DOMESTIC SOURCE RESTRICTIONS THREATEN FREE TRADE: WHAT IS THE FEDERAL GOVERNMENT DOING TO ENSURE A LEVEL PLAYING FIELD IN THE GLOBAL ECONOMY?

HEARING

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

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DOMESTIC SOURCE RESTRICTIONS THREATEN FREE TRADE: WHAT IS THE FEDERAL GOVERNMENT DOING TO ENSURE A LEVEL PLAYING FIELD IN THE GLOBAL ECONOMY?

FRIDAY, MAY 13, 2005

HOUSE OF REPRESENTATIVES,
COMMITTEE ON GOVERNMENT REFORM,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2154, Rayburn House Office Building, Hon. Tom Davis (chairman of the committee) presiding.

Present: Representatives Tom Davis, Duncan, Cummings and Norton.

Staff present: Keith Ausbrook, chief counsel; Chas Phillips, policy counsel; Rob White, press secretary; Drew Crockett, deputy director of communications; Victoria Proctor, senior professional staff member; Edward Kidd and Jaime Hjort, professional staff members; John Brosnan, GAO detailee; Teresa Austin, chief clerk; Sarah D'Orsie, deputy clerk; Corinne Zaccagnini, chief information officer; Andrew James, staff assistant; Nancy Scola, minority professional staff member; Earley Green, minority chief clerk; and Jean Gosa, minority assistant clerk.

Chairman TOM DAVIS. Good morning. The committee will come to order. A quorum being present, I want to welcome everybody to today's hearing on foreign government efforts to institute unfair procurement rules to gain an economic advantage over U.S. companies.

I am particularly concerned with the recent actions by the Chinese Government. China recently circulated draft rules on government software procurement. These rules make it virtually impossible for American software companies and other non-Chinese firms to provide products and services to the Chinese Government, China's largest purchaser of information and technology products.

The rules would require American companies striving to do business with the Chinese Government to manufacture all of their products in China and to register the copyrights in China before they register them anywhere else. In addition, at least 50 percent of the product development must be done in China. These rules make participation in the Chinese Government market nearly impossible for U.S. firms and I might add firms in other parts of the world.

The U.S. software industry already has lost billions of dollars in export revenue due to rampant piracy and counterfeiting in China. The committee has previously held hearings on intellectual property and was astounded to learn that 92 percent of Chinese software products are pirated. A ban against Chinese Government procurement of U.S. software would eliminate our industry's best opportunity to expand its legitimate exports to China.

I am, of course, concerned about the direct impact of the proposed regulations on the U.S. software industry. But even more important is the impact on world trade and the discriminatory precedent this would set if China were to adopt such onerous rules. The fact that the U.S. trade deficit with China has reached record levels only adds to my concern.

Additionally, China should beware of the law of unintended consequences. The proposed regulations would deny China's government the ability to use the world's best software and undermine China's efforts to encourage the active participation of U.S. software companies in developing a vibrant software economy in China.

For the global economy to operate to the benefit of all nations, each country must have procurement systems that are nondiscriminatory, transparent and merit based and technology neutral.

The primary purpose of today's hearing is to get a better understanding of our government's effort to ensure a level playing field for U.S. companies abroad.

We have two distinguished panels of witnesses before us today.

On the first panel, we will hear from Benjamin Wu from the Department of Commerce Technology Administration and Charles Freeman from the Office of the U.S. Trade Representative, who will discuss their efforts to dissuade China from implementing this and other discriminatory policies.

Our second panel features private sector representatives from the Software Information Industry Association, the Business Software Alliance and the U.S.-China Business Council. These representatives will explain the implications of the Chinese law on American competitors.

I have been a strong supporter of trade with China, supported the resolutions before the House on that, and I am a strong supporter of free trade, and I have been a strong supporter of our government not limiting where we can buy our products.

When Accenture won the contract last year for the U.S.-VISIT program, even though it was headquartered offshore, there were efforts on the House floor to strip them of this because they weren't an American company, I was the one who led the debate against that, because, I believe in free and open trade and getting the best products for the American people at the best price wherever they come from, but we are not going to sit here and allow other countries to start building walls around them without us taking a look at other forms of retaliation. We can't let this happen, and free trade can't continue.

I am hopeful as the U.S. Department of Commerce and USTR continue to talk to China that this is a two-way street. China has a lot more to lose than we do by putting up barriers. They have a huge trade surplus right now with the United States.

We need to take a look at how much is the Chinese Government buying from America and how much is America buying from the Chinese Government. Let's take a look at, for the Chinese products we're buying, how much it would cost us to get them somewhere else. This committee is going to look at that data and take a look economically are we really disadvantaged at this point if we point up the barriers. This is of grave concern.

The other thing is, I think if China wants to develop its own software industry, do it the old fashioned way: Enter the market system. They have a lot of smart people over there. Their software industry is emerging and growing every day, but this is not the way to do it. I have to say, I don't think the U.S. Congress is going to sit still if China were to proceed with this and implement this.

I want to welcome everybody to today's hearing.

[The prepared statement of Chairman Tom Davis follows:]

"Domestic Source Restrictions Threaten Free Trade: What is the Federal Government Doing to Ensure a Level Playing Field in the Global Economy"
Opening Statement of Chairman Davis
Friday, May 13, 2005, 10:00 a.m.
Room 2154 Rayburn House Office Building

Good morning. A quorum being present, the Committee on Government Reform will come to order. I would like to welcome everyone to today's hearing on foreign government efforts to institute unfair procurement rules to gain an economic advantage over U.S. companies.

I am particularly concerned with recent actions by the Chinese government. China recently circulated draft rules on government software procurement. These rules would make it virtually impossible for American software companies and other non-Chinese firms to provide products and services to the Chinese government, China's largest purchaser of information technology products.

The rules would require American companies striving to do business with the Chinese government, to manufacture all of their products in China and to register their copyrights in China before they register them anywhere else. In addition, at least 50 percent of the product development must be done in China. These rules make participation in the Chinese government market nearly impossible for U.S. firms.

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For the global economy to operate to the benefit of all nations, each country must have procurement systems that are non-discriminatory, transparent, merit-based, and technology-neutral.

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We have two distinguished panels of witnesses before us today. On the first panel we will hear from Benjamin Wu from the Department of Commerce Technology Administration, and Charles Freeman from the Office of the United States Trade Representative, who will discuss their efforts to dissuade China from implementing this and other discriminatory policies. Our second panel features private sector representatives from the Software Information Industry Association, Business Software Alliance, and U.S. China Business Council. These representatives will explain the implications of the Chinese law on American competitiveness.

I welcome all of the witnesses to today's hearing and look forward to their testimony.

Chairman TOM DAVIS. I now recognize Mr. Cummings.

Mr. CUMMINGS. I want to thank you, Mr. Chairman; and I ask unanimous consent that the statement of Mr. Waxman, our ranking member of the full committee, be a part of the record.

Chairman TOM DAVIS. Without objection.

Mr. CUMMINGS. Thank you very much.

[The prepared statement of Hon. Henry A. Waxman follows:]

Statement of Rep. Henry A. Waxman, Ranking Minority Member
Committee on Government Reform
Hearing on "Domestic Source Restrictions Threaten Free Trade: What is the Federal Government Doing to Ensure a Level Playing Field in the Global Economy?"

May 13, 2005

Mr. Chairman, thank you for holding today's hearing on China's recent proposal to restrict procurement of non-domestic software products for government use. The Chinese government software market is estimated to be worth more than $600 million each year. Chinese laws that restrict access to this market have significant consequences for U.S. manufacturers.

U.S. software manufacturers are already struggling to get a foothold in China. Rampant software piracy is making it extremely difficult to sell legitimate products. Recent estimates indicate that more than 90% of all software used in China today is pirated. Piracy is, to be sure, a global problem. In fact, this Committee held a hearing last September at which we heard how U.S. software manufacturers lose $29 billion in sales each year to global piracy. China is part of that problem. It has continually failed to adequately protect the intellectual property rights of companies doing business within its borders.

Now, China has issued a proposal that threatens to impede significantly the ability of foreign companies to compete in the government software marketplace in China. China has proposed that any software sold to the Chinese government must have at had at least 50% of its development take place in China and that the copyright for that software then be registered in China. Industry representatives have stated that these restrictions will effectively lock them out of the marketplace altogether.

It's not supposed to be this way. When China joined the World Trade Organization, it promised to move quickly to sign the Government Procurement Agreement, known as GPA. GPA expressly prohibits the kind of restrictions on non-domestic products that China has proposed. It is difficult to reconcile China's purported desire to participate in the global economy with actions that contradict fundamental understandings governing international trade.

I look forward to learning more from the witness testimony today about the implications of China's proposal. Thank you, Mr. Chairman.

Mr. CUMMINGS. Mr. Chairman, I agree with what you just said, and I would add one other element to it before I get into my statement, and that is that we have heard complaints all over our country about jobs, people want jobs. With these kinds of policies, Mr. Chairman, it's very, very clear that, while Americans would have greater opportunities if the doors were open and the trade deficit was not as great as it is, the fact is that Americans want to work. So I thank you for calling this hearing to discuss these issues that threaten our Nation's trading relationships with China.

The specific subject of our hearing is a draft law being considered by the Chinese Government that would effectively prohibit American firms from selling software to Chinese Government entities. Technically, the law requires the Chinese Government to buy software only from Chinese companies or from a list of preferred foreign companies. However, to be placed on a list of preferred foreign companies, a company must meet requirements that are so onerous it is likely that no foreign firm would even try to meet them.

While this individual law is troubling on its own, it is all the more troubling because of the context in which it is being considered. Despite having joined the World Trade Organization, the Chinese Government has continued to support policies that are expressly discriminatory; and it has sanctioned the continuation of practices that harm its trading partners.

For example, the Chinese Government continues to enforce discriminatory tax and tariff policies and has thus far failed to take the steps necessary to protect intellectual property. Frequently, the Chinese Government has allowed market access only after firms seeking to do business in China have entered into the so-called offset agreements which have required firms to make available to Chinese industries technical knowledge about a product or process in exchange for increased market access. The law now under consideration would simply continue and expand these policies by requiring businesses wanting to sell software in China to subsidize the research, subsidize the development and production in China of that software.

As unacceptable as these restrictions on software are, particularly as China is now reported to be the second largest market for personal computers in the world, American businesses are rightly concerned that if this law is enacted it could be expanded to include other critical trade sectors such as agriculture, infrastructure technology and other portions of the high-tech sector. Therefore, it is imperative that we take the opportunity that this hearing presents us today to make it known yet again that we oppose the imposition of unfair trade restrictions on American businesses.

The stakes here are extremely high. Total trade, Mr. Chairman, between the United States and China exceeded $230 billion in 2004. Unfortunately, that trade was not balanced. Our trade deficit with China totaled $162 billion in 2004 and is now larger than our deficit with any other country in the world. Not surprisingly, our deficit with China has been more—one of our most rapidly growing deficits in recent years. According to the Congressional Research Service, in 2004, the deficit was more than 30 percent higher than the deficit incurred in the previous year.

I echo the comments of so many of my colleagues regarding trade with China or with any nation. We must have fair trade. Unfortunately, the provisions being considered by China will continue what is an inherently unfair trade relationship between the United States and China. It may therefore be time for us to finally take steps to show the Chinese Government that we simply will accept nothing less than fair trade in our trade relations.

Mr. Chairman, I look forward to hearing from our witnesses today; and I yield back.

[The prepared statement of Hon. Elijah E. Cummings follows:]

Opening Statement

Representative Elijah E. Cummings, D-Maryland

Government Reform Committee Hearing:

"Domestic Source Restrictions Threaten Free Trade: What is the Federal Government Doing to Ensure a Level Playing Field in the Global Economy?"

May 13, 2005
10:00 a.m.
2154 Rayburn House Office Building

Mr. Chairman:

Thank you for calling this hearing to discuss a critical issue that threatens our nation's trading relationship with China.

The specific subject of our hearing is a draft law being considered by the Chinese government that would effectively prohibit American firms from selling software to Chinese government entities.

Technically, the law requires the Chinese government to buy software only from Chinese companies – or from a list of 'preferred' foreign companies. However, to be placed on the list of 'preferred' foreign firms, a company must meet requirements that are so onerous it is likely no foreign firm would even try to meet them.

While this individual law is troubling on its own, it is all the more troubling because of the context in which it is being considered.

Despite having joined the World Trade Organization, the Chinese government has continued to support policies that are expressly discriminatory, and it has sanctioned the continuation of practices that harm its trading partners. For example, the Chinese government continues to enforce discriminatory tax and tariff policies, and has thus far failed to take the steps necessary to adequately protect intellectual property.

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I echo the comments of so many of my colleagues regarding trade with China or with any nation. We must have fair trade. Unfortunately, the provisions being considered by China would continue what is an inherently unfair trading relationship between the United States and China.

It may therefore be time for us to finally take steps to show the Chinese government that we will accept nothing less than fair treatment in our trade relations.

Thank you and I yield back.

Chairman TOM DAVIS. Thank you very much.

Mr. Duncan.

Mr. DUNCAN. Thank you very much, Mr. Chairman; and thank you for calling this hearing on a very important topic which is becoming more important all the time. Thank you for your heartfelt opening statement.

You know, if 10 years ago, or possibly even 5 years ago, I had said in a speech or put in one of my newsletters or had spoken publicly and predicted that our trade deficit would be running at $55 or $60 billion a month now or we would have a $162 billion trade deficit with China, people would have thought I was crazy. They would have said that never would have happened. And there are some people, even in spite of this shocking trade deficit that we have now, who say, well, we don't need to worry about that. That means lower prices for Americans and so forth.

But, you know, our relatively low unemployment rate is masking a tremendous problem in this country and that is our very great underemployment. We have college graduates—in fact, sometimes with advanced degrees—all over this country who are working as waiters and waitresses in our finest restaurants. Every kid today is going to graduate school or feel they have to. They can't get the good jobs they could have just a few years ago with just a bachelor's degree and so they are going to graduate schools.

Half the kids are going to law school or thinking about it. The universities see the law schools as moneymakers and so the professors tell them, we know there are too many lawyers. Don't worry about it. There is always room for another good one. They don't tell them that half the lawyers getting out of law school can make more money managing a McDonald's or driving a long haul truck.

We have the college graduates who are having to settle for low-paying, service-sector-type jobs because the trade deficit shows us that we are still sending millions of jobs to other countries; and we have to do better. Many, many—in fact, almost every Member of Congress is concerned about this.

A recent column by Paul Craig Roberts, who was Assistant Secretary of the Treasury under President Reagan and who is a nationally syndicated columnist, he wrote this: A country cannot be a superpower without a high-tech economy, and America's high-tech economy is eroding. Corporate outsources presented the loss of manufacturing capability as a positive development. Manufacturing, they said, was the old economy, whose loss ensured American's lower consumer prices and greater shareholder returns. The American future is in the new economy of high-tech-knowledge jobs. So far in the 21st century, there is scant sign of the American new economy. The promised knowledge-based jobs have not appeared. To the contrary, the Bureau of Labor Statistics reports a net loss of 221,000 jobs in six major engineering job classifications, a country that doesn't need as many engineers; and much of the work that remains is being outsourced or filled with cheaper foreigners.

His column goes on and on in that vein. But there's great concern.

I represent a district in east Tennessee whose economy is better than most districts in the country because of two things, because so many people are moving there from the north to retire and be-

cause of government spending. But we have watched the shutdown of almost all of our manufacturing and furniture, textiles in many other ways.

I have a friend who is one of the richest, most successful men in Tennessee. He has a medical company that puts out the lightweight shoes for foot and ankle injuries and puts out the disposable surgical trays. He has plants in Ireland, one in Estonia, two in Mexico, two in Nicaragua. He told me recently—he has eight plants in Tennessee. He said, I want to keep jobs in America, but I am paying $2,850 for my employees in Nicaragua, and I'm one of the highest paid employers there. He says, I pay $3,500 a year for my American employees just for their health care, and I don't know how much longer I can keep jobs in this country because the Chinese are breathing down my neck.

That is happening in every industry; and if we don't wake up, we are going to slowly but surely turn this country into some type of Third-World nation.

I am sorry I am going to have to leave in a few minutes to catch a plane to Tennessee, but I wanted to come and make this statement and express my very great concern about this situation they are in, particularly with the Chinese manipulating their currency, and something has to be done.

Chairman TOM DAVIS. Thank you very much, Mr. Duncan.

What I heard at a graduation speech recently and that is that graduates with a degree in science asks, why does it work; a graduate with a degree in engineering asks, how does it work; a graduate with a degree in accounting asks, how much does it cost; and a graduate with a liberal arts degree asks, do you want fries with that?

The world is changing. There are some educational components to this equation that China can do very, very well in a free and open market. I don't know why they would want to run and hide and look for the protections they are looking at in this case. But I will tell you, they are not going to be using American dollars if that's what they think, buying their goods while putting up restrictions around them.

We have Mr. Benjamin Wu, who is no stranger to this committee. He's the Assistant Secretary for Technology and Acting Director for National Technical Information Service, U.S. Department of Commerce; and Mr. Charles Freeman III, the Office of the U.S. Trade Representative.

Thank you very much for being here and my regards to Mr. Portman, one of our former colleagues, who was just sworn in.

Would you rise with me and raise your right hands.

[Witnesses sworn.]

Chairman TOM DAVIS. Mr. Wu, I will start with you. I am sure this has been carefully scripted when you get into the international language. We are not as scripted up here. We are a little more free flowing in terms of what we have to say, but thanks for being with us.

STATEMENTS OF BENJAMIN H. WU, ASSISTANT SECRETARY FOR TECHNOLOGY AND ACTING DIRECTOR FOR NATIONAL TECHNICAL INFORMATION SERVICE, U.S. DEPARTMENT OF COMMERCE; AND CHARLES W. FREEMAN III, OFFICE OF THE U.S. TRADE REPRESENTATIVE

STATEMENT OF BENJAMIN H. WU

Mr. WU. Thank you, Chairman Davis. Congressman Cummings, Congressman Duncan and Congresswoman Norton, I appreciate being invited to address the committee's concerns on the use of domestic source restrictions by foreign governments.

There is a growing concern that some of our international trading partners are implementing standards and technical regulations that effectively serve the trade barrier and limit the expansion of American exports. This has prompted the administration to take action over the past several years. U.S. businesses are pushing for a fair and equitable playing field where standards could be judged not only on the technical merits but also on the adherence of the principals of transparency, fairness, due process and open participation. So in much of 2003 the Department of Commerce launched a standards initiative to ensure that standards are fair and responsive to market and technology needs and that we partner with industry to combat standards as trade barriers to American goods and services.

In May 2004, as a follow-up, the Department released a report that called for greater collaboration across government and within U.S. industry to prevent technical obstacles that impede U.S. exports. The report also emphasized best practices, provided critical education and training and expanded our early warning tools. We believe that, collectively, these actions will go a long way toward an effective rapid response system when the use of standards are identified as a trade barrier.

It's clear in today's face of intensifying global competition neither industry nor government can be complacent about standards-related issues. Despite the healthy trade relationships, tensions can arise when certain countries take restrictive action that could potentially exclude market access to U.S. businesses. Working in close collaboration with industry, including the witnesses that you will hear from on panel two, the Department is pursuing an active multi-pronged strategy with respect to standards-related issues around the globe, with particular attention on China, given American businesses' desire to enter and help develop the Chinese marketplace. For China, this strategy includes continued engagement at the policy and technical levels to deal with issues as they arise, providing support where appropriate to the U.S.' standards developing organizations to open offices in China, posting a standards attache to the U.S. Embassy in Beijing and sponsoring an ongoing series of both general and sector-specific workshops involving Chinese officials and relevant U.S. private and public sector interests, among other initiatives.

Let me address the committee's focus of the specific example where China is causing great concern within U.S. industry, its pending software procurement regulation which could limit the ability of U.S. industry to sell software products and services to the

Chinese Government. U.S. software companies, which are widely recognized as industry leaders for their leading-edge innovation, have invested billions of dollars in China to participate directly in China's growing information technology market. This is especially necessary to combat and offset the perceived high rate of software piracy in China.

The Chinese Government is a major source of legal software purchases and represents an open market for the U.S. software industry. China's proposed procurement rules undermine the stated goal of developing a domestic software industry which requires close collaboration of foreign software producers and foreign investment.

On a political level, also, the proposed domestic preference set forth in China's procurement policy runs counter to the spirit of Premier Wen Jiabao's commitment to reducing our trade deficit with China by increasing U.S. exports.

The Department of Commerce, in close coordination with the Department of State and U.S. Trade Representative's Office, has been actively engaging the Chinese Government on this issue since September 2003 to ensure that the U.S.' companies are not excluded from the government's software procurement market.

Our strategy has been a combination of bilateral dialog, industry-to-government exchanges and multilateral coordination. These have included the provision of technical assistance on government-procurement-related activities and topics to relevant Chinese policymakers, facilitation of industry exchanges with key officials at the Ministry of Finance and Ministry of Information Industry and the State Council Informatization Office, communication of our dialog and our concerns directly through bilateral exchanges between the United States and Chinese senior leadership, and also solicitation of other key trading partners such as the European Union and also Japan to engage China directly on this issue. We continue our strong efforts on this issue.

In particular, I would emphasize we have taken every opportunity to address and raise this issue with our Chinese counterparts, especially at the very highest levels, ranging from Deputy Division Director to Vice Premier. For example, Under Secretary for Technology Phil Bond, Commerce Under Secretary, has raised the issue with SCITO Vice Minister Yang Xueshan. I also raised the issue with the Vice Minister as well as with MII Vice Minister Xi Guohua during my August 2004, trip to Beijing where I led a 17-member government industry delegation to discuss related issues.

In addition, former Commerce Secretary Evans has raised the issues on several occasions since October 2003 with Vice Premier Wu Yi, with Vice Premier Zeng Peiyan and also MII Minister Wang, the most recent which occurred in January 2005 on his final trip to China before he completed his tenure as Commerce Secretary. And it is expected that current Commerce Secretary Carlo Gutierrez will also be raising this issue in his future discussions with senior Chinese ministers as well.

We have also approached the European Union and Japan repeatedly to enlist their support in this effort since both have shared goals regarding a fair and nonrestrictive procurement policy in China. The European Union in particular is lobbying aggressively

for China to begin negotiations on the WTO agreement on government procurement, the GPA. And Japan's Ministry of Economy, Trade and Industry has raised the issue with China's Ministry of Commerce as well.

In our exchanges with the Chinese Government, our message is clear and consistent. By moving to implement this policy, China would be undermining its explicitly stated objective of encouraging the development of a domestic software industry.

Developing software in a global context requires the formation of partnerships between foreign and domestic companies to provide users the best products at the lowest price possible and the lowest total cost of ownership. Restricting the purchase of foreign software discourages foreign software vendors from seeking cooperative associations with local companies, which can also isolate Chinese domestic companies from the international software community. Furthermore, firms generally invest in research facilities where there is an active market for the results of their research and the strong likelihood of recouping their investment costs. In the face of limited market potential, many foreign firms are likely to reduce their research and development in China, and they will be required to implement procedures or eliminate it completely. China's best hope for development for its software industry lies in the creation of enforcement of intellectual property rights and also in fostering a climate of innovation, not in implementation of restricted measures.

The potential impact of China's proposed software procurement measures on the U.S. software industry is less certain but certainly would not be positive. We are concerned that the overly restrictive definition of domestic software contained in the draft regulations has the potential to sharply restrict the sales of U.S. software to the Chinese Government.

Mr. Chairman, the fact that you are holding this hearing underscores the importance of this issue to American software manufacturers and that the legislative bodies and the executive branch of the U.S. Government shares the significant concerns about the implications of China's pending regulation concerning the Chinese Government's acquisition of software. At Commerce, we will continue to work collaboratively with State, with the USTR's Office to ensure that the U.S. software companies continue to have access to Chinese Government customers. We will continue to work vigorously to achieve this goal.

Thank you, Mr. Chairman; and I would be happy to respond to any questions you and members of the committee will have.

Chairman TOM DAVIS. Thank you, Mr. Wu.

[The prepared statement of Mr. Wu follows:]

TESTIMONY OF

BENJAMIN H. WU

ASSISTANT SECRETARY FOR TECHNOLOGY POLICY

U.S. DEPARTMENT OF COMMERCE

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

Mr. Chairman and members of the Committee, thank you for the opportunity to address your concerns on the use of domestic source restrictions by foreign governments. Since standards and technical regulations affect over 80 percent of global commodity trade, domestic source restrictions by foreign governments, in the form of standards as trade barriers, are a concern and have prompted the Department of Commerce to take recent action.

The Department of Commerce is committed to ensuring that standards are fair and responsive to market and technology needs, and that we partner with industry to combat standards as trade barriers to American goods and services. In March 2003, the Department launched a Standards Initiative, under former Secretary Donald L. Evans, to meet this commitment. Current Commerce Secretary Carlos Gutierrez has reinforced this focus as he begins his tenure in the President's Cabinet.

The Department of Commerce Standards Initiative specifically addressed U.S. industry concerns that issues relating to standards and conformity assessment in foreign markets were among the greatest barriers to expanding exports. U.S. businesses were pushing for a fair and equitable standards playing field, where standards would be judged not only on their technical merits but also on their developers' adherence to the principles of transparency, openness, impartiality and consensus, effectiveness and relevance, and coherence.

In May 2004, as a follow-on to the Standards Initiative, the Department released, *Standards and Competitiveness: Coordinating for Results*, a report to reduce standards-related trade barriers that called for broader collaboration across government and with U.S. industry to prevent technical obstacles that impede U.S. exports. The Department of Commerce report can be accessed at http://www.technology.gov/Reports.htm.

The report focused on improving the efficiency and effectiveness of the Department's standards-related programs and policies. It emphasized best practices, provided critical education and training, expanded our early warning tools, and created greater collaboration with industry and government. Collectively, these actions will go a long way towards an effective rapid response system when standards become trade barriers.

The report's recommendations have also helped the Department identify new opportunities and better ways to work with the private sector and other U.S. government agencies on standards-related concerns. The recommendations outlined how we can improve on tackling standards issues that distort trade and undermine our competitiveness. Information for the report was gathered from more than 200 industry associations and standards organizations in 13 industry roundtables convened over a year.

In the face of intensifying global competition, neither industry nor government can be complacent about standards-related issues. In close collaboration with industry, the Department is pursuing an active multi-pronged strategy with respect to standards-related issues around the globe, with particular attention on China. This strategy includes continued engagement at the policy and technical levels to deal with specific issues as they arise, providing grant support where appropriate to U.S. standards developing organizations to open offices in China, posting a standards attaché to the U.S. Embassy in Beijing this summer, and sponsoring an ongoing series of both general and sector-specific workshops involving Chinese officials and relevant U.S. private and public sector interests.

While U.S. standards concerns are not specific to just China, because American industry has demonstrated a clear interest to compete and participate in the Chinese marketplace, it is important that there is a standards development process that is open, transparent, participatory, and fair in China. In 2004, China was the United States' third largest trading partner, with total merchandise trade between the two nations reaching $231 billion. The United States exported over $35 billion of merchandise to China, an increase of over 25 percent over the previous year.

To further the dialogue between the U.S. and China, last August, I led a 70-member U.S. industry-government delegation that completed a two-day workshop in Beijing in order to address some of the most challenging issues facing the U.S.-China trade relationship. The U.S.-China Standards and Conformity Assessment Workshop, was hosted by the U.S. Department of Commerce and China's General Administration of Quality Supervision, Inspection and Quarantine (AQSIQ) to seek greater cooperation in standards development and conformity assessment issues.

The U.S. delegation represented major industrial sectors, leading corporations, and top standards organizations. The workshop addressed industry concerns that standards can be used as technical barriers to trade. This event was organized at the behest of the U.S. private sector and resulted from agreements reached at the 15th Session of the U.S.-China Joint Commission on Commerce and Trade meeting held in April 2004 between Commerce Secretary Donald Evans, U.S. Trade Representative Robert Zoellick, and Vice Premier Wu Yi.

The workshop responded to industry needs and furthered the ongoing cooperation between the United States and China on standards and testing issues. A strong partnership between the public and private sectors in both countries can ensure that standards

development processes are responsive to market and technology needs, while promoting and not hindering trade.

Collaboration and continued dialogue on critical standards-related issues are important to strengthening good relations between all of our nation's trading partners. Tensions have arisen, however, when certain countries take restrictive action that could potentially exclude market access to U.S. businesses. In this regard, I have been asked by the Committee to address a specific example where China has caused great concern with U.S. industry in its application of domestic source requirement standards – China's pending software procurement regulation which could limit the ability of U.S. industry to sell software products and services to the Chinese government.

U.S. software companies, which are widely recognized as industry leaders for their leading-edge innovation, have invested billions of dollars in China to participate directly in China's growing information technology market. This is especially necessary to combat and offset the perceived high rate of software piracy in China. Accordingly, the Chinese government, as a major source of legal software purchases, represents an important market for the U.S. software industry. China's proposed procurement rules undermine its stated goal of developing a domestic software industry, which requires close collaboration with foreign software producers and foreign investment in the sector. On a political level, the proposed domestic preference set forth in China's procurement policy also runs counter to the spirit of Premier Wen Jiabao's commitment to reducing our trade deficit with China by increasing U.S. exports.

The Department of Commerce, working closely with other U.S. Government agencies, has been actively engaging the Chinese government to ensure that U.S. companies are not excluded from the government procurement market.

CHINA'S GOVERNMENT PROCUREMENT SYSTEM

China published its Government Procurement (GP) Law during the summer of 2002. The GP Law went into effect on January 1, 2003, and was the first step in China's effort to create a modern and comprehensive procurement system for the Chinese government at all levels. The Law was modeled after the United Nations Model Law on Government Procurement and attempts to follow international procurement principles. It includes a preference for the Chinese government to procure domestic products and services, with limited exceptions, and software is the first category of procurements for which the Chinese government has begun drafting regulations to implement this domestic preference policy.

Although China acceded to the World Trade Organization (WTO) on December 11, 2001, China is not yet a member of the WTO Agreement on Government Procurement (GPA) and, consequently, does not have any WTO market access obligations in the area of government procurement. When China joined the WTO, it did, however, commit to conduct its government procurement in a transparent manner and to provide all foreign

suppliers with equal opportunity to participate in procurements opened to foreign suppliers (Most Favored Nation principle). It also committed to become an observer to the GPA and to table an offer and initiate negotiations for membership to the GPA "as soon as possible."

In February 2002, China became an observer to the WTO Committee on Government Procurement but, to date, it has not tabled an offer to begin negotiations on GPA accession.

CHINA'S PROPOSED SOFTWARE PROCUREMENT POLICY

China's Ministries of Finance (MOF) and Information Industry (MII) held a joint forum to present the basic framework and key aspects of its draft software government procurement implementing measures in November 2004 and released a partial copy of the regulations for public comment. In the works since early 2003, the published draft, though only a summary, identified for the first time the methodology China was considering to determine whether a given software product or service qualifies as being "domestic". This methodology consisted of a three-part requirement: software products would need to be made within China, its copyright belong to an entity registered in China, and its China-based development costs exceed fifty percent of its total development cost in order to be classified as being "domestic". The summary of the draft regulations also proposed that a software service would similarly qualify if the cost of services provided by a company registered outside of China does not exceed thirty percent of the total cost of the services to be provided.

The summary also highlighted China's intent to implement a three-tier preference for government procurements. For those products that would not qualify as "domestic", the Chinese government would establish a catalogue of foreign software for preferential procurement to differentiate products from foreign suppliers whose domestic investment, domestic research and development, subcontracting to Chinese enterprises or taxes paid in China exceed certain yet-to-be-determined thresholds from the products of all other potential foreign suppliers.

In April 2005, after repeated requests from the U.S. Government and industry, China released for public comment a complete draft of the software procurement implementing measures. Although the revised draft appeared to incorporate some U.S. Government comments, it retained the same definition of "domestic" and three-tier preference structure, including the catalogue of foreign software for preferential procurement, as the previous draft.

U.S. GOVERNMENT ACTIONS

The Department of Commerce, in close coordination with the Department of State and Office of the U.S. Trade Representative, has been actively engaging the Chinese government on this issue since Summer 2003. Our strategy has been a combination of bilateral dialogue, industry-to-government exchanges and multilateral coordination.

These have included the provision of technical assistance on government procurement-related topics to relevant Chinese policymakers; facilitation of industry exchanges with key officials at the MOF, MII, and the State Council Informatization Office (SCITO); communication of our concerns directly through bilateral exchanges between U.S. and Chinese senior leadership; and solicitation of our key trading partners such as the European Union and Japan to engage China directly on this issue. We continue our strong efforts on this issue.

In particular, I would emphasize that we have taken every opportunity to raise this issue with our Chinese counterparts, at levels ranging from Deputy Division Director to Vice Premier. Under Secretary for Technology Phil Bond raised the issue with SCITO Vice Minister Yang Xueshan and I also raised the issue with the Vice Minister, as well as with MII Vice Minister Xi Guohua, during my August 2004 trip to Beijing. In addition, former Commerce Secretary Evans raised the issue on several occasions since October 2003 with Vice Premier Wu Yi, Vice Premier Zeng Peiyan and MII Minister Wang, the most recent of which occurred during his final trip to China in January 2005.

We have also approached the European Union and Japan repeatedly to enlist their support in this effort. The European Union in particular is lobbying aggressively for China to begin negotiations on GPA accession, while Japan's Ministry of Economy, Trade and Industry has raised the issue with China's Ministry of Commerce.

IMPACT OF CHINA'S SOFTWARE PROCUREMENT POLICY

In our exchanges with the Chinese government, our message is clear and consistent. By moving to implement this policy, China would be undermining its explicitly stated objective of encouraging the development of a domestic software industry.

Developing global software requires the formation of partnerships between foreign and domestic companies to provide users the best products at the lowest total costs of ownership. Restricting the purchase of foreign software discourages foreign software vendors from seeking cooperative associations with local companies, which can isolate Chinese domestic companies from the international software community. Furthermore, firms generally invest in research facilities where there is an active market for the results of their research and a strong likelihood of recouping their investment costs. In the face of limited market potential, many foreign firms are likely to reduce their research and development investment in China either to the barest minimum that will be required under the implementing measures or to eliminate it completely. China's best hope for software development lies in the creation and enforcement of intellectual property rights, not in the implementation of these restrictive measures.

The potential impact of China's proposed software procurement measures on the U.S. software industry is less certain but certainly would not be positive. We are concerned that the overly restrictive definition of domestic software contained in the draft regulations has the potential to sharply restrict the sales of U.S. software to the Chinese government.

CONCLUSION

The U.S. Department of Commerce, along with the Department of State and Office of the U.S. Trade Representative, have been working hard to ensure that U.S. software companies continue to have access to Chinese government customers. We will continue to work vigorously to achieve this goal.

Thank you Mr. Chairman. I would be happy to address any questions you or the members of the committee may have.

Chairman TOM DAVIS. Mr. Freeman.

STATEMENT OF CHARLES W. FREEMAN III

Mr. FREEMAN. Thank you, Mr. Chairman and members of the committee. It is a great honor for me to be here today.

Thank you for the greetings to Ambassador Portman. I come from being in the middle of a request by Ambassador Portman to initiate a top-to-bottom review of our trade policies with respect to China, so I look forward to coming back to the committee and discussing those in greater depth.

I appreciate Congressman Duncan's mention of the concerns that we have as a result of the increasing competitiveness in this country of Chinese imports. I know we are here today to discuss market concerns into China, so I will address my remarks to that. I have submitted testimony for the record, which I would ask be included.

Chairman TOM DAVIS. Without objection, your entire written statement is in the record.

Mr. FREEMAN. If I could summarize it fairly briefly, we have had over the past few years, especially since China joined the WTO in 2001, a series of concerns with respect to their WTO commitments and also concerns about the extent to which our companies and our businesses, our farmers and workers have access to their market. We have some fairly significant concerns that still remain, although we have made progress.

China has become our fifth largest export market. It has been our fastest growing by far in the past few years. So we have grown from a fairly low base a number of years ago to about $35 billion in exports last year. That is the good news.

The greater concern I think is as a result of some of the market access problems we have. Primary among those would obviously be China's protection of intellectual property rights. If we are talking about the software market, we are looking at piracy rates of upwards of 90 percent. That is extraordinarily difficult for our companies to deal with and extraordinary difficult not just in the Chinese marketplace but increasingly as a result of exports of counterfeit and pirated materials from China to either third-country markets or even into our own.

We have made progress but continue to have concerns with China's treatment of our agricultural exports, particularly through the use of sanitary standards that questionably have scientific bases.

We continue to be concerned about the treatment of our services industries through the use of high capitalization costs or other requirements that put an excessive burden particularly on our smaller firms.

We have concerns about China's implementation of its commitments on distribution rights, the ability of our firms not to just get a product in the Chinese market but actually have it appear on Chinese shelves and reach Chinese consumers.

And, finally, we have concerns with respect to China's implementation of its commitments on transparency, in other words, the ability of not just our firms but Chinese companies and others to see the rulemaking and licensing decisions as they occur and to have access to the processes which will ensure that these are not operating beyond the veil of secrecy.

We are here also to discuss the increasing use in China of industrial policies that have the effect of limiting the access of our exports and limiting the ability of our exports to achieve penetration to the Chinese market. We have seen this in the use of standards, as Under Secretary Wu discussed, where China produces Chinese-specific standards that make it very difficult for our firms to produce on an economic basis for the Chinese market. We have seen this through the use of discriminatory tax policies. Last year, the United States filed the first and only case against China in the WTO for its use of discriminatory tax policies in the semiconductor area.

And increasingly now we are seeing it in the use of government procurement regulations. To review the bidding in 2002, China promulgated the government procurement law which set in place in effect a "buy China" set of regulations that made it difficult or created the prospect that certain sectors would be reserved or at least presented to Chinese companies more favorably than to foreigners. This comes, as I think the chairman and others have suggested, at a very bad time when we do have a $162 billion trade deficit, where increasingly our products that do have a competitive advantage or should have a competitive advantage in the Chinese marketplace, including technology products and software products, when these are increasingly beginning to have a market develop particularly in the government's market, which is, as most of you know, the only legitimate market for software in China. This presents significant problems to us.

In November 2004, China targeted software as the first sector in its government procurement law to produce these "buy China" policies; and they fleshed out the law further in March 2005. The policy itself attempts to put in place limitations on U.S. software and other foreigners' penetration of the marketplace by insisting upon a narrow definition of domestic. If a United States or foreign company wants to qualify as domestic, it has to put in place significant R&D in China, qualify for tax purposes, have a certain number of Chinese employees and, in other words, raise the cost of doing business in China so that—as an exporter—so that, in effect, you are supposed to relocate to China.

What has the United States done? What has the administration done? In addition to some of the activities that Assistant Under Secretary Wu described, the administration has targeted this policy at the highest levels for discussion at the Joint Commission of Commerce and Trade, which was in December 2003, elevated by President Bush and Premier Wen to be the primary problem-solving dialog in the relationship to overcome trade frictions and, as has been said and what was described by Premier Wen, as the process to encourage U.S. exports, as opposed to discouraging Chinese imports to the United States. So we have targeted this policy specifically for inclusion in resolution at that dialog.

In addition, we are working very hard to make sure that China lives up to its 2001 commitment to join the government procurement agreement as soon as possible. If it were to join the government procurement agreement, this policy would be in violation, in our view, of the agreement. So the shortest distance between these

two points is for China to join the GPA. They said it is ready to join as soon as possible.

We have been working very hard to make sure we are preparing China to be technically ready to achieve the negotiations and accession to GPA. They are saying the key concern is whether it's possible yet. We have been working with our fellow WTO members, the Europeans, the Japanese, to encourage China toward a path that gets them toward GPA accession. But we are trying to use the power of logic and persuasion. That is, if the stated policy of the Chinese is to encourage a domestic software industry, the way to do it is not to eliminate competition. Silicon Valley was not created in a vacuum but through the free exchange and flow of ideas. The key is not to further reduce the ability of others to compete in that marketplace. That will only stagnate the market, in our view, and stagnate the development of China's software development and make it difficult for us to support open markets to Chinese products.

Mr. Chairman and members of the committee, I greatly appreciate the opportunity to be here today. I'm happy to discuss this and other things the administration is doing to ensure a level playing field with respect to China and look forward to your questions.

Chairman TOM DAVIS. Thank you.

[The prepared statement of Mr. Freeman follows:]

TESTIMONY OF

CHARLES W. FREEMAN III

ASSISTANT U.S. TRADE REPRESENTATIVE

BEFORE THE

COMMITTEE ON GOVERNMENT REFORM

May 13, 2005

Chairman Davis and members of the Committee, thank you for the opportunity to address your concerns on the use of non-tariff trade barriers by the People's Republic of China, particularly in the area of government procurement of U.S. computer software.

In the more than 20 years since China began its process of internal economic reform, the quantity of U.S. goods sold in China has expanded dramatically. Since China joined the World Trade Organization in 2001, growth in China's market for U.S. products has only accelerated. In 2004, U.S. exports to China totaled $35 billion, nearly double the total for 2001. In fact, from 2001 to 2004, U.S. exports to China increased nearly eight times faster than U.S. exports to the rest of the world. As a result, China rose from our ninth largest export market in 2001 to our fifth largest export market in 2004. During that same time, of course, China's exports to the United States (and to the rest of the world) have also exploded. In 2004, imports from China totaled $197 billion, nearly double the total for 2001, and China is now the United States' second largest supplier.

Clearly, China's economic emergence presents both challenges and opportunities for U.S. manufacturers, farmers, service providers and workers. While there is much positive to say about our success in penetrating the Chinese market, there is understandable concern that certain Chinese trade practices have frustrated efforts to further open the market, or have in other ways contributed to our large and growing trade deficit with China.

There are several areas where we have problems with China's trade practices, including China's efforts to implement its WTO commitments, and this Administration is working vigorously to address those, using the most effective tools at our disposal, including our trade remedy laws. Let me first put our trade agenda in context. Then, I will focus on one area in which China's policies and practices put U.S. firms, products or services, at an unfair disadvantage in the Chinese market – the government procurement of software.

China's WTO Compliance

In its accession agreement to the WTO, China agreed to extensive, far-reaching and often complex commitments to change its trade regime, at all levels of government. China committed to implement a set of sweeping reforms that required it to lower trade barriers in virtually every sector of the economy, to provide national treatment and improved market access to goods and services imported from the United States and other WTO members, and to protect intellectual property rights (IPR). China also agreed to special rules regarding subsidies and the operation of

state-owned enterprises, in light of the state's large role in China's economy. In accepting China as a fellow WTO member, the United States also secured a number of significant concessions from China that protect U.S. interests during China's WTO implementation stage. Implementation should be substantially completed – if China fully adheres to the agreed schedule – by December 11, 2007.

To date, while China's efforts to fulfill its WTO commitments are impressive, they are far from complete. At times, China's efforts have been unsatisfactory, and the Administration has responded with appropriate steps in such cases. The first year of China's WTO membership (2002) saw significant progress, as China took steps to repeal, revise or enact more than one thousand laws, regulations and other measures to bring its trading system into compliance with WTO standards. In 2003, however, China's WTO implementation efforts lost momentum, and we identified numerous specific WTO-related problems.

In response, the Administration stepped up its efforts to engage China's senior leaders. In December 2003, President Bush and China's Premier, Wen Jiabao, committed to upgrade the level of economic interaction and to undertake an intensive program of bilateral interaction with a view to resolving problems in the U.S.-China trade relationship. Premier Wen also committed to facilitate the increase of U.S. exports to China. This new approach was exemplified by the highly constructive Joint Commission on Commerce and Trade (JCCT) meeting in April 2004, with Vice Premier Wu Yi chairing the Chinese side and Secretary of Commerce Evans and United States Trade Representative Zoellick chairing the U.S. side. At that meeting, which followed a series of frank exchanges covering a wide range of issues in late 2003 and early 2004, the two sides achieved the resolution of no fewer than seven potential disputes over China's WTO compliance. Those successes ranged across the economic spectrum, from wireless standards to biotechnology to trading rights and distribution services.

At the same time, when our discussions with China were not successful, we did not hesitate to use the full range of tools made available to us as a result of China's WTO accession. The United States filed, and was able to successfully resolve, the first-ever dispute settlement case brought against China at the WTO. In that case, the United States, with support from four other WTO members, challenged discriminatory value-added tax policies that favored Chinese-produced semiconductors over imported semiconductors. In July 2004, about three months after the United States had initiated the case, China agreed to end its discriminatory policies, allowing U.S. manufacturers to preserve and expand their $2 billion export business to China.

Key Problem Areas

Our trade relationship with China is large and growing, so it is not surprising that despite successes in a number of areas, problems still remain and new ones have emerged. Of key concern is when China's implementation of its WTO commitments lags in areas in which the United States has a competitive advantage, particularly where innovation or technology plays a key role. At present, we are pressing China in the following priority areas:

- The Administration places the highest priority on stemming the tide of intellectual property rights (IPR) infringement in China. Counterfeiting and piracy in China are at

record levels and are hurting a wide range of U.S. businesses. On April 29, USTR released the results of its special Out-of-Cycle Review, or OCR, of the IPR situation in China. We concluded that while China has recently undertaken a number of serious efforts at the national level to address this situation, such as lowering the value thresholds that trigger criminal investigations and prosecutions, these steps have not significantly reduced IPR infringements across China. Therefore, we have elevated China to the Priority Watch List. We will use this year's JCCT (likely to take place in July) to focus additional attention on this issue, including through the pursuit of clear benchmarks to ensure China's progress on IPR protection. We will use the TRIPS Agreement's transparency provisions to obtain specific evidence from China on the operation of its IPR enforcement regime, and we will work closely with industry with an eye toward utilizing all available WTO procedures to bring China into compliance with its TRIPS obligations.

- Supplementing these bilateral IPR efforts, the Administration has taken comprehensive action to block trade around the world in counterfeit and pirated goods through the Strategy Targeting Organized Piracy (STOP!), a U.S. government-wide initiative begun in October 2004 to empower U.S. businesses to secure and enforce their intellectual property rights in overseas markets, to stop fakes at U.S. borders, to expose international counterfeiters and pirates, to keep global supply chains free of infringing goods, to dismantle criminal enterprises that steal U.S. intellectual property and to reach out to like-minded U.S. trading partners in order to build an international coalition to stop counterfeiting and piracy worldwide.

- Since acceding to the WTO, China has periodically resorted to policies – including in the areas of standards and government procurement -- that limit market access by non-Chinese origin goods and that aim to extract technology and intellectual property from foreign rights-holders. The objective of these policies seems to be to support the development of Chinese industries that are higher up the economic value chain than the industries that make up China's current labor-intensive base, or simply to protect less-competitive domestic industries. Of particular concern is China's recent proposal to implement restrictive government procurement policies for software, which I will address below. The United States and China made important progress toward resolving conflicts over a number of these industrial policies in 2004, but more work needs to be done, and the advent of new or similar policies in the future will require continued vigilance. In particular, we will continue to focus on standards policy that aims to limit foreign high-tech and other products' market access in China.

- While China has implemented its commitment to allow companies and individuals to import goods into China directly without having to use a middleman, China has been slow to permit our companies to freely distribute those products within China at the wholesale and retail level. China did issue regulations calling for timely implementation of its WTO commitment to open up wholesaling and retailing to foreign companies by December 2004. However, U.S. and other foreign companies have encountered impediments to actually providing these services because of ambiguities in the application of these regulations, as well as related licensing procedures. The

Administration has been pressing the Chinese authorities to clarify these procedures so that our companies can take advantage of the rights that they have in the wholesaling and retailing areas. Meanwhile, one segment of the distribution services sector – direct selling – is causing particular concern. Not only has China failed to implement timely regulations, but China is also considering restrictions that would make it difficult or impossible for U.S. direct selling companies to operate in China. The Administration has made clear its serious concerns in this area.

- While the United States enjoys a substantial surplus in trade in services with China, and the market for U.S. service providers in China is increasingly promising, problems remain in a number of important service sectors. Through an opaque regulatory process, overly burdensome licensing and operating requirements, and other means, Chinese regulatory authorities continue to frustrate efforts of U.S. providers of insurance, express delivery, telecommunications and other services to achieve their full market potential in China.

- With U.S. agricultural exports totaling $5.5 billion in 2004, China has become one of the fastest growing overseas markets for U.S. farmers. Despite this growth, however, China's regulation of the agricultural sector is beset by uncertainty. Capricious practices by Chinese customs and quarantine officials can delay or halt shipments of agricultural products into China, while sanitary and phytosanitary standards with questionable scientific bases and a generally opaque regulatory regime frequently bedevil traders in agricultural commodities. While the Administration was able to make substantial headway on a number of key issues in agricultural trade in 2004, particularly in the area of biotechnology approvals and the removal of problematic sanitary and phytosanitary measures that had been curtailing trade, maintaining and improving China's adherence to WTO rules in the area of agriculture will require continued high-level attention in the months and years to come. Currently, one of our top priorities in this area is for China to re-open its market to U.S. beef based on internationally accepted scientific standards for human and animal health.

- While China's Ministry of Commerce has made laudable moves toward adopting WTO transparency norms, other ministries and agencies have lagged behind. As a result, China's regulatory regimes continue to suffer from opacity, frustrating efforts of foreign – and domestic – businesses to achieve the potential benefits of China's WTO accession. The Administration remains committed to seeking improvements in this area.

Let me now address the specific problem area that the Committee has raised: the procurement of software by the Chinese Government.

Government Procurement of Software

In 2002, China enacted the Government Procurement Law, which provides generally that the government shall procure "domestic" goods and services, but allows for exceptions. The law is framework legislation and contemplates sector-specific implementing regulations, which would, among other things, define the scope of "domestic" goods and services and also provide

for any exceptions to the general "buy domestic" preference. China has identified software as the first sector in which to implement the Government Procurement Law.

In November 2004, China's Ministry of Information Industry and Ministry of Finance released an outline of the draft software regulations that would define "domestic software" very narrowly -- to qualify, a product would have to be made in China, IPR would have to be held by a PRC person, and China-based development costs would have to comprise at least 50 percent of total development costs. If domestic products or services are not available, the draft regulations would permit foreign software to be considered, but only if the foreign firm conducts certain (yet to be defined) levels of China-based research and development, investment, subcontracting, or taxable transactions. In March 2005, China released a more complete draft of the measures, which maintains many of these restrictive conditions.

The proposed regulations would put U.S. firms at a significant disadvantage in the Chinese market. In a country where piracy of computer software is rampant, the government is one of the few organizations actually willing to purchase legitimate software. Indeed, at last year's JCCT meeting, China committed that all government offices would use only legitimately purchased software. While China has taken steps to follow-through on that pledge, the procurement policy threatens to undercut its value to the United States. We have made clear to China, including at senior levels, our serious concern with the draft measures. This is the wrong policy for China to implement, given the $160+ billion trade deficit in goods with China. We continue to raise this issue with Chinese officials at every opportunity, and it is a major element of our bilateral engagement.

In addition to bilateral efforts, we are working through WTO mechanisms to try to ensure that software and other U.S. firms have access to China's procurement market. When China acceded to the WTO in 2001, it committed to initiate negotiations to join the WTO Government Procurement Agreement (GPA) as soon as possible. We have urged China to honor that commitment by beginning those negotiations now to open its procurement market, to ensure that all U.S. firms can compete in China's vast procurement market on the same basis as Chinese firms. This move would not only honor China's WTO commitment; it would also serve China's interests to have competitive procurement markets.

GPA accession will represent another critical step in China's integration into the world economy. To help China in this effort, we are providing technical advice and other assistance, while we continue to press China to commence its GPA negotiations without further delay. We are coordinating these efforts with other interested WTO Members.

In addition to utilizing points of leverage, we ultimately need to persuade China with ideas, and we believe that the power of free markets should convince China that its proposed policy is mistaken. Chinese ministries claim that the proposed software policy is designed to help China's nascent software industry develop. We believe that the proposed regulations will not only limit our firms' interests in China, but also will reduce investment in China by foreign firms, and will reduce the incentive for Chinese software makers to improve and refine their own products – the exact opposite of China's goals. A software industry cannot develop behind a wall; Silicon Valley succeeded because of conditions that encourage the free flow of ideas and robust competition, as well as strong IPR protection and enforcement.

The best way to improve China's software industry is to enact and enforce effective IPR laws that provide a level playing field for all software makers. Without strong IPR protection, Chinese firms will not be able to fully capitalize on the creativity of Chinese programmers and service providers. We have made this point clear to the Chinese Government, and, of course, improving China's IPR regime is a major part of our bilateral agenda with China.

Conclusion

Mr. Chairman and members of the Committee, thank you for providing me with the opportunity to testify. I look forward to your questions.

Chairman TOM DAVIS. Do either one of you have any idea how much our government is buying in Chinese goods and services annually? Any ballpark?

Mr. FREEMAN. I don't have a figure. As a result of China not participating in the GPA, they are not as active as they otherwise might be.

Chairman TOM DAVIS. There was a controversy about buying those green beret caps from China. But I've got to believe at least on the good side that there are a number of items we are purchasing, and I'm wondering if you could try to see if you could put a dollar figure on what we're buying from China. Because I think their program, although they cite buy America and some other provisions in our law which are very, very slight—which by the way, for the record, I don't like—but although they cite this, I think they have a lot more to lose if we get into a trade war on this in terms of the expanding markets.

The other thing we look at is the component of what we are buying from China, how much would it cost us if we had to go somewhere else, what's the cost to taxpayers in value. I think we need to be aware of those things as we enter into negotiations and add up some dollars and cents.

I agree with you. There are a lot of minds in China. They're putting a lot of emphasis on education. Their software industry is going to do just fine over the long term. Our countries are offshoring a lot of work to China right now. The last thing they want to have, I think, is a trade war into these areas. They can learn and grow and prosper and be very, very competitive. But if they start putting up barriers, they are going to be finding out that they're going to be left with inferior software and they are not going to be able to compete in global markets. What are the Europeans doing about this?

Mr. FREEMAN. The Europeans are primarily focused on getting China to join the government procurement agreement. They have less of a stake in China's software market than we do. They have their own problems in terms of developing a software market for themselves. So their key is, I think, they are trying to get China to join the GPA so that the next step, whatever that might be, if it's not software, it's an area that Europe is even more competitive, that they do not fall afoul.

Chairman TOM DAVIS. I think in IT we are running an $8 billion trade surplus. It's one of the few areas we're running a surplus, and now they want to put up a barrier to do that.

You know, I don't think it serves their own purposes certainly, but I don't think we can sit there and be a punching bag. You have to remember, the Accenture contract last year on U.S.-VISIT was almost overturned in the House. The mood of Members will be very angry if they are to implement these regulations. And although the administration wouldn't like it, it's hard to figure there wouldn't be some congressional retaliation. All a Member has to do is take a look on any appropriation bill and say no funds shall be expended to a good company from China and it's made in order. You can't protect this from leadership.

There are a lot of vulnerabilities that the Chinese need to understand. They better add up the dollars and cents before they try to

start getting into this. There has to be a better way to try to get at their end results, I think, than just putting up a "buy China" for software.

Also, I don't know—although American businesses have invested a lot over there, given the intellectual piracy and other issues that are raised, I don't think it's a smart move. And I think you are doing everything to encourage them. I don't think Congress will sit idly by and watch this happen.

The Chinese Government has stated that its procurement framework is modeled in large part of those of other countries, including our Buy America Act. That's not really accurate, given the depth and breadth of the proposed regulation, is it?

Mr. FREEMAN. In our view, it is not. The key again is, is it consistent with the government procurement agreement? If China has committed, as they have, to join the government procurement agreement as soon as possible, the fact they would be putting in place policies in the interim that are not consistent with GPA neither makes sense nor is fair play.

Chairman TOM DAVIS. Would you agree that the domestic source restrictions that we do have on our acquisition system, such as the Buy America Act or the Berry amendment and various other restrictions that apply to defense procurements, that they make it more difficult for us to argue against restrictions like the ones we are discussing today? Do they throw that back at us?

Mr. FREEMAN. They do. I think there is a fairly open and transparent process by which we arrive at those regulations, and we feel quite confident that those are consistent with GPA.

Mr. WU. Mr. Chairman, in relation to software, procurement by the U.S. Government is done through service contracts. That means the development, the maintenance and consulting. The Buy America Act does not apply to service procurement.

Chairman TOM DAVIS. The Trade Agreements Act has a limited role there? Trade Agreements Act would have a limited role where Buy America doesn't apply, or are you familiar with it?

Mr. FREEMAN. I'm not certain. I have to get back to you.

Chairman TOM DAVIS. In the written testimony, the U.S.-China Business Council said some of their member companies considered the Chinese pending software procurement rules indicative of the country's overall procurement practices. Do you think that's accurate?

Mr. FREEMAN. I think it is. The reason we are spending so much time on this issue is that it could very well be the tip of the iceberg. If this is clearly the first sector that they have targeted, there are others that are out there; and if this is successful for whatever reason, then we face significant problems down the road.

Chairman TOM DAVIS. As you know, China has a huge trade surplus with the United States. Mr. Duncan talked about it; Mr. Cummings talked about it. China's Premier has stated that China will reduce surplus by importing more American products, but it appears that the Chinese Government is about to throw up a new barrier to market access for one of the competitive exports by requiring government ministries to purchase only Chinese software. This is the one area where America leads the world, where you would think, if they wanted to develop their own industry, they

could work with us, learn with us, team with us, contract with us, instead of putting up a barrier. What is the administration doing to China to hold the Chinese Premier to its word that they are going to buy more American products?

Mr. FREEMAN. Well, the initial thing and the immediate thing is to make sure that China does everything in its power to dismantle this policy in the context of the Joint Commission on Commerce and Trade, which we will hold in the middle of this summer, chaired on the U.S. side by Secretary Gutierrez of Commerce and now Ambassador Portman of USTR and Vice-Premier Wu on the Chinese side.

The key is to make sure that China recognizes that in the context of bilateral trade discussions the injection of this kind of policy is completely the wrong direction and not just in terms of its own interest in developing software but particularly considering the depth of the passions up here with respect to trade.

Chairman TOM DAVIS. We have the largest economy in the world. China's economy is growing, but starting a trade war with us is not very smart. Both sides get hurt, of course, in trade wars, but China has more to lose at this point, given the balance of payments. Do you agree with that?

Mr. FREEMAN. Exports to the United States are about 10 percent of China's GDP. That is a lot to lose.

Mr. WU. Mr. Chairman, I would also add, it is not just loss in sales and revenue. We believe and are trying to underscore this point with the Chinese that they would also lose innovation capabilities as well, because the U.S.' industry, if they are allowed to engage in the marketplace, if they are allowed to make the investments that they know will be fair and equitable and able to recoup back, then they are willing to provide the assistance, the support necessary that will help develop the Chinese marketplace, and that is so critical in this international marketplace and global market that we have. So if the Chinese want to be engaged in the process, they have to be part of the process and not to be closed and an isolationist.

Chairman TOM DAVIS. The procurement side really bothers me; and, of course, that's the jurisdiction of the committee. Everybody has a different view on trade. I have been a very strong free trader. I have looked at it that if we get a pretty good deal in our relationship with China in the sense that we are buying goods from them at reduced costs which bring down inflation here and it's good for our consumers and what China is buying mostly from us is our paper, that is not a bad tradeoff; and when we quit doing it from each other, it could hurt us both.

We appreciate the administration's efforts, but I am afraid that, if we are unsuccessful, we have to understand they have to expect some kind of congressional retaliation in terms of government procurement at a minimum; and I think they end up losing if that happens. So let's try to work this out. Everybody gets hurt in a trade war.

Mr. Cummings.

Ms. Norton.

Ms. NORTON. I appreciate Mr. Cummings has allowed me to go ahead of him. I have people waiting in my office.

I wanted to come to this hearing to try to do what I have been trying to do for a long time, to figure China out. We don't seem to be getting very far with China. I have a question of what we think the real strategy is here. In many ways, this seems a counterproductive proposal, but is it? So the assumptions we make, it seems to me, about what China is doing may be peculiarly western assumptions about market and so forth. Let me ask you a question based on how the Chinese might be looking at this.

Some of this, 50 percent of the market to be developed, some of that is what developing countries have done all along. We are talking about pre-technology. It is not uncommon all over the world today. We have all kinds of government policies that say, if you want to do business here, if you want to have access to our resources, if you want access to our market, the quid pro quo is, and we are used to that.

Now we are dealing in technology. Technology literally changes moment to moment. And it looks like from what I can tell we would not only be shut out, but their own development, such as it would be, would be copyrighted. So here they want copyright protection, and to assure it they want the development on their soil.

Now we have had a kind of nervous quid pro quo: We sell, they steal. They pirate, but we sell. Now they are going to continue to pirate, but it's going to be hard for us to sell to the government. And this is China after all, who is the biggest purchaser.

I really wonder if this assumption that it's so counterproductive while they buildup their industry is correct. The Chinese are smart people. This stuff is developing and out of date momentarily. Pirating continues. They may believe they don't need normal trade in order to get access to what it takes to develop their industry. They will do what they have been doing all along. More than 90 percent of our stuff gets pirated anyway, and we haven't been able to do anything about that.

I thought in traditional terms, too, how can they develop their industry if in fact they don't have access to ours? Hey, this is the biggest market in the world. They know that everybody is trying to get access to them. They want to develop that market for themselves. Everybody, hello. They may be under the assumption that if they continue to pirate, close their market, this huge market that everybody is salivating about really becomes only their market. Yeah, they are a little behind the curve, but how much behind the curve if they continue to pirate?

I would like a response to that, but my bottom line is I don't see China doing anything unless they feel they have something to lose; and, thus far, I have not heard what they have to lose. I am very impressed with the way in which China bargains with westerners: Listen and ignore; listen, talk and ignore; keep doing what you were doing all along. Until somebody really does something, and I haven't seen anything of that kind that has occurred, that makes you have to move.

In the Korea talks, to get to another sector altogether, we're there. Whatever is their thinking, they are there. Not only has it not done any good, it has gotten worse. Here, I don't accept that those poor things, they don't know what they are doing. I don't accept what the chairman said, it's counterproductive. Don't they see

they are going to be harmed? I don't think that they're stupid. I think that they think that this is not going to hurt them, and I have indicated some of the reasons why. And I would like your response to that.

Mr. FREEMAN. The Chinese are incredibly patient people, and they do sit there, and they do tend to listen to us, and sometimes it takes a long time for it to sink in.

You raise a very excellent point. Do they know what they are doing? Do the people who have constructed this policy know what they are doing? Of course. But the question is, who are they trying to benefit? The notion that the stated policy is to develop a genuine Chinese domestic software industry with the notion that China doesn't always want to be the sweatshop for the world, they want to rise up the value chain and have their own brands, have their own technology products, they want to do all of that stuff. So they look out there and say, how do we deal with this? How can we possibly compete with the technology, superiority and the software market from the United States and others?

And what they have decided to do is, while we are going to try to find some shortcuts for our own software industry, but instead of having an open policy which allows multiple Chinese software industries to come to the table and operate, what they have tried to do is essentially favor some select, very large state champions.

The problem is, and I think the chairman states it quite correctly, even if you develop these software champions and you have producers for China's market, the fact of the matter is that 90 percent of the software market is pirated. There is not a whole lot of incentive to produce these world-class software industries if you don't protect IT, because the market ends up being very limited to the government market; and it's large but not a world-class market. It's enough for companies to get a foothold, but really unless and until——

Ms. NORTON. Maybe that is what they want, is to get a foothold. They are protecting themselves now and, later on, they might be willing when they get their own—when they themselves are angered to move forward.

My only concern here is that I think that if we want to interrupt this—assuming that what they want to do is get drowned themselves before they have to open up, if we want to interrupt that thinking, assuming that is the thinking, it seems to me they have to understand they have something to lose. And the strategy of sitting there and talking to them and having them listen, be cordial and they are listening seems to me favors their strategy, building themselves, doing nothing while we give them nothing to lose.

WTO really doesn't seem to have mattered a lot here. When it comes to patience, Chinese patience may be legendary, but we ourselves are getting the trophy on patience with the Chinese.

Thank you very much, Mr. Chairman.

Mr. WU. Congresswoman, just to echo some of the points that Charles had made with my own personal observations from the discussions that I have had with senior officials in delegation meetings which I have led here in Washington and in Beijing, it seems clear that there is a significant voice within the Chinese Government to try to use the domestic requirements to try to elevate and

create their software industry. It's for them a sense of nationalism. They want to play as a world leader, that they have to have world markets; and they are feeling, as has been conveyed to me, that if they are going to be purchasing Chinese Government software then they should give preference to the domestic markets so they can build it up and then allow that industry and that company to be able to play in the world stage to compete against some of the international players.

The problem, though, is that in some of the proposed regulations, they do it in such a heavy-handed way that excludes any opportunity for U.S. companies—or any international software company—to enter into that market. And there isn't a process of openness, of fairness or due process or participation.

And what we are seeking is to allow us to be at least part that have process. And that's the effort that USTR's office and Department of Commerce have been trying to push.

I think it's also somewhat divided too, within the Chinese Government. It seems as if there are some people who understand the notion of the importance of innovation—of reaching out and being part of the world economy—especially in the software center. And then there are those who retreat back—that if we are going to help our domestic countries, we have to have domestic—strong domestic country requirements.

There was an article from November of this past year entitled, "Beijing City Slammed over Microsoft Deal," which, according to Beijing Times, Microsoft won a $21.95 million yuan contract from the Beijing municipal government. But then they had to rescind it because it came under fire for damaging China's nascent software industry.

So I think you are seeing divisions also within China. And ultimately we like to, through the administration efforts, through the USTR and Commerce make sure that those who support the innovation and the openness and the fairness of process, make sure they win out. And that's why we are so aggressive in trying to make sure at the very highest levels of government, the Chinese understand the strong support and the insistence that they open their markets in a fair and free way.

Chairman TOM DAVIS. Thank you very much.

Mr. Cummings.

Mr. CUMMINGS. Thank you, Mr. Chairman.

I am seeing and I am listening to all of this. I listened to the chairman's questions, and then I read the testimony that will come up shortly from Mr. Frisbie, and then I read the testimony of Mr. Bohannon of the Software Information Industry Association, and then I read the testimony of Robert Holleyman, who is going to testify, president and CEO of Business Software Alliance, and I have listened to your testimony.

I have to ask you this question, are we impotent with regard to doing anything? I mean, when I look at everything that I have read and heard, it sounds like we have to walk a very—and this is just—I am a trial lawyer, so I am used to listening to testimony. But it sounds like we have to walk a very thin line because we don't want to insult anybody, and we are in the process of trying to negotiate. Is that a fair statement?

In other words, let me tell you why I refer to Mr. Bohannon's testimony. Because I said to myself, now, these are the people who are really—they have something to really lose here. So I was looking for—I wanted to see what he said with regard to what is needed.

And what he said here is at a minimum the Chinese must begin negotiations to join the WTO agreement on government procurement consistent with the WTO commitments which were made more than 4 years ago. To date, no such discussions have taken place.

As for changes in regulations, nonChinese software companies must be allowed to compete as domestic software companies if they meet nondiscriminatory minimal requirements that all companies must meet in order to operate in the Chinese market.

He goes on to say this includes removing the requirement that in order to be "domestic," copyright registration must be held by a Chinese person. The two-scheme, where waivers before any agency can procure foreign software is simply unworkable and unacceptable.

Before that though, he talked about—he was very, very complimentary of the work they have been doing to do with our folks, with you all.

So I am trying to think—and I was looking for the—you know, this is what we got to do, and this is the way we do it. But it sounds like—and then I listened to your answers to Ms. Norton's question. It sounds like we—do we have a big stick back here to kind of wave to get the Chinese to do what we want them to do, or am I missing something? Do you understand the question?

Mr. FREEMAN. Yes, I understand the question. There are a couple of things been, obviously if you talk about $162 billion in trade deficit, and congressional concern, yes, you have a fairly big stick.

Mr. CUMMINGS. Does holding this hearing send any kind of message so far, you think?

Mr. FREEMAN. I think it does. Let me back up for a second. I am not a trial lawyer, but I know that one of the problems we face with this policy is it is not yet implemented.

Mr. CUMMINGS. Yes.

Mr. FREEMAN. What we are trying to do is we are trying to prevent it from becoming implemented. So, in theory, it is not quite right one of the problems we have when we go and scream at the Chinese people.

Mr. CUMMINGS. You don't scream. You don't look like a screaming type of guy.

Mr. FREEMAN. At 2 a.m., I can raise my voice. But what happens, you know, is you say this is a problem. This is a problem our companies face. And they say well we haven't implemented it yet. And, in fact, we just bought $400,000 from such and such company why are you getting spun up about it?

We say, well, what this does is it has a chilling effect on the marketplace. This is the kind of a policy which, even if not implemented, sends the wrong signal. In fact, you have government entities, maybe not in this building in China or Beijing, or maybe down in Yunnan Province, but know about this policy and implement it even actually before it is implemented.

And that's the concern that we have. So we are trying to get this off the table before it actually fully gets in place. If and when it fully gets put in place, you may actually see me scream.

Mr. WU. We work very closely with USTR and Department of Commerce. We serve as advocate for free and fair trade and for industry. USTR has done a very good job in implementing some of the negotiations, in being part of the negotiations. What we need to do is if China wants to be a world player, they have send it to WTO—they have a number of other agreements that they have agreed to. And we need to make sure they live up to their obligations.

Certainly moving the Chinese into being a partner, in the WTO Government Procurement Agreement, is very important. Because then once they send to that status of being a player in that agreement, then they will have obligations that they have to live with. That may very well make issues like this moot.

So moving them forward, they have committed to moving as soon as possible. But using our leverage, partnering with our key trading partners such as the EU and Japan to help achieve a goal and to have demonstrable accountability for the Chinese in procurement issues, is critical. And so I think that's something the USTR does very well.

Mr. CUMMINGS. Is there anything that you all need from us, the Members of Congress, that would help you? I mean, do you have—what you have. I can't imagine what you might need, but is there something that you need from us?

Mr. FREEMAN. Don't underestimate the power of your own voice with China directly. We hear frequently concerns from the Hill at USTR and at Commerce. But China needs to hear that from you all too. So the fact that you are holding this hearing is, in my view, a very positive thing and something that I think does send a strong message. I encourage you to pick up the phone and call the Ambassador if you feel the need.

Mr. CUMMINGS. Mr. Chairman, I have two more questions.

Chairman TOM DAVIS. Sure.

Mr. CUMMINGS. Mr. Wu, IBM recently sold its personal computer division to a computer company that is primarily owned by the Chinese Government. This sale was approved by the Committee on Foreign Investments, despite concerns expressed in the United States over the extent of technology transfer that this sale would represent.

Do you think that the approval of this deal or of other proposed sales would still be warranted if China is continuing to impose unfair trade restrictions, particularly on information technology products?

Mr. WU. Congressman, you are referring to the CFIUS procedure for IBM and Novo merger. That was decided on its merits and really didn't have the externality of these issues as part of that process.

The question with the CFIUS process is whether or not there would be concerns of intellectual property transfer that would raise it to such a level that would warrant the government to step in and block the merger.

If you like, we can provide you with more information about the process, the decisions and deliberations.

I think in this particular issue those, at least for IBM and Novo the issues that—the greater issues that you are discussing here today were not a party of the discussion.

Mr. CUMMINGS. Finally, let me ask you this. You know, industry, in order to maintain any business, you have to have some kind of predictability. You have to be able to reasonably predict your future. And certainly when you are dealing with sales, that's a big deal.

I mean, it basically dictates, as you well know, how many people you are going to employ, whether you are going to expand, whether you are going to move, all of those kinds of decisions.

And I would imagine that people in this computer area feel the same way. I mean, do they still have—they still have the same kinds of problems. I mean if you all, just based upon what I have seen so far, if I am a business person and I am sitting on a seat, I am sitting right now in my office watching this on C–SPAN—and I am wondering what my future looks like with regard to this issue. I know you are not—you don't have a magic ball, but what do you—what is your vision at least of what you think is reasonable of what will happen in the next year or two. You got me?

Mr. FREEMAN. If you are asking do I think we will resolve this question?

Mr. CUMMINGS. Yes.

Mr. FREEMAN. I can't say. We are going to try awful hard. If I am a business person looking at the Chinese market and seeing this kind of policy being implemented and seeing the general lack of transparency in government rulemaking and decisionmaking and licensing and so forth, I recognize the enormous risks of doing business in China and recognize, really, that this market has a long way to go before you can achieve the kind of predictability that you would really like.

It is getting—it is making progress. Things have really come a long, long way in the past 3 years. But it's a long way from being what you call a market of perfect information.

Mr. CUMMINGS. And that coming a long way, what was, if you had to think of one thing, either one of you, that was the brightest light in that, you said we have come a long way. Is there something that happened that just made you say, OK, this looks like we are getting somewhere here? The reason I am asking that question is I am just wondering, you know, what got us to whatever that point was is trying to perhaps duplicate whatever helped us get there so we can get to the next point.

Mr. WU. One of the, I think, brightest lights, certainly, in terms of our negotiations on technology matters with China was the WAPI issue with encryption. And there we were able to work with the Chinese, elevate the discussion with the highest levels with Ambassador Zoellig, USTR; Secretary Powell over at State and Secretary Evans at Commerce to raise it to a level that clearly underscored the administration's concern about this, that we were able to have China work on living up to its WTO obligations.

And we are continuing to work on doing that in that case on the encryption standard, while it's the example of a successful resolu-

tion, it was at least based on WTO obligations that helped facilitate the process.

So we need to get China engaged, be party to a number of obligations and treaties, and make sure they continue to hold up to their obligations, especially on intellectual property rights.

Mr. FREEMAN. Could I just add quickly to that. I think if—even looking at this issue, and where do I see signs of encouragement. Five years ago, you never would have seen them publish the proposed rules or comment. You never would have seen multiple drafts be exposed to public eye. And the fact that you have suggests to me that we have made tremendous progress. Now, the key is to take the next step to not only have them accept comments, but actually do something with them.

Mr. CUMMINGS. So I guess in a way we are kind of commenting here today, would you agree? Mr. Wu.

Mr. WU. Another successful example is the WTO inconsistent rebate on the VAT for semiconductors manufactured in China. And once again, there we had the opportunity to have China be required to live up to its obligation with WTO.

Let me also add, Congressman, in addition to the good work of the USTR in negotiations requiring China live up to its treaty obligations, we are also engaged in the Department of Commerce on the softer side, dealing with the trade and trying to impress upon the Chinese the importance of innovation, of enforcement for intellectual property rights, and especially if they want to be a global player.

Two years ago, when China had ascended to WTO status, I immediately went over and led a delegation of government officials to go to the Chinese science parks to talk to their entrepreneurs and to talk to their innovators and to underscore the importance of ITR if they want to grow, if they want to start their open business, and if they want to be successful.

Because they need to have that intellectual property right. The trademarks all protected around the globe. So Commerce is engaged in a number of those activities, as well as on standards to, in relation to China. We have been working very closely with industry and status of open organizations to make sure there's a process in China. So when we see a standards or trade barrier, we can react immediately.

We can then get, if necessary, all of the highest levels of government engaged. And that's part of the secret, I guess, for WAPI, is that we were able to respond so quickly to the issue and alert the Chinese that this was going to be a major issue for the United States. And they were able to move to concession and accommodation to our needs.

Mr. CUMMINGS. I just wanted to echo what Chairman Davis has said. I think you will get pretty much consensus from both Democrats and Republicans, that when it comes to trade, we are going to have trade, we want it to be fair trade and we want our people to have an opportunity to have jobs. We don't want that college graduate that Mr. Davis talked about with the liberal arts degree—and here we are at graduation time by the way—going out to work to ask the question, "Do you want it with fries?" Our young people are working too hard to be the best that they can be to be denied

these kinds of opportunities. They are invaluable. And these kinds of opportunities, by the way, will last them until they die. So we don't want them to be deprived of that.

Thank you.

Chairman TOM DAVIS. Thank you very much. I want to thank our first panel. Let me just add, I am somebody with a liberal arts degree with Amherst, and I was a head fries man on the day shift at McDonald's early on in my life.

And a voice said, if you can't do anything else, you can always run for office. You just have to be 25 and a citizen of the State.

But we appreciate very much what you brought to this. I hope you will take back to the Chinese some of the concerns that we are raising on a bipartisan here in Congress.

I am going to declare a 2-minute recess while we get our next panel. Thank you very much.

[Recess.]

Chairman TOM DAVIS. Thanks very much, thanks for being patient. You see, the members have a lot of interest in this that the administration is trying to finess.

We will recognize our second panel. We have Mr. Robert Holleyman, the president and CEO of Business Software Alliance. Mr. John Frisbie, U.S.-China Council, and Mr. Mark Bohannon, Software Information Industry Association.

Thank you all for being here. Please rise and raise your right hands.

[Witnesses sworn.]

Chairman TOM DAVIS. Mr. Holleyman, we will start with you.

STATEMENTS OF ROBERT HOLLEYMAN, PRESIDENT AND CEO, BUSINESS SOFTWARE ALLIANCE; JOHN FRISBIE, PRESIDENT, U.S.-CHINA BUSINESS COUNCIL; AND MARK BOHANNON, SOFTWARE INFORMATION INDUSTRY ASSOCIATION

STATEMENT OF ROBERT HOLLEYMAN

Mr. HOLLEYMAN. Good morning, Chairman Davis. It is a pleasure on behalf of the member companies of the Business Software Alliance to have an opportunity to testify before your committee this morning.

The U.S. software industry is a uniquely global industry. U.S. software companies derive more than half of their revenues from exports. Trade liberalization in China and elsewhere is absolutely critical to our industry's growth. And BSA members have consistently and actively supported WTO trade liberalization agenda. We strongly advocated for China's WTO accession in 2001, and we also believe that China must move forward with accession to the WTO's Government Procurement Agreement as it pledged to do.

Our industry is confident that given a fair and level playing field, we can compete in the Chinese market and in any other market in the world.

Yet, we face an uphill struggle in China. China should represent a huge opportunity for our industry. It's the second largest market for personal computers in the world. It has vast opportunity for PC software. But due to rampant copyright piracy, it's only the 25th

largest market in the world for software sales, ranking behind much smaller countries like Denmark.

One bright spot in recent years has been the efforts of the Chinese Government to insure that the government itself uses only legal copies of software. The Chinese Government is by far the largest single purchaser of software in China, and the procurement market represents one of the most significant growth opportunities for the U.S. software industry. And we are concerned that it's about to be closed to U.S. software products and services.

In 2002, as you have heard, China enacted a broad law requiring that the government purchase only domestic goods and services. Unfortunately, the software sector was selected as the first sector in which to apply this new law. As proposed, China software procurement regulations would severely restrict the ability of American software companies to sell to the Chinese Government. The draft proposals sets up a 2-tiered preference system, the first tier for domestic software and the second for qualifying foreign software. Domestic software is to be heavily favored in that process.

Our assessment is that no American software company will qualify as Chinese domestic software under the proposed regulations. And to qualify as eligible foreign software, the software provider must meet and satisfy a number of performance requirements, including things like investments in China, R&D, outsourcing work and taxpayer payments. It's our understanding that government agencies will still need to get a waiver for each procurement of eligible foreign software.

In a market where over 90 percent of the software is pirated and in the Chinese market is by far the largest purchaser of legitimate software, such a discriminatory procurement regime would effectively close the door to many, if not all, U.S. software companies. The Chinese procurement preference will have an immediate and significant harmful economic impact in the United States. These are not theoretical concerns, Mr. Chairman. We are already beginning to see effects in the marketplace, as we have heard from Mrs. Norton earlier this morning, even if the regulations aren't fully in place.

Local and provincial governments have been canceling orders based on pressure and concerns that they would not comply with new procurement regulations.

I have to emphasize, as you have also heard this morning, that this regulation is only the beginning of a process of implementing China's government procurement law. Other sectors will follow, particularly those where China considers it strategic to its economic development.

China's premier has committed to addressing the $162 billion trade imbalance between the United States and China by facilitating an increase of U.S. exports to China. This proposed regulation fails to advance that policy. It also fails to advance China's broader goals of developing a vibrant software economy and efficient, effective-government services.

The single most important thing that could be done to promote a domestic software industry in China would be to reduce the $3.8 billion-a-year piracy problem, and thus expand the market for both domestic and foreign software alike. Whatever we can do in China

to reduce piracy should be aimed at that result, demonstrable market growth.

BSA has joined with a host of IT and U.S. industry leaders, a number of whom you will hear from this morning, urging a delay in implementation of these regulations until a mutual agreement can be reached. China's procurement framework must be open, inclusive and nondiscriminatory. It must allow United States and other foreign software makers to compete without restriction in China's government market.

We appreciate your holding this hearing, Mr. Chairman. We appreciate the efforts to work with the U.S. Government. Time is of the essence as China may move ahead to implement final regulations at any time. Thank you again for inviting BSA to testify. I will look forward to answering questions at the appropriate time.

Chairman TOM DAVIS. Thank you very much.

[The prepared statement of Mr. Holleyman follows:]

TESTIMONY OF ROBERT HOLLEYMAN
PRESIDENT AND CEO
BUSINESS SOFTWARE ALLIANCE
BEFORE THE
HOUSE COMMITTEE ON GOVERNMENT REFORM

MAY 13, 2005

The Business Software Alliance (BSA)[1] is pleased to participate in today's hearing on the threat that domestic source restrictions pose to free trade in the global economy. The U.S. software industry derives more than half of its revenues from exports; thus, free trade and open markets are critical to the industry's continued growth. Due to strong global demand for our products and services, the U.S. software industry has for many years remained a leading driver of economic growth in the United States, and a major contributor of tax revenues and skilled, highly-paid jobs. In 2002 alone, software developers and other computer services industries employed nearly 2.6 million workers and contributed $400 billion to the national economy.

At this moment U.S. software firms are faced with the imminent prospect of being denied or severely restricted in their access to the government procurement market in China. This is a result of onerous domestic source

[1] The Business Software Alliance (www.bsa.org) is the foremost organization dedicated to promoting a safe and legal digital world. BSA is the voice of the world's commercial software industry and its hardware partners before governments and in the international marketplace. Its members represent one of the fastest growing industries in the world. BSA programs foster technology innovation through education and policy initiatives that promote copyright protection, cyber security, trade and e-commerce. BSA members include Adobe, Apple, Autodesk, Avid, Bentley Systems, Borland, Cadence Design Systems, Cisco Systems, CNC Software/Mastercam, Dell, Entrust, HP, IBM, Intel, Internet Security Systems, Macromedia, McAfee, Microsoft, PTC, RSA Security, SAP, SolidWorks, Sybase, Symantec, UGS and VERITAS Software.

restrictions that have been proposed by the Chinese government as part of regulations implementing a 2002 law on government procurement. This is an issue of paramount concern to the software industry, and my testimony this morning will focus on this serious development.

I will note at the outset that BSA member companies strongly advocated for China's WTO accession in December 2001. As a condition of WTO membership, China committed to a program of extensive and far-reaching reforms that, among other things, require it to extend national treatment and improved market access to U.S. exports, protect intellectual property rights and initiate negotiations for accession to the WTO Government Procurement Agreement (GPA).

Discriminatory policies like China's proposed software procurement regulations violate the spirit of openness that China embraced in joining the WTO. Shielding the domestic software industry from U.S. competition is also inconsistent with Premier Wen Jiabao's commitment to facilitate the *increase* of U.S. exports to China. The true test of China's commitments is whether China agrees to abandon protectionist policies like these proposed regulations.

Once implemented, the procurement regulations will have an immediate, negative economic impact on the U.S. software industry. Much of the Chinese market for business software is already lost to rampant piracy that results in billions of dollars in lost export revenue. A large part of what remains of the software market after subtracting the 92 percent that is lost to piracy, consists of government purchases. The Chinese government's policy of walling off access to the country's largest purchaser of IT products thus has an outsized impact in this environment.

Moreover, we believe that severely restricting access of U.S. software makers to China's government procurement market will retard, rather than advance China's broader development goals. This policy will not only deny China's government the ability to use some of the world's most advanced software, it will undermine China's own efforts to encourage the active participation of U.S. software companies in developing a vibrant software economy in China.

BSA applauds the Administration's efforts to engage China's senior leaders in an attempt to resolve these and other trade issues. With Congress' support, we hope these efforts will lead to a result that benefits both countries.

China's Discriminatory Software Procurement Regulation Would Severely Limit U.S. Exports of Software Products and Services and Set a Dangerous Precedent for other U.S. Industries

The Chinese government procurement market represents one of the most significant growth opportunities for the U.S. software industry and the global IT industry as a whole. The Chinese government is the primary purchaser of software in the world's largest emerging market for IT products. According to a recent study conducted by IDC, a leading IT research firm, the market for packaged software in China grew 19.5 percent in 2002 to reach $1.62 billion. IDC predicts that the market will continue to grow at a compound annual rate of 25.8 percent, making it a $5.1 billion market by 2007. This explosive demand for software and other IT products will be fueled in significant part by government IT procurements, including China's proposed multi-billion dollar E-government initiative. In 2003, for example, government procurement of software products and services totalled $608.4 million.

BSA is thus deeply concerned about China's plan to close its government procurement market to U.S. software and other products and services. In 2002 China enacted a law requiring with limited exceptions that its government purchase only domestic goods, services and public works. This law is applicable to every services and goods industry from which the Chinese government procures and has very significant ramifications for all U.S. industries seeking access to China's government procurement market.

China has indicated that it will issue implementing regulations on a sector-by-sector basis and has decided that software will be the first area subject to the new law. The draft software procurement regulations that were released in March would severely restrict the ability of American (and other non-Chinese) software companies to sell to the Chinese government. They establish a two-tiered preference system - the first tier for "domestic" software and the second for qualifying "foreign" software, with domestic software heavily favored in the procurement process. To qualify as "domestic" software, a product must be made and primarily developed in China, and the copyright must be owned by a Chinese entity. Open source software distributed by a domestic Chinese distributor will also be treated as domestic software. To qualify as eligible foreign software, the software provider must satisfy as-yet unspecified levels of investments in China, R&D expenditures, outsourcing of jobs, technology transfer, and tax payments. Every procurement of foreign software must be

justified in writing and approved in advance by the Ministry of Finance (or the local equivalent, for purchases by local government). Procurement of foreign software that is not on the list of eligible foreign software will be permitted only in "special circumstances."

If enacted, these onerous requirements would impose far greater barriers to the procurement of U.S. software by Chinese government agencies than U.S. law imposes on government procurement of Chinese software and services. In a market where over 90 percent of software is pirated, costing the industry more than $3.8 billion per year, and where the Chinese government is by far the largest purchaser of legitimate software, such a discriminatory procurement regime would effectively close the door to many, if not all, U.S. software companies - or for that matter, any non-Chinese company.

Because U.S. software companies derive more than half of their income from exports, the Chinese procurement preference will have an immediate and significant economic impact on the United States in the form of decreased exports to China. These are not theoretical concerns; we are already seeing the effects of China's restrictive procurement policy in the marketplace, even though the regulations haven't been promulgated. Last November, after the Chinese government released a description of the draft regulations, a number local and provincial governments either cancelled orders for American software or awarded substantial purchases exclusively to Chinese suppliers. Thus, China's decision to close or greatly restrict its government procurement market to much of the world's best software products is already translating into lost jobs and tax revenues for the United States economy.

BSA is also concerned that such a regulation would set a dangerous precedent for other U.S. industry sectors. Given the broad scope of China's 2002 public procurement law, there is every reason to believe that the proposed software regulation is merely the first of a series of measures that will ultimately close to foreign competition all sectors of procurement that China considers strategic to its economic development. A discriminatory procurement regime of this type would deny U.S. industry a vital export market and exacerbate the U.S. trade deficit with China.

China's Procurement Regulation Violates the Spirit of its WTO Commitments and Serves to Protect its Domestic Industry at the Expense of U.S. Economic Interests

China's plan to close its government procurement market to software and other U.S. products and services would clearly violate the spirit of China's WTO

commitments. In its WTO accession agreement, China committed to initiate negotiations for accession to the WTO GPA "as soon as possible." Not only has it failed to honor this commitment, its proposed procurement regime rejects each of the fundamental tenets of the GPA, namely openness, transparency, fair competition based on merit, equality, and accountability. It would also violate Premier Wen's commitment to increase U.S. exports to China.

BSA and other industry groups have urged the Chinese government not to adopt these domestic software preferences or, alternatively, to define eligible "domestic" or "foreign" software in a way that permits unlimited competition by U.S. software companies. We have also urged the Chinese government to adopt merit-based procurement rules that do not favour one type of technology or licensing model of software over another. Senior U.S. trade officials have also expressed concerns about the proposed regulation repeatedly with the relevant Chinese authorities. It remains unclear, however, whether these messages have been heard by China's political leadership. The Chinese government appears determined to promote its domestic software industry through discriminatory government procurement policies. Software developers worldwide are concerned that China will maintain this protectionist course, unless the United States and its major trading partners take specific action.

BSA has joined with a broad cross-section of IT and other U.S. industry leaders to urge that immediate steps be taken to delay implementation of the software procurement regulation pending mutual agreement of a software procurement framework that is open, inclusive and non-discriminatory and that allows U.S. and other foreign software makers to compete without restriction in China's government procurement market. We request that the U.S. government - in cooperation with the European Union and other governments around the world - take all necessary steps, including continued work to promote China's accession to the GPA, to preserve market access for all non-Chinese companies to China's very important government procurement market. Time is of the essence, as China may move ahead to implement final regulations at any time.

* * *

BSA appreciates the opportunity to participate in today's hearing, and we look forward to working with the Congress on these important issues. I would be happy to answer any questions you may have.

Chairman TOM DAVIS. Mr. Frisbie. Thanks for being with us.

STATEMENT OF JOHN FRISBIE

Mr. FRISBIE. Chairman Davis, thank you for giving me the opportunity to testify today. When China joined the World Trade Organization in 2001, it agreed to conduct its government procurement transparently. China became an observer to the WTO agreement on government procurement in 2002 and began the process of joining the GPA as soon as possible. Accordingly, our expectation has been that China's procurement rules in the interim would move it closer to the principles was GPA.

In March of this year, China released draft regulations on the procurement of software, to raise important questions about China's commitment to the spirit of the GPA. As currently written, the draft regulations are a key concern for many of the U.S.-China business councils, approximately 250 member companies. It's, of course, a concern for our members who are software companies. But it is also a concern to other companies who look at this as an indication of China's government practices more generally.

I do want to note that we applaud the Chinese Government for its transparency and the release of the proposed rules for public comment. This is a step forward, as you probably know. However, we have significant concerns that the new rules are also a step backward for their procurement regime.

Our specific issues are twofold. First the software rules would essentially block American companies from competing on equal basis with Chinese firms for PRC government contracts for software products and services. And second, the software rules could set a precedent for future discriminatory procurement policies.

The full explanation of the regulations is in my written statement, but in short the implementing measures for the government procurement of software lay out guidelines for the certification of domestic software and services.

The measures also envision a list of preferred nondomestic software and service providers. Essentially, the implementing measures would require Chinese Government entities to purchase domestic software products in domestic software services unless they receive a special waiver from the Ministry of Finance and the Finance Administration Ministry to buy a list of qualified companies. As a result these rules, as they are drafted contain a number of concerns.

On a technical level, the rules appear to contradict open procurement principles by effectively prohibiting access by international software providers to the PRC government market. The definitions of domestic software products and domestic software services are restrictive to a point that even those international companies with subsidiaries, manufacturing facilities and large levels of investment in China might be unable to qualify their products as domestic, as that term is defined in the proposed rules.

To be certified as domestic, the software product must meet three requirements. It must be developed in China. A Chinese entity must hold its copyright, and half the development costs of this software must be incurred in China. Software, of course, is typically not created in any one country.

In addition, today's software is often based on older programs written years ago, and therefore could not have been developed in China. So as a result to meet the domestic criteria, software companies would likely have to create entirely new products using programming code written only in China.

Since the rules, in effect, would therefore grant an absolute preference to domestic products and services, this amounts to a prohibition on the procurement of products developed and distributed by international suppliers.

Furthermore, the procedures and the regulation for a listing in the catalog of preferred nondomestic suppliers appear to give international companies only the most minimal level of market access.

Chinese Government entities will only be allowed to purchase software listed in this catalog if there is no domestic substitute and if they obtain a waiver from those ministries I mentioned a moment ago.

Those are highly restrictive requirements. And the proposed rules will effectively block international software companies from competing in this market on an equal basis with Chinese suppliers.

Many countries, including the United States, grant domestic firms some form of preference in government procurement contracts. These preferences, however, are almost always accompanied by cost thresholds or other mechanisms that limit the use of such preferences.

In contrast, China's proposed software procurement rule set out an absolute reference for domestic goods. There are no general circumstances described in the proposed rules, in which an international company would enjoy the same access to the government software market bears of domestic supplier.

So when you combine this absolute preference with the highly restrictive definition of domestic software, the proposed rules essentially block companies from competing in the market.

As such, the proposed rules do not conform to the requirements of the WTO, the Government Procurement Agreement, which China has said it intends to sign.

So where does that lead us? Our recommendations are these. First I want to point out, as mentioned earlier, that China Wen Jiabao, during his last visit to the United States in December 2003, called for the expansion of U.S. exports to China to help reduce the U.S. trade deficit.

He also said at that time that the U.S.-China trade relationship should be based on the principles of mutual benefit, and that each side should consider the effects on the other. We support these statements by Premier Wen. We, therefore, would be disappointed to see China implement policies that would greatly limit American access to its government procurement market for software at such a critical time in the U.S.-China trade relationship.

We need more opportunities for U.S. companies to sell products to China, not less. Access to the PRC government procurement market for software is exactly the type of win/win outcome of significant mutual benefit that Premier Wen spoke of in September 2003.

In addition, we strongly support the PRC's government stated intention to join the GPA at the earliest possible time, and in the

meantime, to develop rules consistent with the GPA. We have asked the Chinese Government to be consistent with these stated intentions and suspend further action on these rules until they can be discussed in full at the JCCT meetings to be held in Beijing in the next month or two. It's our understanding that these proposed rules will be a key part of the U.S. agenda at that meeting.

We fully support this approach and encourage the USTR and the Department of Commerce to first secure commitments from Beijing to shelve these software procurement rules or to revise them to address the concerns of American businesses and conform to international best practices.

Second, to work to establish a timetable for China to sign the GPA and reinvigorate their commitment to do so.

Third, seek China's agreement to delay in the meantime other procurement regulations that might be under contemplation, not in conformity with the GPA.

Through formal and informal channels, we have been making these points to the Chinese Government in pointing out the benefits of having access to the best possible software at the best value, and that this requires open procurement.

China is rightly interested in encouraging technological development and innovation, but this can best be done through greater competition and more openness to new technologies. American business and government should impose measures that use discriminatory policies to achieve these goals.

Thank you, Mr. Chairman. I am happy to answer any questions you may have.

Chairman TOM DAVIS. Thank you very much.

[The prepared statement of Mr. Frisbie follows:]

CONCERNS WITH CHINA'S PROPOSED RULES ON GOVERNMENT PROCUREMENT OF SOFTWARE

Prepared Statement of
John Frisbie
President, US-China Business Council

House Government Reform Committee
May 13, 2005

Chairman Davis, ranking member Waxman, members of the Committee, thank you for giving me the opportunity to testify today.

When China joined the World Trade Organization (WTO) in 2001, it agreed to conduct its government procurement transparently. China became an observer to the WTO Agreement on Government Procurement (GPA) in 2002 and pledged to begin the process of joining the GPA as soon as possible. Accordingly, we expect China's procurement rules in the interim to move it closer to the principles of the GPA.

In November of last year, China released a summary of draft regulations on the procurement of software that raised important questions about China's commitment to the spirit of the GPA. American business and government expressed strong opposition to the rules described in the summary, but the concerns of US companies were not addressed in the fuller draft regulations released in March 2005. As currently written, the regulations are a key concern for many of the US-China Business Council's approximately 250 member companies, which are engaged in all manners of business—some in software, but others who look at this as an indication of China's government procurement practices more generally.

We applaud the Chinese government for its transparency in releasing the proposed rules for public comment; this is indeed a step forward. However, we have significant concerns that the new rules are a step backwards for China's procurement regime. Our specific issues are twofold. First, the software rules would essentially block American companies from competing on an equal basis with Chinese firms for PRC government contracts for software products and services. Second, the software rules could set a precedent for future discriminatory procurement policies.

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Summary of the Proposed Rules

The Implementing Measures for Government Procurement of Software are based on the PRC Government Procurement Law and lay out guidelines for the certification of domestic software and services. The measures also create a list of preferred non-domestic software and service providers. Essentially, the implementing measures would require PRC government entities to purchase "domestic software products" and "domestic software services" unless they receive a special waiver from the Ministry of Finance and Ministry of Information Industry to buy from a select group of international companies listed in a *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference.*

To be considered a "domestic software product," software must meet certain requirements:

- The software must be developed within China;
- The copyright for the software must be held by natural person(s), legal person(s), or other organizations within China;
- Development costs incurred in China must account for at least 50 percent of total costs of the software.

"Domestic software services" is defined as computer information system integration, information system engineering supervision, and other related professional technical services provided by natural person(s), legal person(s), or other organization(s) in China. International companies may work with providers of "domestic software services," but the value contributed by the foreign side may not exceed 30 percent of the total value of the project.

Based on the letter of the law, these definitions suggest that Chinese subsidiaries of international companies could, in theory, compete for software procurement contracts if they satisfied the requirements I have described.

Non-domestic software providers—that is, American or other international software suppliers that do not have subsidiaries in China—may apply to the China Software Industry Association—an industry association with a vested interest in China's domestic industry, not a government entity—for one-year inclusion in the *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference*, with final approval required by the Ministry of Information Industry. To qualify for a listing in the catalogue, non-domestic software providers must be able to provide software services (such as support and after-sales service) in China and also meet certain investment and revenue

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requirements for their operations in China. These requirements are not defined in the draft.

In order to purchase non-domestic software, the government customer additionally must seek the approval of the Ministry of Finance, which will consult with the Ministry of Information Industry on the request. These requests must be submitted for each proposed purchase of a non-domestic software product or service.

Finally, the rules also suggest a preference for open-source software.

Problems with the Rules

These rules contain a number of concerns.

On a technical level, the rules appear to contradict open procurement principles by effectively prohibiting access by international software providers to the PRC government market. The definitions of "domestic software products" and "domestic software services" are restrictive to a point that even those international companies with PRC subsidiaries, manufacturing facilities, and large levels of investment in China might be unable to qualify their products as "domestic" as that term is defined in the proposed rules.

As I mentioned before, to be certified as "domestic," the software product must meet three requirements: it must be developed in China; a Chinese entity must hold its copyright; and half the cost of the software must be development costs incurred in China. Software, however, is not created in any one country. Software companies operate research centers and employ programmers who work collaboratively with colleagues in multiple countries. Also, today's software is often based on older programs written years ago.

To meet the "domestic" criteria, software companies would likely have to create entirely new products using programming code written only in China. This is an unreasonable demand. Since the rules in effect would therefore grant an absolute preference to domestic products and services, this amounts to a prohibition on the procurement of products developed and distributed by international suppliers.

Furthermore, placement of a product on the *Catalogue of Non-Domestic Software Products with Priority Purchasing Preference* appears to give international companies only the most minimal level of market access. PRC government entities will only be allowed to purchase software listed in the Catalogue if there is no domestic substitute

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and if they obtain a waiver from the relevant ministries. These are highly restrictive requirements, and the proposed rules will therefore effectively block international software companies from competing in the PRC government procurement market on an equal basis with Chinese suppliers.

Many countries, including the United States, grant domestic firms some form of preference in government procurement contracts. These, however, are almost always accompanied by cost thresholds or other mechanisms that limit the use of such preferences. For example, when a contract is valued at more than the specified threshold, no preferences are awarded to domestic goods.

In contrast, the PRC's proposed software procurement rules set out an absolute preference for domestic goods. There are no general circumstances described in the proposed rules in which an international company would enjoy the same access to the PRC government software market as a domestic supplier.

When this absolute preference is combined with the highly restrictive definition of "domestic software," the proposed rules essentially block international companies from competing for PRC government procurement contracts. As such, the proposed rules clearly do not conform to the requirements of the World Trade Organization (WTO) Government Procurement Agreement (GPA), which China has said it intends to sign.

Moreover, the preference for open-source software distributed by Chinese suppliers would exclude competing products that are based on the development or licensing model. This preference runs counter to the fundamental international practice of merit-based procurement, which is recognized in several GPA principles. These principles include the requirement that technical specifications in procurement rules be specified in terms of performance characteristics and similar function-based criteria.

Recommendations

We were greatly encouraged by the Five Principles for US-China Trade proposed by Premier Wen Jiabao during his visit to the United States in December 2003. Premier Wen called for the expansion of US exports to China to help reduce the US trade deficit. Premier Wen also said the US-China trade relationship should be based on the principles of mutual benefit and that each side should consider the effects their policies have on the other.

We would be disappointed to see China implement policies that would greatly limit American access to its government procurement market for software at such a critical

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time in the US-China trade relationship. We need more opportunities for US companies to sell products to China, not less. Access to the PRC government procurement market for software is exactly the type of "win-win" outcome of significant mutual benefit that Premier Wen spoke of in 2003. Now more than ever, it is important for China to demonstrate its commitment to increasing its imports from the United States and to a rules-based trading system.

We strongly support the PRC government's stated intention to join the GPA at the earliest possible time and in the meantime to encourage the development of rules consistent with the GPA. To be consistent with its stated intentions, the US-China Business Council has asked the PRC government to suspend further action on these rules until they can be discussed in full at the US-China Joint Commission on Commerce and Trade (JCCT) meeting to be held in Beijing in the next month or two.

We understand that the proposed rules will be a key part of the US agenda at this year's JCCT meeting and we look forward to working with Secretary of Commerce Carlos Gutierrez, US Trade Representative Rob Portman, and their staffs to ensure a successful resolution of this issue. We encourage USTR and the Department of Commerce to:

- Secure commitments from Beijing to shelve the software procurement rules, or to revise them to address the concerns of American businesses and conform to international best practices;
- Establish a time-table for China to sign the GPA and work to reinvigorate China's commitment to do so; and
- Seek China's agreement to delay in the meantime further progress on all other procurement regulations not in conformity with the GPA.

Through formal and informal channels, the US-China Business Council has stressed to the PRC government the benefits of having access to the best possible software at the best value—and that this requires open procurement. China is rightly interested in encouraging technological development and innovation, but this can best be done through greater competition and more openness to new technologies. American business and government must oppose measures that use of discriminatory policies to achieve these goals.

Thanks to the work of the Department of Commerce and USTR, and to the efforts of those in the Chinese government who understand the benefits and importance of open trade policies, China's leaders have previously revised policies that would have imposed significant restrictions on the ability of American companies to compete in

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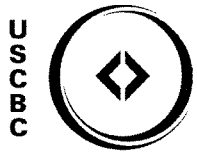

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China. Agreements between China and the United States on China's value-added tax rebate for domestically manufactured semiconductors and on the proposed WAPI (Wireless Authentication and Privacy Infrastructure) wireless network standard are encouraging signs that the American government and business community can work successfully with China to correct discriminatory policies to the benefit of both sides.

As we firmly resist the proposed software procurement rules and any other attempts to use procurement policy to block American companies from competing in China, we should look to these previous successes as examples of the robust engagement that has convinced China to adopt more reasonable policies. This should again be our policy as we work to secure China's agreement to revise the software procurement rules.

Thank you Mr. Chairman and Congressman Waxman. I am happy to answer any questions you or other members of the Committee may have.

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Chairman TOM DAVIS. Mr. Bohannon.

STATEMENT OF MARK BOHANNON

Mr. BOHANNON. Mr. Chairman, thank you for the opportunity to appear here today on behalf of the members of the Software Information Industry Association. Our more than 600 members produce world class products for a variety of markets. They range from some of the smallest and newest in the field to some of the largest and well-known brands.

In the context of China, we have members that have been active in the China market for many years, as well as those who are just at the beginning stages of getting into that market.

Through our leadership and the U.S. information technology office, which is the leading voice of the U.S. IT industry in Beijing, we have followed the developments on the new government procurement law, the drafting of these regulations and China's efforts to support a domestic software industry.

Unfortunately, based on this, we feel that the developments here are, at least, one step forward, two steps back. We have, as my colleague Mr. Holleyman indicated, provided detailed sets of concerns and outstanding questions to the Chinese Government. I believe we have made these available to the committee, and, if appropriate, would ask that they be included in the record.

Chairman TOM DAVIS. Without objection.

[The information referred to follows:]

Comments on the "Implementation Rules for Government Software Procurement (draft)" (March 31, 2005)

Distributed by the Ministry of Finance and the Ministry of Information Industry

Contributed by the U.S. Information Technology Office (USITO), The Business Software Alliance (BSA), The American Chamber of Commerce in Beijing (AmCham), The Telecommunications Industry Association(TIA), The U.S. Chamber of Commerce, The Software & Information Industry Association (SIIA)

General Comments

The U.S. business community again expresses its appreciation that the Chinese ministries have provided foreign and Chinese organizations alike with the draft of the "Implementation Rules" and the opportunity to contribute our views on the impact of proposed legislation on our businesses.

As we noted in our comments that were provided last November, over the course of more than one year of exchanges with the Chinese government about the proposed regulations, international software companies were assured that their access to the Chinese market would be preserved. At that time, when the earlier summary of the proposed "Implementation Rules" was distributed, the software and service companies that our organizations represent offered what we hoped were useful questions and constructive ideas for possible improvement to the draft.

Our careful review of the "Implementation Rules" leads us to the same concerns and questions as before, with further questions about a number of new details that are found in the latest document. Specifically, the "Implementation Rules," as currently proposed, would dramatically curb access to the Chinese market by virtually all international software companies.

The "Implementation Rules" describe new government procurement practices in software that are unique to China and that bear little relation to the principles of the WTO Government Procurement Agreement (GPA), whose goal is to ensure non-discriminatory, pro-competitive, merit-based and technology-neutral procurement of goods and services so that governments can acquire the best goods to meet their needs for the best value. This is of great concern as the proposed "Rules" appear to be in conflict with China's commitment to become a member of the GPA.

No country has attempted to isolate its software industry and software procurement market from the international IT marketplace to the degree set forth in the proposed "Rules." As such, the proposed "Rules" represent a large step backward in the Chinese government's efforts to integrate its domestic IT industries into the global economy.

We respectfully submit that the Chinese government's original goal in developing a procurement regime for software was to enable the government to use the best possible software at the best possible price, and to promote interoperability, thereby reducing redundant purchases. China's procurement regime should support the ambitious and effective e-government program being implemented in government agencies. The "Implementation Rules" severely impair the ability of the Chinese government and Chinese citizens to obtain the best possible products at the most competitive price, and instead promote the interests of certain domestic software companies.

The companies represented by our associations request, as we did before, that legitimate software enterprises in China, even if their ultimate owner is a foreign company, be granted status in government procurement equal to that given to companies that originated in China. As drafted, the performance requirements to qualify as "domestic software" essentially ensure that software of foreign invested companies in China will not be able to qualify as "domestic software." The requirements to qualify as "domestic software services" would also be very difficult to meet for any foreign invested company in China.

The effect of the draft would be to relegate foreign companies and foreign invested companies in China to seek inclusion of their software in the "Preferred Government Procurement Catalogue of Non-domestic Software Products." This creates a two-tiered system that discriminates between domestic and foreign software vendors and will prevent foreign and foreign invested software companies from operating on an equal basis with domestic software providers. Moreover, the distinction is unrelated to product quality, features or price. The performance requirements to qualify for inclusion in the preferential catalogue appear to envisage substantial investment, R&D or technology transfer in China, which would discriminate against small- and medium-sized foreign companies and even if their products get listed they would be on unequal footing with domestic software providers.

A further complication is the inclusion of a waiver process, which local and national agencies would need to go through to purchase items in the preferred catalogue. The waiver process should be eliminated.

We respectfully urge China not to implement the "Rules" as drafted. Rather, we strongly encourage China to adopt a transparent, competitive, non-discriminatory and technology neutral procurement system that is consistent with the WTO GPA and international practice. Furthermore, we urge China to begin negotiations to join the WTO Agreement on Government Procurement, consistent with its WTO commitments.

Our other, more detailed comments and questions are provided below.

Chapter I: General Provisions

Definitions of "Domestic Software" – "Domestic Software Service" – "Domestic Software Product"

We believe that the significance of these "Implementation Rules" lies in the definitions they provide of "domestic software" – "domestic software service" – "domestic software product." Although we disagree with the definitions provided, we note that the drafters have not excluded foreign brands entirely from the procurement process.

Our analysis leads us to conclude that the standards in the "Implementation Rules", as proposed, would probably exclude all international software products—and, if strictly observed, some Chinese products—from government procurement, for several reasons:

- The requirement that a software product have its "final formulation\shaping up" in China seems artificial and unnecessarily constraining. If substantial development takes place within China, will a company be excluded if it compiles the code on an overseas-hosted server? Many international foreign software companies maintain research and development centers in China but centralize their manufacturing facilities, where the CDs are pressed, or their marketing operations overseas. If software is manufactured and packaged overseas, but is co-developed by the vendor's Chinese research and development center, the "Implementation Rules" would still exclude such software from the preferred status of "domestic software" – and in many instances would exclude such software from the list of preferred non-domestic software. This result would create a tremendous disincentive to foreign direct investment in China's software industry.

- The requirement that 50% of a product's development cost be incurred in China would create a hurdle that would be impossible for virtually all international companies to meet. First, we view this requirement as outmoded and it ignores the emphasis many companies place on support, service, and upgrades. For products such as anti-virus software, the development cost may be trivial compared with the maintenance cost. Secondly, not all software companies capitalize development costs on a product basis; some companies lump together development costs for all products. Determining the development cost for a particular piece of software would ultimately depend upon a company's own reporting, and the assessors could ultimately have no objective means for verifying the reports. We also submit that we do not see how auditing can be effective as the proportion of local content in any product may vary over time and is intrinsically difficult to measure when companies maintain cross-national development teams. Third, many software products and services that are on the market today are built from previously developed software or service components. How are these prior, and significant, development costs to be treated under the draft "Rules"? Finally, because even companies that make large R&D and other investments in China would often fail to satisfy the 50% threshold, the "Implementation Rules" would create a substantial disincentive to future foreign direct investment in China's software industry.

- The draft "Rules" continue to have the requirement that the copyright belong to a Chinese natural person, legal person or other organization in the PRC in order to be "domestic." Our previously stated concerns remain on this point. First, registration of copyright as a precondition is specifically prohibited by the WTO TRIPs Agreement. Second, software companies that operate internationally

would find it burdensome to deposit bits of code in different countries. That would force their units abroad to develop new software based on different foundations, and products gradually would become a hodge-podge of different code and standards. If this occurs only in China, China would run the risk of creating an isolated IT market for "domestic software." The result would be that "domestic software" would be unsuitable for distribution or use in other contries and would work poorly with other software in the international market.

- The draft "Implementation Rules" include a new category which has not been presented in any discussions over the last several years, was not in the November summary, and has generated numerous questions and confusion. The new category is "domestic software product" which refers to both "domestic software" and "domestic software service." The draft "Rules" appear to interchange the term "domestic software" and "domestic software product" and make it unclear when certification of software and services is required. We respectfully request clarification on this new point.

- We are pleased to see in Article 6 that the certification processes and establishment of the Catalogue shall follow the principles of just, fair and openness, and that it includes a requirement that departments and staff are to treat confidential information as secret.

- We believe that any company registered to do business in China should be qualified to be a provider of a "domestic software service."

Chapter II. Certification of Domestic Software Products

- In our prior comments, we requested clarification of the requirement that software must be tested for conformance with information security requirements. We note that Article 11 of the draft "Rules" still includes this requirement. Currently, the only certification for information security that we are familiar with is the "Regulation of Commercial Encryption Codes" (China State Council Directive No. 273). To date, this regulation has been applied only to products specifically used for encryption, not for products that contain encryption algorithms and mechanisms. In addition, the draft "Rules" include new, additional requirements that the products must conform to a variety of Chinese product standards, technical laws and regulations. This requirement is very broad and does not provide upfront clarity to companies. We again request clarification on this point.

- Article 8 of the draft Rule continues to require at least two years' of upgrades in a software contract. Our concerns with the provision remain. In our November comments, we noted that such a requirement would make it difficult for companies using U.S. Generally Accepted Accounting Principles (GAAP) to recognize sales revenue from China. Upgrades may be reasonably expected, but companies should be able to contract and charge for them separately.

- Open Source: The "Implementation Rules" continue to establish a procurement preference for open source products when distributed by Chinese companies regardless of where the underlying code originated. By creating a procurement preference based on the product's method of development, rather than based on the criteria of performance or price, this provision creates substantial disruption for all software developers. It would also not serve the interests of the Chinese government and taxpayers. Many software products already incorporate both open source and non-open source elements. It would be very hard to anticipate how these products would be treated. In all likelihood,

the distinction between products on this basis would be arbitrary and prevent competition between relevant products. In addition, the commercial value associated with many open source products is in services, which are subject to separate requirements in the draft "Rules" that are very hard to meet. For these reasons we urge that any preference based on a product's method of development be removed from the "Implementation Rules."

- We commend the draft "Rules" for recognizing the need for promptness in making certifications, and look forward to further discussions with the Chinese ministries regarding measures that can make the timetables in Articles 13 and 14 operate to the satisfaction of all affected parties.

- The three year period of validity of the certificate is too short and needs to be lengthened.

Chapter III: "Preferred Government Procurement Catalogue of Non-domestic Software Products"

We do not support a two-tiered, discriminatory system of procurement. Beyond the general principle of inclusiveness, we offer the following comments:

- We are shocked to see that a non-governmental entity is given the prominent role of making determinations of what companies and products fulfill the requirements. The Chinese Government Procurement Law regulates the government's purchase of products, including software. This is a governmental function. The draft "Rules" do not allow an appeal of a negative decision by the association to the relevant Chinese ministries. Our associations have worked closely with the Chinese Association of Software Industry and believe it makes important contributions to the development of a domestic software industry. However, placing them in this important role is not appropriate.

- The one-year period of validity for software products listed in this Preferred Catalogue is too short and needs to be lengthened. In addition, non-domestic software should have the same validity period as "domestic software".

- We strongly believe that all foreign software listed in this Preferred Catalogue should be treated as domestic software with all the same rights and privileges.

- In our November comments, we stated that, to date, Chinese government procurement lists have been lists of products, not of companies. The draft "Rules" appear to be an effort to clarify this problem, but we remain concerned about the particular requirements. We continue to urge that the "Preferred Catalogue" should list products, and it should list *all* of an approved company's software products.

- Companies affiliated by ownership links of 50% or more should be treated as a single company for certification purposes. Many corporations establish overseas subsidiaries to carry out their investment activities. A corporation that has invested in China should not be excluded simply because it used one or more subsidiaries as the vehicle to invest in China.

- The threshold used for investment -- which assumes some number of "hundred million USD" -- is very high. This very high amount level would negatively impact many of our associations' members and prevent virtually all small- and medium-sized companies -- and even many large companies --

from having their products in this "Preferred Catalogue." The contributions of small- and medium-sized enterprises in the software industry are significant and we respectfully urge the Chinese Ministries to reconsider this amount level so as not to exclude these enterprises from the government procurement market.

- The draft "Rules" also discriminate between small- and medium-sized companies, on the one hand, and large companies on the other, by requiring a specific amount of accumulated investment in the aggregate, as the draft does in the first part of Article 19(1). This approach also favors equipment companies that may also make or distribute software over companies that only supply software since manufacturing is more capital-intensive. The same problem relates to the requirement for a specific number of persons to be granted training in the aggregate, as the draft does in Article 19(3).

- The effect of using aggregate numbers will be to decrease competition in the Chinese market among the foreign companies, squeezing out small- and mid-size companies. This may result in higher prices and reduced services for Chinese buyers.

- Outsourcing of software should not be included as any qualification for inclusion in the list. International companies cannot support a government policy in China that requires them to displace domestic jobs from their home countries in order to gain market access in another country.

- Some of the items listed in Article 19, paragraph 2, were independent criteria in the earlier draft in November and should remain independent (e.g., taxes paid). The current phrasing, which makes all the elements cumulative, is likely to be unworkable.

- Article 19 provides that approvals in this "Preferred Catalogue" shall be valid for one year. This is an exceedingly short term of validity. A one-year term provides no public benefit and imposes tremendous costs and burdens on international software vendors. It creates great uncertainty for all the government agencies. The "Implementation Rules" should provide terms of validity in this "Preferred Catalogue" that are equal to the terms provided to "domestic software."

- We respectfully urge the Chinese government to grant all products included in the Catalogue equal opportunity in procurement regardless of the relative size and investment of the companies.

Chapter IV: "Approval of non-domestic software products purchase"

In our prior comments, we raised points on the "Waiver Process" that continue to cause concern. The "Implementation Rules" provide that even if a foreign provider of software is on the approved list, local and national agencies will still have to apply for a waiver to purchase items on this list. This would be extraordinarily time-consuming and would impose enormous costs, delays in implementation, and inefficiencies on agencies that are quite busy. The requirement to seek a waiver will, in and of itself, discourage procurement of non-Chinese software which is already on an approved list. This duplicative requirement is a significant market access impediment for software companies that have products that are otherwise already eligible for procurement. Qualifying international software should be eligible for procurement without a waiver and on an equal basis to domestic software.

Chapter V: "Supervision and inspection"

We commend the Chinese Ministries for recognizing the need to supervise implementation of these "Rules," which are likely to lead to confusion. The supervision and inspection should operate according to the general principles established that the Rule should follow the principles of justice, fairness and openness. In the gathering of information on implementation of the "Rules," it is essential that the Ministries consult with all affected parties, including "domestic" and "non-domestic" software and service companies.

Conclusion

We greatly appreciate the opportunity to submit these comments. Given the extensive questions and concerns with the draft "Implementation Rules," we urge China not to implement the "Rules" as drafted. Again, we strongly encourage China to adopt a transparent, competitive, non-discriminatory and technology neutral procurement system that is non-discriminatory and is consistent with the WTO GPA and international practice.

April 8, 2005

Signed by:

The United States Information Technology Office (USITO)

The Business Software Alliance (BSA)

The American Chamber of Commerce in Beijing (AmCham)

The Telecommunications Industry Association (TIA)

The U.S. Chamber of Commerce

and

The Software & Information Industry Association (SIIA)

Mr. BOHANNON. In the simplest of terms, our concerns are threefold. First, it does create a two-tiered system that does discriminate between domestic and foreign vendors and will effectively prevent any nonChinese company from participating. As my colleague indicated, we believe no international software company will be able to get its products to be eligible.

And I would go so far as to say that even many domestic Chinese companies will have that trouble as well, which raises the issue of transparency and consistency of the possible application of the rules. The second issue is that rules impose onerous requirements to be able to get on a second tier list of preferred foreign vendors, requirements that are not imposed on Chinese companies.

And the third, the rules discriminate against U.S. companies by demanding a waiver from the ministry of finance if a local or national government agency wishes to purchase so-called foreign software, a hoop that no Chinese company has to go through.

It's unfortunate that this is the result, because today, U.S. software vendors enjoy generally favorable market access to the Chinese Government, despite the many challenges of piracy, lack of transparency and the inconsistent rule of law.

It is our view that this two-tiered system of domestic and foreign treatment of the rules appears to be intentionally designed to subvert this current status quo and change the current situation.

As my colleagues suggested, the developments in China really bear no relation to international norms or to the requirements of the Government Procurement Agreement, which promotes nondiscriminatory, competitive, merit-based purchases of goods and services.

I would even go further to say that based on our experience and working in a variety of markets—and in my own background working on technology development in the U.S. government—that no country has attempted to isolate its software industry and software procurement market from the international marketplace to the degree set forth in the rules.

And as such, the proposed rules represent a large step backward in the Chinese Government's efforts to integrate its domestic industries into the global economy. As you pointed out in your opening statement, Mr. Chairman, the implementation rules will severely impair the ability of the Chinese Government to obtain the best possible products at the best competitive price. Sadly in our view, these rules as drafted instead appear to promote only the interests of certain domestic software companies.

As I detail in my testimony, it didn't have to turn out this way. Over the years, both U.S. industry and the U.S. Government have been meeting with experts at all levels of the Chinese Government to better understand their goals and to share the lessons learned by U.S. agencies in their move from government-specific requirements for IT purchases to greater reliance on commercial off-the-shelf products and emphasis on the best value in government purchases. Our discussions have emphasized the benefits of open, transparent and competitive procurement policies.

And we have appreciated very much the leadership of the Department of Commerce, Department of State and the U.S. Trade Representatives office, as well as many Members of Congress, who

have engaged Chinese officials on how best to achieve their goals while not discriminating against U.S. companies and avoiding trade distorting measures.

I think the key question is where do we go from here? It is incumbent on both U.S. industry and the U.S. Government to continue to press for changes and to continue to see a delay in the rules until real changes are made. We must work to insure that the government procurement law achieves what it set out to do originally, to bring China's practices into the mainstream of international commerce.

This commitment is important, because these regulations are the first of what is likely to be a series of regulations affecting other industries and products. And to that point, Mr. Chairman, I would like to introduce into the record a letter from 15 association presidents representing the entire IT industry, as well as the business community generally on this point.

Chairman TOM DAVIS. Without objection, it will be entered into the record.

[The information referred to follows:]

AeA
American Business Conference
Business Roundtable
Business Software Alliance
Coalition of Service Industries
Computer Systems Policy Project
Computing Technology Industry Association
Electronic Industries Alliance
Emergency Committee for American Trade
Information Technology Association of America
Information Technology Industry Council
National Association of Manufacturers
National Electrical Manufacturers Association
National Foreign Trade Council
Software & Information Industry Association
United States Council for International Business
U.S. Chamber of Commerce

April 8, 2005

Ministry of Finance Treasury Department
Attn: Lin Jie
San Li He, Yue Tan South Street, Xicheng District
Beijing 100820

Ministry of Information Industry Electronic Products Management Department
Attn: Chen Ying
27 Wan Shou Street
Beijing 100846

Dear Sirs:

On behalf of the many U.S. businesses represented by our associations, we thank you for the opportunity to comment on the draft "Implementation Measures for Government Procurement of Software." As you may recall, our associations strongly supported China's accession to the World Trade Organization (WTO) and led the fight in the United States in support of permanent normal trade relations with China. While we appreciate China's many efforts to meet many of its WTO commitments and foster a more positive U.S.-China economic relationship, we are very concerned that the draft Implementation Measures represent a step backwards.

The proposed Implementation Measures would severely restrict market access by non-Chinese companies in a manner that goes far beyond the procurement practices of the United States. Such a discriminatory procurement regime would effectively close the door for most, if not all, U.S. companies and other non-Chinese companies to sell software products and services to China's largest purchaser, the Chinese Government. Software piracy rates exceeding 90% in China already cost U.S. software companies billions of dollars in sales. Effective denial of the ability to sell to China's government market would render meaningless to U.S. and other foreign software companies China's efforts to promote the use of legally purchased software in its government.

Non-discriminatory, transparent, merit-based and technology-neutral procurement in software and all industries is not only important to U.S. companies, but to each country's own economic and technological development. Access to the best products and services from around the world is critical to spur technological progress, growth and higher living standards.

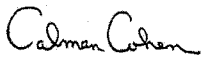
It is our understanding that the draft Implementation Measures represent the first of what will likely be a series of sectoral rules promulgated by the Chinese Government to implement its new government procurement law, which requires, with limited exceptions, that its government purchase only domestic goods, services and public works. This law is applicable to every services and goods industry from which the Chinese Government procures and has very significant ramifications for all U.S. industries seeking access to China's government procurement market.

The government procurement law and the Implementing Measures strike us as moving in precisely the wrong direction from China's WTO accession pledge, yet unfulfilled, to "initiate negotiations for membership in the GPA [Government Procurement Agreement] . . . as soon as possible." We are particularly concerned that now, more than three years from its WTO accession, China has yet to begin the process for GPA accession and has proposed procurement regulations that severely restrict access by non-Chinese companies.

As concerns in the United States increase over the growing U.S. trade deficit with China, the Chinese Government's closure of its government procurement market in software and other industries appears to undermine Premier Wen Jiabao's pledge to foster an improved U.S.-China trade relationship based on increasing, not restricting, market access for U.S. exports, and to be inconsistent with the spirit of openness China embraced in joining the WTO. We hope that the Chinese Government will quickly renew its commitment to open, inclusive, non-discriminatory and transparent procurement policies by commencing negotiations to accede to the GPA and suspending adoption of the Implementation Measures and any similar discriminatory procurement rules. There are several upcoming, high level meetings between the U.S. and Chinese governments at which we hope significant progress can be made in this area.

We greatly appreciate the opportunity to provide these comments and look forward to working with the Chinese Government to implement a non-discriminatory government procurement regime in software and other sectors in a manner that fulfills China's commitment to fair and open trade.

Respectfully,



Calman Cohen
President
Emergency Committee for American Trade

Harris Miller
President
Information Technology Association of America

John J. Castellani
President
Business Roundtable

John Venator
President and CEO
Computing Technology Industry Association

Robert Holleyman
President
Business Software Alliance

Robert Vastine
President
Coalition of Service Industries

Malcolm O'Hagan
President
National Electrical Manufacturers Association

Bruce P. Mehlman
Executive Director
Computer Systems Policy Project

Dave McCurdy
President
Electronic Industries Alliance

John Endean
President
American Business Conference

John Engler
President & CEO
National Association of Manufacturers

William T. Archey
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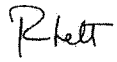
AeA

Ken Wasch
President
Software & Information Industry Association

Thomas M.T. Niles
President
United States Council for International Business

William A. Reinsch
President
National Foreign Trade Council



Rhett B. Dawson
President
Information Technology Industry Council

Thomas J. Donohue
President and CEO
U.S. Chamber of Commerce

cc: Vice Premier Wu Yi
Minister Bo Xilai, Ministry of Commerce
Minister Jin Renqing, Ministry of Finance
Minister Wang Xudong, Minister of Information Industry
Minister Xu Guanhua, Ministry of Science and Technology
Director Ma Kai, National Development Reform Commission
Director Cao Kangtai, State Council Legislative Affairs Office

Mr. BOHANNON. As Mr. Cummings stated more eloquently than I read from my testimony, it is incumbent that the Chinese begin negotiations to join the WTO Government Procurement Agreement. And as for changes in the regulations, we must make sure that nonChinese software companies must be allowed to compete—and I emphasize the word "compete"—as domestic software companies as if they meet nondiscriminatory applicable requirements to all companies who must operate in the Chinese market.

Mr. Chairman, my members are under no illusion of what it takes to operate in the Chinese market these days. It is a complex market. Unfortunately, the developments in the implementation of the new government procurement law and the draft regulations we have before us are really not a step, forward, but a step back in terms of making that situation more transparent, more open and more competitive.

Thank you, and I would be happy to take any questions you have.

Chairman TOM DAVIS. Thank you very much.

[The prepared statement of Mr. Bohannon follows:]

Software & Information Industry Association
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Washington, DC 20005-4095

Prepared Testimony of

Mark Bohannon
General Counsel & Senior Vice President, Public Policy
Software & Information Industry Association (SIIA)

on

China's Regulations on Software Procurement

Before the
Committee on Government Reform
U.S. House of Representatives

At a Hearing Entitled:

"Domestic Source Restrictions Threaten Free Trade: What is the Federal Government Doing to Ensure a Level Playing Field?"

May 13, 2005

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PREPARED STATEMENT OF MARK BOHANNON

Mr. Chairman, members of the Committee, I appreciate the opportunity to testify today on the Chinese government's regulation of software procurement.

I am Mark Bohannon, General Counsel & Senior Vice President of the Software & Information Industry Association (SIIA), the principal trade association of the software and digital content industry. Our more than 600 members produce world-class, innovative software products and information services for the business, consumer, educational and government markets, and range in size from many small and medium enterprises to many of the larger, well-known brands.

Through our leadership in the US Information Technology Office (USITO), the leading voice of the American information technology industry in Beijing which we helped create in the mid-1990's,[1] we have closely watched the enactment of China's new Government Procurement Law, the development of the regulations (known as "Implementing Rules") specifically addressing the procurement of software, and the overall efforts of the Chinese government to promote an indigenous software industry.

This hearing raises a number of relevant and appropriate questions: Are the efforts of the Chinese government to update and modernize its government procurement system likely, in the end, to impose restrictions on free trade? Are the domestic source restrictions in the Rules distorting free trade? Are they consistent with international norms? Do the "Rules" isolate the Chinese IT market from global commerce? And – perhaps most importantly – will the procurement regime prevent the local and national governments in China from getting the best available products at the most competitive price?

A careful examination of the software regulations, the details of which were released last month, indicates that the answers to these questions are far from acceptable.

Mr. Chairman, I submit for the record a detailed set of concerns and unanswered questions with the Rules that we submitted to the Chinese government on April 8th.[2] In the simplest of terms, the framework:

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[1] **USITO** is an independent, not-for-profit, membership-based trade association, established in 1994 to act as the joint office in China for the U.S.-based high-tech industry. Currently, USITO's member, includes, in addition to more than 50 corporate leaders in the industry, the following parent organizations: the American Electronics Association (AeA), the Software and Information Industry Association (SIIA), the Telecommunications Industry Association (TIA), the Semiconductor Industry Association (SIA), the Information Technology Industry Council (ITI), and the Computer Systems Policy Project (CSPP).

[2] "Comments on the 'Implementation Rules for Government Software Procurement (draft) (March 31, 2005' ", contributed by the U.S. Information Technology Office (USITO), The Business Software Alliance (BSA), the American Chamber of Commerce in Beijing, the Telecommunications Industry Association, the U.S. Chamber of Commerce, and the Software & Information Industry Association (SIIA).

- Creates a two-tiered system that discriminates between "domestic" and "foreign" software vendors that will effectively prevent non-Chinese software companies from operating on an equal basis with "domestic" enterprises. Virtually no international software company could, based on our analysis, meet the requirements for producing "domestic software" under the Rule.

- Imposes onerous requirements on non-Chinese companies – including having to show potentially "hundreds of millions of USD" in accumulated investment in China, as well as specified percentages of foreign investment, research & development, outsourcing and taxes paid in China – simply to have their products *eligible* for consideration in government procurements.

- Discriminates against US, and all other non-Chinese, companies by demanding that a "waiver" must be given from the Ministry of Finance before any local or national government agency could purchase any product off the so-called "Preferred" list of non-Chinese software products and services. This duplicative requirement is imposed on foreign, but not domestic, companies. This time-consuming requirement alone is a market impediment that discourages Chinese government agencies from buying products that have already been deemed eligible for procurement after they have already met the discriminatory tests applied to foreign (non-Chinese) vendors.

If these Rules go into effect without substantial change, the result will be, in our view, demonstrable and detrimental restrictions on free trade. As it stands now, US software vendors enjoy generally favorable market access to the Chinese government procurement market. This is true despite the many real challenges that our industry faces in the Chinese market, including piracy of our products, lack of transparency in the adoption of government rules and inconsistent application of the "rule of law." Our current market access is a recognition that US software vendors provide world-class, if not the best, products and services available in a globally competitive market for information technology products and services. The two-tiered system of "domestic" and "foreign" treatment found in the Rules appears to be intentionally designed to subvert this status quo.

In addition, the Rules as written stand in stark contrast to the international norms adopted by many of our other trading partners, including Japan and members of the European Union. The Rules describe novel government procurement practices in software that are unique to China and that bear little relation to the principles of the WTO Government Procurement Agreement (GPA), whose goal is to ensure non-discriminatory, pro-competitive, merit-based procurement of goods and services without technology-specific mandates. This is of great concern as the "Rules" appear to be in conflict with China's commitment to become a member of the GPA, which today includes 36 parties.[3]

[3] See "GOVERNMENT PROCUREMENT: THE PLURILATERAL AGREEMENT, Notification of national implementing legislation", at http://www.wto.org/english/tratop_e/gproc_e/notnat_e.htm.

The "Rules" also stand in stark contrast to the stated goals of the Chinese government to bring its economy and its industries into the mainstream of global commerce. No country has attempted to isolate its software industry and software procurement market from the international IT marketplace to the degree set forth in the proposed "Rules." As such, the proposed "Rules" represent a large step backward in the Chinese government's efforts to integrate its domestic IT industries into the global economy.

Significantly, the procurement regime implemented by the Chinese government will prevent the local and national governments from getting the best available products at the most competitive price. The Chinese government's original goal in updating its government procurement for software was to enable the government to use the best possible software at the best possible price, and to promote interoperability, thereby reducing redundant purchases. The U.S. IT industry has been very encouraging of the goal that China's procurement regime should support the ambitious and effective e-government program being implemented in government agencies. The "Implementation Rules" severely impair the ability of the Chinese government and Chinese citizens to obtain the best possible products at the most competitive price, and instead promote the interests of certain domestic software companies.

It simply didn't have to turn out this way. Over the course of several years, US industry and the US government have met enumerable times with experts at all levels of the Chinese government to get a better understanding of their goals, while sharing the experiences of US agencies in moving from government-specific requirements for procuring IT to a focus on "commercial-off-the-shelf" products and emphasis on "best value" in government purchases. Our discussions have emphasized the benefits of open, transparent and competitive procurement policies in meeting government needs. SIIA and USITO have hosted delegations of Chinese officials, providing them with the best expertise in this area. We have patiently explained in detail how our own system works, responding to misunderstandings about US preferences which are not, in fact, prohibitions on non-US companies. US industry has – working constructively with the leadership of the Department of Commerce, Department of State and the Office of the US Trade Representative – vigorously sought to engage with the Chinese government on a framework that achieved their goals while not discriminating against US companies and avoiding trade distorting measures, and how domestic source restrictions in their proposals threaten free trade.

Where do we go from here? It is incumbent on both the U.S. IT industry and the US government to continue to press for changes in the regulations on software so that US (and for that matter all non-Chinese) software providers are treated no less favorably than domestic ones. We must work with the Chinese government to ensure that the Government Procurement Law achieves what it set out to do originally – to bring China's practices into the mainstream of international commerce. We commend the US government representatives, as well as many members of Congress, for their steadfast work on this issue. This commitment is important not just to our industry, but also

because the regulations on software are the first of what we expect to be a series of regulations affecting other industries and products.

At minimum, the Chinese must begin negotiations to join the WTO Agreement on Government Procurement, consistent with its WTO commitments, which were made more than four years ago. To date, no such discussions have taken place. As for changes in the regulations, non-Chinese software companies must be allowed to compete as "domestic" software companies if they meet non-discriminatory, minimal requirements that all companies must meet in order to operate in the Chinese market. This includes removing the requirement that, in order to be "domestic", copyright registration must be held by a Chinese entity or person. The two-tiered scheme, where waivers must be obtained before any agency can procure "foreign" software, is simply unworkable and unacceptable.

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Background on the Software Regulations

The origins of the Software "Implementation Rules" issued in April emanate from two distinct policies adopted in China in recent years. The first is a new ***Government Procurement Law*** that went into effect at the beginning of 2004, following attempts over the years to modernize the way that the Chinese government at all levels purchases products and services. The Law is generally applicable to all products and services.

The Law, according to the Chinese government itself, is intended to establish a predictable and stable government procurement market that is administered scrupulously and efficiently, and requires that government procurement shall be carried out following the principles of openness and transparency, fair competition, equality, and accountability. Key points of China's Government Procurement Law include a definition of government procurement and procurement parties, methods, procedures, contracts, complaints, supervision, verification, and legal obligations.

There are many regulations required to implement the Government Procurement Law including establishing the requirements for Article 10 which stipulates, "Government procurement shall purchase *domestic* goods, works and services…the definition of the above-mentioned 'domestic goods, works and services' are under the relevant regulations of the State Council." [emphasis added]

The second pillar has been a concerted effort to promote ***an indigenous software industry*** through a series of policy statements that established goals and measures such as tax incentives, domestic procurement, and protection of intellectual property. For example, in the earliest statement on the subject, the State Council Informatization Office (SCITO) promulgated State Council Document No. 18 (SC18)[4] which outlined incentives

[4] "Some Policies to Develop the Integrated Circuit & Software Industry", June 2000.

from 2001-2010 for the software industry, along with specific targets to reach by 2005 and 2010. In 2002, a supplementary Document No. 47 (SC47)[5] outlined a short term supplementary policy to spur government agencies into implementing the provisions of SC18 that never became implemented. With regard to government procurement, the Action Plan in SC47 included the following provision:

> **Preferential Procurement of Local Software Products and Services**
> When drafting the government procurement of software products and services Catalogue and standards, government procurement should procure local software products and services. Using Finance funds to build informatization projects, the funds used for purchasing software products and services should in principle not be below 30% of the overall investment. Major national informatization projects should implement the bidding process system,[6] project management system, and the implementing agency should have a quality certification. Encourage enterprises and other social institutions that during their own informatization construction to cooperate on development with software companies or to actively purchase local software products and services.

Need for China to Accede to WTO Government Procurement Agreement (GPA)

The "Implementation Rules" that were released in April demonstrate that China must enter into negotiations to join the WTO's Government Procurement Agreement (GPA). In December 2001, China joined the WTO and became an observer to the WTO's Government Procurement Agreement (GPA) at the time of its accession. China pledged to join the GPA and committed to begin GPA negotiations. To date, no such negotiations have been initiated.

China's announcement of its intention to join the GPA was a very positive development. Establishing a procurement environment in China that conforms to global norms will assist Chinese enterprises to develop and survive in the global government procurement market. An open government procurement market will encourage Chinese enterprises to enhance their competitive edge and to participate effectively alongside foreign companies.

Summary of Concerns with "Implementation Rules" for Software

In a joint submission made on April 8th, several associations with member companies in the US IT industry identified a number of significant concerns and

[5] "Action Plan for Invigorating Software Industry Development, 2002-2005", July 2002.
[6] Ed. Note: This is a reference to China's new Government Procurement Law.

outstanding questions about the Software procurement Rules. The major concerns are summarized below:

1. The Rules create a two-tiered system that discriminates between "domestic" and "foreign" software vendors that will effectively prevent non-Chinese software companies from operating on an equal basis with "domestic" enterprises.

Central to the Rules' operation is a definition of "domestic software" and "domestic software service" that Chinese agencies are required to purchase. Thus, Chinese agencies will be able to purchase items that have been "certified" as "domestic" without restrictions. All other software products and services will be relegated to a second-class listing in the "Foreign Catalogue."[7] Our analysis leads us to conclude that the standards for being treated as "domestic" in the "Implementation Rules", as proposed, would most likely exclude all international software products and services from government procurement.

To be "domestic" under the Rules, a software product must have its "final formulation\shaping up" in China, an artificial and workable concept. The Rules do not take into account the realities of today's software development environment. Many of our members -- software companies of all sizes with customers around the world -- maintain research and development centers in China but centralize their manufacturing facilities where the CDs are pressed or their marketing operations overseas. If software is prepared and packaged overseas, but is co-developed by the vendor's Chinese research and development center, the "Implementation Rules" would appear to still exclude such software from the preferred status of "domestic software" – and in many instances would exclude such software from the list of preferred "foreign" software. This result would create a tremendous disincentive to foreign direct investment in China's software industry.

The Rules also require that 50% of a product's development cost be incurred in China, a hurdle that is impossible for virtually all software companies – small as well as large enterprise -- to meet. First, the requirement ignores the emphasis many companies place on support, service, and upgrades. For products such as anti-virus software, the development cost may be trivial compared with the maintenance cost. Secondly, not all software companies capitalize development costs on a product basis; some companies lump together development costs for all products. Determining the development cost for a particular piece of software would ultimately depend upon a company's own reporting, and the assessors could ultimately have no objective means for verifying the reports. The proportion of local content in any product may vary over time and is intrinsically difficult to measure when companies maintain cross-national development teams. Third, many software products and services that are on the market today are built from previously developed software or service components. It is unclear whether and how these prior, and significant, development costs would be treated under the "Rules." Finally, because even companies that make large R&D and other investments in China

[7] "Preferred Government Procurement Catalogue of Non-domestic Software Products" established in Article 18 of the "Implementation Rules".

would often fail to satisfy the 50% threshold, the "Implementation Rules" would create a substantial disincentive to future foreign direct investment in China's software industry.

The "Rules" also maintain a requirement (which US industry has consistently urged be removed) that the copyright belong to a Chinese natural person, legal person or other organization in the PRC as a condition for being "domestic." First and foremost, registration of copyright as a precondition is specifically prohibited by the WTO TRIPs Agreement. Second, software companies that operate internationally would find it burdensome to deposit bits of code in different countries. That would force their units abroad to develop new software based on different foundations, and products gradually would become a hodge-podge of different code and standards. If this occurs only in China, China would run the risk of creating an isolated IT market for "domestic software." The result would be that "domestic software" would be unsuitable for distribution or use in other contries and would work poorly with other software in the international market.

2. The "Rules" impose onerous requirements on non-Chinese companies simple to have their products *eligible* for consideration in government procurements.

US, and other Non-Chinese companies, must meet extraordinarily stringent (and in many cases impractical) requirements just to be included in the catalogue of "Foreign Software." (As noted below in point 3, mere inclusion in the catalogue does not give non-Chinese software companies equal footing with domestic providers.)

To qualify for the "Foreign Software" catalogue, a supplier must show that it has (1) accumulated investment in China in the hundreds of millions of US dollars (the actual amount is unspecified at the moment) and that its annual investment in China is some fixed percentage of its annual turnover (again, the actual percentage is unspecified at the moment) for the last two years; (2) total R&D investment, outsourcing and taxes paid is a fixed percentage of annual turnover in China (again, actual percentage is unspecified) for the last two years; or (3) a software R&D center located in the China, is transferring "core software technology" to China, and annually training mid- and senior-level software personnel above some established number for the last two years. These requirements will have to be demonstrated on a yearly basis.[8]

These determinations will not be made by a Chinese government institution, but rather by a non-governmental organization, the Chinese Software Industry Association. We are shocked to see that a non-governmental entity is given the prominent role of making determinations of what companies and products fulfill the requirements. The Chinese Government Procurement Law regulates the government's purchase of products, including software. This is a governmental function. The draft "Rules" do not allow an appeal of a negative decision by the association to the relevant Chinese ministries. While we have worked closely with the Chinese Software Industry Association and believe it

[8] By contrast, a certification for a domestic software product is good for three (3) years.

makes important contributions to the development of a domestic software industry, placing them in this important role is not appropriate.

The problems with these requirements are numerous. For example, Chinese government procurement lists have been lists of products, not of companies. However, these requirements are about companies. In addition, it is not clear how the Rules will treat Companies affiliated by ownership links of 50% or more. Normal rules in this area would have them treated as a single company. Many corporations establish overseas subsidiaries to carry out their investment activities. A corporation that has invested in China should not be excluded simply because it used one or more subsidiaries as the vehicle to invest in China.

The threshold used for investment -- which assumes some number of "hundred million USD" -- is very high. This very high amount level would negatively impact many of our Associations' members and prevent virtually all small- and medium-sized companies – and even many large companies -- from having their products in this "Foreign Catalogue."[9] The contributions of small- and medium-sized enterprises in the software industry are significant and the Rules should not to exclude these enterprises from the government procurement market.

Outsourcing of software to China should not be a qualification for inclusion in the list. We have made clear that none of our organizations can support a government policy in China that requires them to displace domestic jobs from their home countries in order to gain market access in another country.

3. The Rules discriminate against US, and all other non-Chinese, companies by demanding that a "waiver" must be given from the Ministry of Finance before any local or national government agency could purchase any product off the list of "Preferred" list of non-Chinese software products and services.

Even if the requirements above are met in order to be included in the "Foreign Catalogue", the "Implementation Rules" provide that local and national agencies will still have to apply for a waiver to purchase items on this list. This would be extraordinarily time-consuming and would impose enormous costs, delays in implementation, and

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[9] The draft "Rules" discriminate in a number of ways between small- and medium-sized companies, on the one hand, and large companies on the other, by requiring a specific amount of accumulated investment in the aggregate, as the draft does in the first part of Article 19(1). This approach also favors equipment companies that may also make or distribute software over companies that only supply software since manufacturing is more capital-intensive. The same problem relates to the requirement for a specific number of persons to be granted training in the aggregate, as the draft does in Article 19(3).

The effect of using aggregate numbers will be to decrease competition in the Chinese market among the foreign companies, squeezing out small- and mid-size companies. This may result in higher prices and reduced services for Chinese buyers.

inefficiencies on agencies that are quite busy, as well as adversely affect the affected companies. The requirement to seek a waiver will, in and of itself, discourage procurement of non-Chinese software which is already on an approved list.

This duplicative requirement is a significant market access impediment for software companies that have products that are otherwise already eligible for procurement. Qualifying international software should be eligible for procurement without a waiver and on an equal basis to domestic software.

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Mr. Chairman, members of the Committee, we appreciate the opportunity to provide our views on these developments in the Chinese government procurement market. We will be glad to answer any questions that you may have.

Chairman TOM DAVIS. I guess, if we implement the regulations as drafted, is it fair to say that most of your members would not be able to compete for the business?

Mr. BOHANNON. I think, certainly, they would have difficulty making and showing the specific requirements there.

I think one of the developments and possibilities here is that what is going to happen to the existing installed, and I think that's a question none of us can answer at this stage. But certainly in terms of meeting the technical requirements of the regulations, I think many would be hard pressed to insure they meet those.

Chairman TOM DAVIS. That is why they are drafting them. They want the work done in China by Chinese-owned companies.

Mr. Frisbie, do you agree?

Mr. FRISBIE. My response would be the same; it would negatively impact our companies. But also, if they were implemented as drafted, I think that would get the attention of our nonsoftware company membership too, who would then have concerns about what might follow on in other sectors of the procurement market.

Chairman TOM DAVIS. All right.

Mr. HOLLEYMAN. Mr. Chairman, I think ultimately a huge concern, in addition to the initial threshold task, which is unduly burden is that even a company that managed to make a second-tier list, which is a qualified foreign software, would always be subject to a waiver requirement that would have to come out of the ministry of finance before any ministry could purchase it. So it is a double burden, and it is, we believe, ultimately going to be arbitrary and harmful.

Chairman TOM DAVIS. What are software sales, American software sales to the Chinese Government today? Does anybody have any idea?

Mr. HOLLEYMAN. The estimate—I don't know for American software sales. I know the total acquisitions in China are estimated to be in the $606 to $660 million a year. I don't know what portion of that is U.S. companies, but a significant portion would be.

Chairman TOM DAVIS. That's it, and they are going to risk a trade war over that. I mean, look, let me ask you this. If they were to do this, if I were to put an amendment in on the floor, which would pass, that we would not—that we would be prohibited from buying goods from China. The government would not be able to buy goods from China, easy amendment to put on a restrictive spending amendment, it is not subject to point of order.

What do you think the Chinese reaction would be, and what would be your reaction to that? It would certainly get their attention because we are buying everything from AK–47s to clothing to a lot of other goods from them right now.

Mr. BOHANNON. I think certainly it would send a message at a minimum. I think that, you know, the challenge here is keeping the focus on making sure the rules don't get implemented so that we can avoid such a situation. And I think our focus really is to make sure that they don't get implemented as they are proposed so we can avoid exactly that kind of confrontation.

Chairman TOM DAVIS. But that would certainly send a message to the Chinese that we are not bluffing, wouldn't it? Mr. Frisbie, what do you think?

Mr. FRISBIE. I think the first thing I would like to see is what happens at the JCCT meetings, because I know that for the USTR and Commerce, it is one of the issues at the top of their list. I also know from conversations with the Chinese Government that they are considering this as well. So, I want to see what the results of that meeting are.

Chairman TOM DAVIS. But if the meeting is bad, if we have a bad outcome, what are we left to do at that point? Continue to buy their goods? Continue to go out and have open procurement with China? I think we have to take a look at how much it will have cost us if we knock them off of our list. That's a fair question. But after that, I think, we have nothing to lose and you have to let countries know that they can't—that this has to be a 2-way Street. Mr. Holleyman.

Mr. HOLLEYMAN. Mr. Chairman, I certainly think this morning's hearing and your statement is getting a lot of attention. So I think it's a useful step. And we hold out, as Mr. Freeman testified on the first panel, that a specific item of discussion at the JCCT needs to be on this topic.

We think ultimately there are three things that are going to help in this, making sure at the highest political levels within China this issue gets attention. Second, that there is an immediate standstill of any effort to impose these new regulations for software; and, three, that China move forward with its commitment to join the Government Procurement Agreement.

Chairman TOM DAVIS. Well, if they join the Government Procurement Agreement, these regulations probably wouldn't be in order, would we agree with that?

Mr. HOLLEYMAN. That's correct.

Chairman TOM DAVIS. I think that's what we need to work at. I will just tell you if the we implement these regulations, somebody will offer the amendment on the floor. We see these every year for much less onerous actions by other companies and the governments. They need to know it is coming.

Sometimes we defeat these, sometimes we don't. But Chinese just need to understand that is going to happen. I don't know if it is a good idea or a bad idea at this point. Actually, after the hearing, I am beginning to think it is not such a bad idea. If that is all we have left—but we all prefer to work this thing out as adults and recognize whatever the Chinese are trying to accomplish, help them accomplish that.

But, you know, at the same time, we are opening our markets to them, and we have a huge trade deficit, that their government needs to take a leadership role. And this is one of the few protected areas, right? In terms of software and integrity if the government buys there.

Let me ask you this: Each of you has identified specific concern with the proposed rule. We talk about how the U.S. industry would adopt these requirements of how we are predicting it. The Chinese regulations require that in order to be considered domestic 50 percent of a product's cost should be incurred in China, and that the product must have its final formulation in China.

Is that realistic in light of the international way in which software development occurs?

Mr. HOLLEYMAN. Well, it's certainly not realistic for any existing provider who has a global business.

Chairman TOM DAVIS. Is there any company or, for that matter, any known software development model that tracks its costs by geographical input?

Mr. BOHANNON. No. I mean, we have gone back to our members to make sure that we are fully up to speed on the latest. We are not aware of any company that does that. It's both impractical and not the reality of the way software development occurs.

Chairman TOM DAVIS. Also, the Chinese Government stated its procurement framework is modeled in large part on those of other companies. And they quote our Buy American or Trade Agreement Act. But is this really an accurate statement from the experience of your member companies?

Mr. BOHANNON. I can say categorically, no. I personally sat for 5 hours with the Chinese experts and brought in some of the best in both private and public sector procurement experts—and had them walk through with the Chinese how our system really works, that it is based on a series of system preferences, not prohibitions, which is at the heart of the Chinese approach. And that the U.S. system, for all its complexity, does not discriminate on the basis of national treatment. And we have explained this ad infinitum. But they continue to make the suggestion that is the case. And certainly our experience in the EU is also indicative that Chinese approach is not based on any known model that we are aware of.

Chairman TOM DAVIS. Isn't the Chinese software industry growing? I mean, it is growing like hopsi, isn't it?

Mr. HOLLEYMAN. It is growing, Mr. Chairman. I mean, a lot of that industry is the industry that is based on the outsourcing model.

Chairman TOM DAVIS. Offshoring a lot of it.

Mr. HOLLEYMAN. A lot of what India is doing. But they also have domestic producers of software. I mean, we think that the inconsistency of this is that it will isolate the Chinese Government in terms of the type of software it uses. It will deny the government the efficiency it wants. And no domestic Chinese producer who satisfies that government test is going to ever be competitive in our view in the global marketplace. So long term, it hurts the Chinese software industry short-term; and long term, it hurts the government for its e-government efforts.

Chairman TOM DAVIS. Mr. Bohannon.

Mr. BOHANNON. I will just add to Mr. Holleyman, the SIIA office believes that the revenues of the domestic Chinese companies have been going up 20 to 30 percent over the last 2 or 3 years, mainly because they have benefited just like U.S. companies from the positive policies to get government agencies to procure legitimate software, for example. So what we need is to make sure that the good pieces of the Chinese Government policies proceed because they benefit everyone, and not go back to this discrimination between foreign and domestic.

Chairman TOM DAVIS. Also, I mean, once, as their software development grows in China—and we all agree and understand, it can grow exponentially without doing this—they are going to have

more demands from China to stop piracy and for IP legitimacy and the right; correct?

Mr. BOHANNON. That's exactly right.

Chairman TOM DAVIS. I don't know why they have such a good model right now. Everything I read about what's going on, U.S. companies are a major part of what is growing in the software industry over there. And I think this is just a major step backward for them.

And I am not sure if this is part of a political agenda, but the Chinese are getting a lot of work now on government work, American government work for our government—because, as you say, our business models don't call for software to be developed in one single place, it's developed in pieces all over.

What actions would you like to see our government take in response to your concerns? Are we doing enough at this point? Is going to the table and talking enough, or do you think hearings like this, congressional pressure helps your meetings with your counterparts help? What do we need to do? This needs to be, I think, a coordinated effort. Whoever wants to. I have asked all of you.

Go ahead. Mr. Holleyman.

Mr. HOLLEYMAN. I will start. I think that this hearing is absolutely useful. I know that a number of Members of Congress have contacted the Chinese Ambassador in Washington, have raised this on their trips outside the United States, I think raised this at the highest political levels, as we have had at the cabinet level is absolutely important. I think the JCCT, which is upcoming in the next couple of months, is a golden opportunity to try to insure some specific commitments from China that they will not implement these rules and that they will move forward with the GPA. And as Assistant Secretary Wu testified, there have also been consultations with the EU and with Japan.

I know that the EU has become engaged on this. And I think working with our foreign trade partners who just want to make sure that this market is open for America or any software to compete fairly. And we believe there are a lot of allies in this effort.

Mr. FRISBIE. This is clearly an important market access issue. Again, it is not just software, but they are looking ahead if this goes forward, how it might impact other sectors as well. So definitely this hearing helps to bring attention to the issue, and I think attention will be given to this hearing. As we have all said, the JCCT meeting is actually the right next focus. I know that USTR and Commerce have that focus. A consistent message here and in Beijing is also extremely important. And to the extent other governments do that as well here and in China and send a consistent message, I think that will make a big difference, too.

Mr. BOHANNON. I would second all the comments of my colleagues. The two suggestions that I would make, in addition, are I think we not only need to talk about this as an issue that affects the software industry, but, Mr. Chairman, given your background on procurement reform and the need for open and competitive procurement issues, I think we need to approach it at that broad level as well. I think we can, you know—even if we solved the software regulation issue, we still have a fundamental problem with the gov-

ernment procurement law that China has put in place. And that is ultimately where we will have to deal with this.

The second is that we now have new leadership at the State Department, Ambassador—Secretary Rice, we now have a new head of USTR, a new Secretary of Commerce. I think it's essential that they continue the consistent messages that have come out of those departments with regard to the need to address this before the rules get implemented.

Chairman TOM DAVIS. I supported BNTR, I supported Fast Track, NAFTA, CAFTA, you like it, I am a free trader. And this committee doesn't have jurisdiction on trade issues, that's the Ways and Means Committee. We do have jurisdiction on procurement. This is the committee that will take those decisions, and I take it very seriously, I have always—again, I led the fight last year when they tried to knock licensure out of the U.S. visit, when they have tried to put domestic source restrictions. I strike Buy America every year as they try to expand that on appropriation bills. So my record is pretty clear.

But we are just not going to sit here and let China take shots at us without some kind of retaliation. Somebody is going to do it, and that's under this committee's jurisdiction. So I am hoping we can work these things out around the conference table if we need to give the leeway, but I just want to say if that doesn't happen, I just don't see Congress sitting idly by. I hope the Chinese understand that as they sit down.

Trade war, everybody gets hurt. Consumers get hurt, efficiency gets hurt. I just don't see this helping anybody. But you can't just sit here and have it one sided on the procurement side.

I believe, when we add up everything, you are going to find that China sells us a lot more than we buy from them, government to government, and has a lot more to lose. I guess the question that we would have to answer, before moving ahead is, you know, how much would it cost us to take and buy these goods and services somewhere else than China. We intend to get that information, just to have that, should we have to proceed.

But let's all work together. I think industry to industry, government to government, trying to get this resolved in an applicable way that makes economic sense.

Mr. Holleyman, let me just ask this final question: You mentioned software piracy in your statement. I know it's a concern of all of you. How does piracy relate to the government procurement issue?

Mr. HOLLEYMAN. It relates directly in that the best legal and largest market in China for legitimate software is with the Chinese Government. And, in fact, there have been significant efforts by the Chinese Government in the last couple of years to try to insure that its software usage is, in fact, legal. BSA is working with the Chinese Government this year on a number of education seminars for Chinese Government officials to insure that they are using only legal software. So that's been very positive.

We are very concerned about anything that would restrict access to that growing legal market. And let me just add, in conclusion, that our companies are ultimately very optimistic about our ability to compete in China. But we have to address the piracy problem,

and we have to make sure that we have fair access to the best legitimate market that exist here today.

Chairman TOM DAVIS. OK. Anything else anybody want to add?

Well, our pleasure. Thanks for this important issue, not just for software developers, but you say this can extend straight down the procurement system, and that would not be helpful to anybody at this point.

So I appreciate everybody for sharing your testimony. We have entered into the record the accompanying data. We will get some more facts on this, and we will continue to keep an eye on this as it moves forward.

Thank you very much. This hearing is adjourned.

[Whereupon, at 12 noon, the committee was adjourned.]

[Additional information submitted for the hearing record follows:]

Import & Exports Data Provided by the Commerce Department

Total Imports from China in 2004: approximately $196.7 billion

Top 5 imports from China:

- Automatic data process machines (i.e., computers); magnetic readers, etc.: $24.46 billion
- Office machine parts: $9.13 billion
- Transmission apparatus for radio, telecommunications, wireless, etc; TV camera & recorder: $8.07 billion
- Footwear: $6.94 billion
- Toys: $6.92 billion)

Total U.S. Exports to China in 2004: approximately $34.7 billion

Top 5 Exports:

- Electronic integrated circuits & microassembled parts (i.e., multi-function integrated circuits (not discrete semiconductors), such as microprocessors): $2.65 billion
- Soybeans: $2.33 billion
- Aircraft: $1.62 billion
- Cotton: $1.42 billion
- Scrap metal: $933 million

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