report to Congress on China's WTO Compliance*, 11 December 2004, p. 5.

88 As well as examples given in this section see chapter 6, paragraphs 6.46 and 6.47.

89 Ian Heath, 'A perspective on Intellectual Property Protection in China', *Growth*, Melbourne, no. 55, May 2005, p. 74.

90 *Committee Hansard*, 21 June 2005, p. 52.

91 *Submission P40*, p. 16.

92 *Submission P40*, p. 17.

regard to copyright piracy and trademark counterfeiting, in criminal actions and action at the border.⁹³

4.65 It was also of the view that China is currently failing to enforce IP standards effectively. Some of their members asserted that 'it is common Chinese practice to simply copy products without fear of reprisal'. It cited the example of Xerox which took a Chinese company to court in China for breach of copyright and although successful were awarded damages of only US\$2000.⁹⁴

4.66 It maintained that enhanced intellectual property protection is essential. It argued that China needs 'to implement and enforce effective and commercially realistic penalties that have a clear deterrent effect'.⁹⁵ Dr Davis was more emphatic in pointing out the failure of IP laws in China to protect foreign businesses. He stated:

The classic has always been intellectual property rights. For years, many companies have been concerned about de-engineering or reverse engineering of the products that they allow to be licensed in China. You do not have to be a small firm; I think it was the Ford Motor Company that licensed the production of one of its new little cars and, lo and behold, in about three months, there was an almost identical little car being made by a Chinese company.⁹⁶

4.67 Drawing the committee's attention to measures taken by some foreign companies to help them manage this difficulty, he explained that one of their members had used the following approach:

What I give them is three generations behind what I am making in the West.' He then said, 'I am up to the sixth generation of this product and they have been given only generation 3. By the time they have worked out how generation 3 was made and then how to make generation 4, I am on to generation 7.' So he is almost three generations ahead. That means that China is at a disadvantage. The technology it is being given is older and not cutting edge. As that goes deeper and deeper within China, I think there will start to be a crackdown.

...If the Chinese want to move up the value-add chain, they will have to do better on intellectual property or the flying ducks approach to development, as it is called—which is that it moves from country to country—will mean they are bypassed on the elaborately transformed manufactures. From the bits and pieces we are picking up in the business community, for ETMs or elaborately transformed manufactures, companies are going to India before China.⁹⁷

93 *Submission P63*, p. 28.

94 *Submission P63*, p. 28.

95 *Submission P63*, p. 28.

96 R. Davis, *Committee Hansard*, 29 June 2005, pp. 22–23.

97 R. Davis, *Committee Hansard*, 29 June 2005, p. 23.

4.68 The Department of Communications, Information Technology and the Arts (DCITA) was also of the view that there is considerable scope for enhancing efforts to address intellectual property in China.⁹⁸ The department believed that Australia may be well placed to take a collaborative approach in assisting China with the process of improving their IP regime.⁹⁹ Indeed, in the recent round of FTA negotiations, Australia offered to 'provide detailed materials for consideration in the reform of China's intellectual property regime'.¹⁰⁰

Committee view

4.69 It is clear that Australian companies exporting goods and services to China need to be aware of the pitfalls with regard to the protection of IP in China and take the necessary precautionary measures to minimise risk. Australia should join with other like-minded countries to work through the various multilateral fora to encourage China to remedy the failings in its IP regime including enforcement throughout the country.

Enforcement

4.70 Foreign companies operating in China want to be certain that the laws, rules, regulations or decisions arising from legal proceedings will be enforced consistently, transparently, and without favour. Hunt and Hunt Lawyers were of the view that a foreign business in China finding itself in dispute is no longer faced with the option of having to walk away and write-off the investment. It explained:

Whilst there are still inefficiencies in the Chinese court system and the process can be slow and a little mysterious to foreigners (the Chinese find our processes equally mysterious) the Chinese legal system is rapidly improving and no more challenging than the systems, which currently exist in India or Indonesia.

The Chinese government in the early 1990s encouraged the re-establishment of a private legal profession, which had ceased to exist during the Cultural Revolution. There are now a large number of very bright well-trained Chinese lawyers, many of whom had experience working outside China in Australia, the United States, Britain or Europe.

Chinese arbitration bodies have been opened up to include foreigners. It is no longer necessary if you have a dispute in China to choose a Chinese arbitrator. Bodies such as China International Economic Trade Arbitration Commission ("CIETAC") include in the panel of arbitrators many

98 *Submission P62*, p. 3.

99 *Submission P62*, p. 3.

100 Australia–China FTA negotiations, Subscriber update, Department of Foreign Affairs and Trade, 1 September 2005, http://www.dfat.gov.au/geo/china/fta/050901_subscriber_update.html (accessed 28 September 2005).

foreigners. There are six Australians on the CIETAC panel of foreign arbitrators.

Foreign companies including Australian companies have won arbitrations in China and have successfully enforced arbitral awards. It is not suggested that the system is today perfect or without challenges created by culture and language but in the last 10 years there has been a dramatic change in the capacity of foreign parties to exercise their legal rights and enforce same in China.¹⁰¹

4.71 Some lawyers were not as positive as Hunt and Hunt Lawyers about the extent of improvement in the legal system. Ian McCubbin referred not only to a lack of understanding of the law by administrators, but the absence of strong and efficient enforcement mechanisms. When looking at competition law in China, he stated:

...what China really lacked was an ACCC, led by an Alan Fels or a Graeme Samuel, to provide the vision (and the stick) needed to inculcate the laws into daily commercial activity across the country. Not only was there no single, focused administrative authority charged with the responsibility, and equipped with the sanctions to make the law effective in daily business, the underlying policy issues were simply not understood by the relevant administrators. If the laws were not understood by the senior regulators in Beijing, how much less likely was it that an official in Wuhan or Xian, far less in Xinjiang Province, would be able to exercise consistent interpretations in the enforcement of those laws?¹⁰²

4.72 A number of witnesses supported this contention that there were significant problems with the application and enforcement of laws in China. Ms Vivienne Bath argued that although China is reforming its legal system, a problem remains with the independence and competence of the Chinese courts.¹⁰³ Based on anecdotal evidence, she stated:

There are still quite a lot of judges who are not legally trained. Also I think quite a few judges are placed in a very difficult position because of their relationship with local government and the influence which local government and party officials are able to place upon them...But certainly outside the major cities—places like Beijing, Shanghai and Guangzhou, which have a relatively high level of judiciary—it can be very difficult for foreign investment enterprises or companies to be confident that they will get a fair hearing if they have a dispute or that the judiciary will be truly independent in their cases.¹⁰⁴

101 *Submission P24*, p. 12.

102 Ian McCubbin, Partner, Deacons, 'The legal system and business environment', Australia–China Free Trade Agreement Conference, p. 3.

103 See V. Bath, *Committee Hansard*, 1 August 2005, p. 86.

104 *Committee Hansard*, 1 August 2005, p. 87.

4.73 According to Ms Bath, a lot of people appointed to judicial positions were party or military officials who may not have had legal training. She told the committee that the Chinese are now trying to appoint judges who are trained and have legal training and noted that there is a judicial college in Beijing where judges are trained before taking up positions.¹⁰⁵ Dr Biddulph also referred to the lack of independence in Chinese courts. She attributed this difficulty with independence in part to 'the exercise of party power which undermines or makes incursions into that legal system'. She stressed, however, that the courts lack of independence is not due entirely to the Communist Party but also stems from the structure and status of the courts. She explained:

The budget for the courts is mostly appropriated at the local level. That means that in certain areas the local government exercises quite strong influence over decision making in certain courts—not all, but in some. There is a problem, too, in that the judges do not have the same security of tenure that they have here nor do they have the same status that they have here. So there is a range of ways in which the independence of adjudication by courts is undermined.¹⁰⁶

4.74 Stephen Morgan also believed that there are serious issues with the training of the judiciary and the transparency of the courts.¹⁰⁷ Professor Jacobs shared this view. He also identified problems with the training, education and independence of the judiciary and saw a role for Australia in assisting China improve their legal system. He stated:

One of the problems that the Chinese have is establishing a legal system. They talk about trying to establish a rule of law but they are clearly having difficulties—and this is a very difficult issue... The same thing is happening in Indonesia. Judges do not change over night and legal education does not change over night. It is probably fair to say in a democratising situation that the legal system is always one of the areas which is behind other parts of government. China certainly have not democratised, but they are also having problems depoliticising the legal system. We could probably be helpful there, and we should offer to help. Since we are a medium-sized power, help from Australia would perhaps be less threatening than help from the United States. I think that is a place where we could have a good role to play.¹⁰⁸

105 *Committee Hansard*, 1 August 2005, p. 87.

106 *Committee Hansard*, 1 August 2005, pp. 100–101.

107 S. Morgan, *Committee Hansard*, 27 June 2005, p. 9.

108 J. Jacobs, *Committee Hansard*, 27 June 2005, p. 50. Professor Jacobs is Professor of Asian Languages and Studies at Monash University and also Director of the Taiwan Research Unit. He appeared in a private capacity.

Committee view

4.75 The committee sees enormous potential for the Australian government to take an active and coordinating role in encouraging, sponsoring and in some cases funding a range of Australian organisations and institutions to assist China develop a judicial system that would be noted for the quality of its members and its independence. Bodies such as the ACCC, ASIC, APRA, various courts such as the High Court, relevant government departments, law associations, universities and even private law firms would be ideal participants in such a program.

Summary

4.76 In summary, the committee concluded that doing business in China is complicated by a cumbersome and inefficient bureaucracy and the influence exerted by state-owned enterprises.¹⁰⁹ It found a complex legal system exacerbated by added layers of rules and regulations. In some instances, the system operates in favour of domestic firms. It notes that enforcement is a significant problem with major deficiencies in the judicial system such as poorly trained judges and lack of independence.

4.77 The Chinese government accepts the importance of reforming its legal system. For foreign firms conducting business in China, reforms in the areas of government administration and corporate governance need to go beyond the measures currently implemented by the Chinese government. It is clear that Australian businesses look to strong and public support from the Australian government to ensure that the Chinese business environment does not put them at a disadvantage.¹¹⁰

Local government interference—the mightiest dragon cannot crush the local snake'

4.78 As discussed earlier, local or municipal authorities have also been active in promulgating rules and regulations since the 1980s. With this in mind, the committee notes a 16th century Chinese saying that 'the mightiest dragon cannot crush the local snake'.¹¹¹ The following section looks at the relationship between the central government and the provinces to determine whether there are problems that create difficulties for foreign business.

4.79 While acknowledging the changes that have been implemented since China's accession to the WTO, some commentators recognise that one of the major challenges, as noted above, is not only implementing law reform but ensuring that the laws, once introduced, are enforced. This raises the question of the provincial

109 Anne O. Krueger, First Deputy Managing Director, International Monetary Fund, Keynote address at the American Enterprise Institute Seminar, Washington, D.C., 10 January 2005, p. 7.

110 *Submission P19*, p. 13.

111 See 'A survey of business in China', the *Economist*, 20 March 2004.

governments and their place in assisting the central government with its reform programs. For example, two commentators noted that China had at the central government level made fundamental changes to its legal and regulatory frameworks to comply with WTO principles. Even so, they observed that:

...China's commitments imply a need to ensure adequate enforcement of new rules at all levels, especially the provincial and municipal levels, where administrative and judicial capacity constraints, as well as the potential role of vested interests, may hamper progress (e.g., in eliminating restrictive practices such as the pervasive inter-provincial taxes, fees and other non-tariff obstacles).¹¹²

4.80 In some instances, local governments may not only fail to enforce laws but may impose additional burdens on foreign businesses. One group of commentators with the IMF have suggested that 'in an effort to protect industries from competition, local governments in China are erecting barriers to entry of goods from other provinces'. They went on to say:

For instance, managers of China firms confirmed that they have indeed experienced some difficulties in accessing markets in other provinces. A manager of a medical manufacturing plant reported that the shipments to other provinces are occasionally stopped by local rail officials for two to four weeks for no apparent reason. The administrative units of the industry and commerce department were reportedly obstructing access to markets through audits or local registration requirements.¹¹³

4.81 They noted that it is not possible to measure such barriers directly and added, as it is illegal to impose trade restrictions, 'the measures adopted to protect local industries from competition are usually more subtle than a direct border tax'.¹¹⁴

4.82 Some Australian businesses also regarded the interference at the local level as an impediment to conducting business in China. They were particularly concerned that local authorities did not always enforce laws.¹¹⁵ Ms Valerie Kelly, Department of Agriculture, observed that while at the federal level of government there is 'a passion for the WTO', this does seem to have trickled down to the provincial level.¹¹⁶ The Australia China Business Council also identified the application of laws at the municipal level as a major problem. It stated:

112 Thomas Rumbaugh and Nicholas Blancher, 'China: International Trade and WTO Accession', *IMF Working Paper*, WP/04/36, March 2004, p. 10.

113 Mary Amity and Beata Smarzynska Javorcki, 'Trade Costs and Location of Foreign Firms in China', *IMF Working Paper*, WP/05/55, March 2005, p. 4. See also Steven Macmillan, *Committee Hansard*, 27 June 2005, p. 12.

114 Mary Amity and Beata Smarzynska Javorcki, 'Trade Costs and Location of Foreign Firms in China', *IMF Working Paper*, WP/05/55, March 2005, p. 4. See also S. Macmillan, *Committee Hansard*, 27 June 2005, p. 12.

115 See also chapter 5, paragraphs 5.58–5.59

116 V. Kelly, *Committee Hansard*, 1 August 2005, p. 20.

Enforcement is needed particularly as you move from central administration down the line to provincial and local levels of where the decision makers are. As we say in our submission, the further away you move from the central government, the less likely the decision might be in your favour.¹¹⁷

4.83 Hunt and Hunt Lawyers also referred to problems associated with the additional levels of regulation or interference from provincial or local governments. Its submission stated:

There is significant anecdotal evidence of problems experienced by Australian traders who believe that they have secured national Government approvals for investment or trading but are then faced with significant (and regularly changing) regulations and restrictions imposed by lower levels of Government. The removal (or limitation) of these restrictions would afford significant opportunities for Australian traders.¹¹⁸

4.84 To the same effect, Steven Macmillan, Consultant, China Business Focus, told the committee:

It is a very common experience for businesses in China to find, in our experience, that regulations and the way they are enforced differ from the national to the provincial level. Some of the provincial governments have a range of regulations in place that can sometimes mirror or contradict those at the national level. A good example is the wool research and development arm—AWI—in our group. There is a testing procedure for wool that is imported into China and it has a small fee attached to it. That fee is set at the provincial government level and it differs from provincial government to provincial government. That is an example of something that should ideally be under the purview of the national government, being a foreign trade issue. But it is not, and it is unpredictable as a result of that.¹¹⁹

4.85 Mr Woodard noted that the difficulty of coordinating the provinces is an 'even greater challenge' for China and one they 'have not yet solved'. He stated:

...the aim is to know as much as is possible about what is going on and to attempt to ensure that what happens is orderly and serves the total interests of each country and of the relationship.¹²⁰

4.86 The Australia China Business Council reinforced the view that regional protectionism and barriers to inter-provincial trade disadvantaged Australian companies. It argued that these local obstacles create a sense that 'foreign companies are unable to compete on equal terms'. It argued that:

117 Australia China Business Council, *Committee Hansard*, 29 June 2005, p. 16.

118 *Submission P24*, p. 6.

119 S. Macmillan, *Committee Hansard*, 27 June 2005, p. 13.

120 C. Woodard, *Committee Hansard*, 27 June 2005, p. 26.

China needs a mechanism to apply consistency to enforcement, as the issue of inconsistency in the application of laws and regulations encourages local protectionism. It also extends to allegations of 'home-town' decisions in arbitration and intellectual property enforcement, together with inconsistent tax regimes.¹²¹

Committee view

4.87 The committee finds that the involvement of local authorities in trade and commercial affairs at the provincial level is a major impediment for Australian companies operating in China.

4.88 Clearly, China is a country that, despite reform, still has inadequate legal protections, intellectual property rights violations and government interference particularly at the local level. Australian business should understand the legal and regulatory framework operating in China to ensure that they are fully aware of the legal and business implications of any decision or agreement entered into and are in a position to adequately protect their interests. In particular, Australian business should not underestimate the influence of local bodies in China.

4.89 More effective, fairer and consistent enforcement of laws, rules and regulations at all levels of government would benefit and encourage Australian companies to establish their business in China.

Suitable mechanisms

4.90 The need for uniform application of legislation and consistency in law-making applies across China and has relevance for all who come under the respective laws. In this regard, a multilateral agreement rather than a bilateral arrangement, such as the proposed Australia China FTA, appears to be a more suitable mechanism to pursue the matter. Furthermore, reform is called for in areas such as corporations law, particularly IP law and the laws governing contracts. An overhaul of this type of legislation requires wide ranging legal reform and, again, a bilateral agreement does not seem to be an effective vehicle to effect such broad changes. Dr Ranald noted that:

...a lot of the processes which business identify as being tariff barriers are actually broad policies or laws in the Chinese context. It is difficult to see them being changed; you cannot change those in a bilateral context. It would take a general change of policy in the Chinese context, and I think that is true of labour and environmental standards too.¹²²

4.91 To address the difficulties discussed in this chapter effectively—especially the need for uniform and consistent application and enforcement of legislation at the provincial level—governments at all levels throughout China need to embrace legal change. Central and local authorities need to commit to reform and actively co-

121 *Submission P40*, pp. 17–18.

122 P. Ranald, *Committee Hansard*, 29 June 2005, p. 4.

operate to ensure that laws and government undertakings are applied consistently throughout the country and in the spirit of China's reform agenda. The nature and extent of reform required to bring China's legal system into step with international standards requires wide ranging change. It underlines the importance of Australia joining other WTO members to encourage China to undertake further reform and to impress on China the need to ensure that its legislative reforms are adopted and effectively enforced throughout the country.

4.92 Austrade has emphasised that Australian companies must be prepared for sudden changes in Chinese government policy, and that business conditions and policies in different regions of China are 'very diverse'.¹²³ Indeed, the committee heard on several occasions that the implementation of national policies is often interpreted and implemented differently across the country. This makes it very difficult for foreign investors with multiple investments in China to establish a national operating system.¹²⁴ There is also evidence that foreign companies receive less favourable treatment than local operations.

Recommendation 1

4.93 The committee recommends that the Australian government increase its efforts through the WTO, Asia-Pacific Economic Cooperation (APEC) and bilaterally to encourage China to promulgate laws that comply with the WTO and to ensure that they are interpreted and applied consistently and without discrimination throughout the country. In particular the committee cites the contract and intellectual property laws and local government intervention as areas of most concern to Australian businesses.

Recommendation 2

4.94 The committee recommends that the Australian government place a higher priority on developing and implementing practical measures to assist China manage its transition from a planned economy to a market economy, especially to improve its corporate governance regime. For example, by facilitating exchange programs between Chinese and Australian departments or agencies or offering special training and education programs for Chinese officials in the area of corporate governance.

Recommendation 3 (see also recommendation 16)

4.95 The committee recommends that Austrade establish a system for handling complaints on China's provincial regulations. This system would:

- **encourage Australian companies to register such complaints;**

123 See 'China Profile: Assisting Australian exporters', *Austrade*, http://www.austrade.gov.au/australia/layout/0,,0_S2-1_CLNTXID0019-2_-3_PWB156799-4_doingbusiness-5_-6_-7_,00.html.

124 AustCham Beijing, *2004 Business Issues Paper*, p. 14.

- **record the complaints in a central register and monitor their management;**
- **disseminate information about these complaints among the Australian business community; and**
- **report the complaints to the Australian government.**

4.96 The proposed Australia–China Free Trade Agreement and whether it is an appropriate or effective vehicle for resolving some of the difficulties cited in this chapter is discussed in chapter 12.

Chinese companies in Australia

4.97 The submissions to the committee that covered trade barriers were concerned with impediments existing in the Chinese market that made trading difficult for Australian businesses. Little mention was made about the barriers Australia has erected to protect its markets. It should be noted that Chinese companies are not well represented in Australia—they do not make the top twenty list.¹²⁵ The following section takes a look at the Australian market from the Chinese perspective.

Barriers to trade with Australia

4.98 Australia employs a number of protective measures that other countries regard as barriers to trade. The Chinese Ministry of Commerce has noted:

Though the overall tariff level in Australia is fairly low, high tariff rates are kept for certain products, typically exemplified by automotive vehicles, textiles, garments and footwear. The Australian government has passed relevant laws to implement a 5% to 7.5% reduction on import duties imposed on textiles as of January 1 2005. The existing level will be maintained till 2009. Import duties on buses and auto components and parts have been reduced to 10%, effective as of 1 January 2005. A further reduction to 5% will be made in 2010. Despite the reduction, tariff rates for automotive vehicles, textiles, garments and footwear remain high compared with those for other products. The tariff peak has adversely affected the Chinese exports, especially textiles.¹²⁶

According to the relevant provisions of GATT 1994 on national treatment, the importing country should not levy other taxes or fees on imported duty-paid items in such a discriminatory manner as to protect the domestic products. However, the Customs Tariff (Antidumping) Act provides that the extra consumer tax ‘wine tax’ is levied on imported wine in addition to

125 Information taken from table in *BRW*, 17–23 March 2005.

126 Ministry of Commerce, People's Republic of China, *Foreign Market Access Report*, 2005, pp. 23–34.

the import duty. Such unjustified tax policy has increased the cost of wine importers, and therefore weakened the competitiveness of imported wine.¹²⁷

4.99 The Ministry also clearly identified what it held to be problems with gaining access to Australia's markets, particularly sanitary and phytosanitary (SPS) measures imposed on products imported into Australia, which remain an area of controversy. In its report on foreign market access, the Chinese Ministry of Commerce noted:

Such conservative and stringent sanitary and phytosanitary system adopted by Australia has brought great impediment to the access of foreign agricultural products to Australian market, and the mostly affected products of China include fruit, vegetable and certain cash crops.

As the basis for sanitary and phytosanitary measures, Import Risk Assessment (IRA) is a protracted process, and the technical standards involved are ambiguous. The AQIS, the agency conducting IRA, usually deals with one product from one country at one time with the result that many foreign products are unable to get the IRA and the import license in time. Other countries are calling for Australia to comply with the WTO rules of transparency by increasing transparency of the quarantine process. Philippine and EU has appealed successively to the WTO for a ruling on the reasonableness of the results of the IRA, which had served as the basis for rejecting their agricultural products.¹²⁸

4.100 It also identified a number of other impediments it believes creates difficulties for Chinese importers. They include:

- the system for administrating foodstuff which in China's view is 'very complicated and decentralized';
- the differences in food standards imposed by different states, which according to the report 'have brought about a lot of trouble for Chinese enterprises, and at the same time, make Chinese exporters more susceptible to Holding Orders';¹²⁹
- the approval and labelling system regarding bio-tech food which the report considered as harsh;
- the mandatory requirements on labels which have created 'an extra burden on manufacturers, packaging enterprises, importers, and retailers, in particular, the importers';

127 Ministry of Commerce, People's Republic of China, *Foreign Market Access Report*, 2005, pp. 26–27.

128 Ministry of Commerce, People's Republic of China, *Foreign Market Access Report*, 2005, pp. 29–30.

129 A holding order is an administrative mechanism ensuring future shipments of a failed food from a particular source are referred to the Imported Food Program and inspected at a higher rate than foods in the same category.

- the security certification or registration procedure on the import of medicine, which in China's view is not only complicated but also costly and has brought heavy burdens to relevant Chinese enterprises;
- the requirement to pass Australia's GMP accreditation which have increased the burden on Chinese manufacturers and impeded their exports to Australia;
- the comparatively lengthy period and costly expenses involved in the safety certification process for machinery and electronic products which, according to the report, 'have made it difficult for Chinese enterprises to introduce new products to the Australian market';
- various income subsidies granted by the Australian government to producers—the report cites high domestic production subsidy to dairy products, sugar and rice;
- the rules governing the employment of foreign labour as well as the qualifications of companies providing guarantee for foreign labour;
- difficulties in obtaining working visas; and
- the high rejection rate for the short-term business visa.¹³⁰

4.101 The findings outlined in the Ministry of Commerce's market access report are a reminder to Australians that trade is a two-way street. While Australia's interests are centred on the removal of impediments to gaining access to China's markets, it should also be cognisant that the Chinese perceive real obstacles to conducting business in Australia.

Conclusion

4.102 Clearly, the business environment in China presents challenges for Australian enterprises doing business there. This chapter has discussed in broad terms the various impediments to trade between Australia and China. Trade barriers, however, do not apply uniformly across sectors or indeed to specific products. The following chapters examine a number of specific sectors that are of major importance to Australia's trade with China and which highlight and expand on aspects of the trading partnership, including barriers to trade.

130 Ministry of Commerce, People's Republic of China, *Foreign Market Access Report*, 2005, pp. 23–34.

