Executive Summary Commission Staff Working Document

On significant distortions in the economy of the People's Republic of China (PRC) for the purposes of trade defense investigations

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Introduction

Within the framework of its competence to - in the case of severe market distortions due to government intervention in third countries - make use of trade defense instruments, the European Commission prepared a document describing the market circumstances and distortions of the People's Republic of China (PRC). The document starts with a comprehensive overview of the so-called 'cross-cutting distortions' (i.e. distortions that are a consequence of the structural foundations of the social, economic, financial and political system of the PRC). The second part of the report scrutinizes distortions in a range of production factors, after which it takes a close look at four specific industries, simultaneously harking back to the main elements described in the first two chapters.

Part I: Cross-cutting distortions

CHINA'S SOCIALIST MARKET ECONOMY

The Chinese State practices a **socialist market economy**. This has been officially stipulated within the fundamental legislatorial documents of the PRC and implies that the state applies planned economy on the basis of socialist public ownership. Still, a range of legislatorial pieces mention that the economy is not fully planned compared to the period before the Chinese opening up and reform in 1978. The *Chinese* and the *Chinese Communist Party (CCP) Constitutions*, together with several laws, plans and governmental regulations recognize the role of non-public sectors and private enterprises. During the 18th Party Congress in 2012, the necessity of a balanced relationship between market and government and the importance of granting a decisive role to the former was stressed, resulting in the presentation of sixty reform proposals. In practice, however, these 'reforms' seem to cover the development of new sectors, the acceleration of technological transformation and the strengthening of China's economic competitiveness rather than the diminishment of the role of the state in its economy. The main foundations of the latter remain on the one hand, the importance of state-owned industries and, on the other hand, the major influence of the Party in China's development 'towards a prosperous, powerful, democratic and culturally advanced socialist country'. During the 19th Party Congress in 2017, the role of the Party and its leadership over all areas in every part of the country was reconfirmed and legally anchored.

Since China's opening up and reform, its socialist market economy transformed from a state-planned to a hybrid system, underpinned by several pillars, the first one being **state-ownership**. Several industries, in particular those having strategic features, are dominated by state-owned firms and are practically inaccessible for private market players. It should be noticed however, that the distinction between private-owned and state-owned companies in the Chinese system is particularly difficult to make due to the existence of many mixed-owned companies and the private sector's proximity to the State. The second pillar covers the top-down **allocation of factors of production**. While the time in which the Chinese government directly decided upon the prices of capital, labor, land, energy and raw materials is officially over, indirectly, the

government virtually retains control over the cost of these production factors. This also applies to the third pillar of China's economy; the government's disposal of instruments to implement **interventions in the Chinese industry**, ranging from conditional subsidies and investment catalogues to the control of supply of raw materials, fiscal incentives and regulatory permits. While these instruments are used at national level to achieve the goals and guidelines put forward in the pile of five year plans, guiding opinions and notices of the national government, they can be found in the toolkit of the local governments as well. **Provincial and municipal governmental entities,** for their part, thus, implement local guidelines, derivated from their national counterparts. While ostensibly effective, this tiered system has several perverse effects. Competition on the local level regularly leads to overinvestment and inefficiencies. As some examples will indicate, consequently, problematic levels of overcapacity in the Chinese industry are anything but exceptional.

CHINESE COMMUNIST PARTY (CCP)

The political, economic and financial structure and organization of the PRC is entirely imbued by **the leadership of the CCP**. Before explaining how this materializes, it is of vital importance to keep in mind that **the Party and the State** in China are practically **indistinguishable**. The latter is namely run by the so-called 'State Council' which largely reflects the structure of the Party. A similar overlap exists between the CCP and the National People's Congress (NPC), considered 'the highest organ of state power' and between the CCP and the ministries and departments at every political level in China. A well thought out **cadre system** gives the CCP the authority to appoint key officials across all political institutions, the military, public institutions but also the top management of SOE's. While this cadre system does not include the private sector, the latter does not seem immune to it either. Since 2002, private business leaders are warmly welcomed as members of the Party, an invitation many of them cannot resist.

This indicates how far the Party's tentacles have penetrated the entire Chinese system. Intense Party penetration is not limited to the political scene but prevails in practically every component of the Chinese society. SOE's, and a growing group of POE's as well, are increasingly monitored by so-called **party organizations**. These organizations are under inspection of the CCP and are tasked to make sure that business activities of the enterprise remain in line with the State policies. A same function is executed by the smaller **Leading Party members' groups**, which can be set up under the supervision of the CCP and oversee the functioning of state organs, organizations as well as non-Party units. Such organizations and groups exist next to China's **industry associations**, which are often a heritage of former ministries and which act as an influential bridge between government and business.

The role of the CCP goes far beyond the political and economic sector, though. Despite some judicial reforms since the 18th Party Congress to make law less dependent on politics, in China, rule by law still wins out over rule of law as political committees, laws and appointments guarantee Party control over courts, judges and lawyers. Last but not least, the CCP is the key facilitator for China's comprehensive and in depth

economic **planning system**. Any significant policy initiative in China is kicked off, or at least been approved, by the Party.

THE SYSTEM OF PLANS

China's planning system is at the core of the country's economic development. Its **structure** is multi-tiered with at the top, China's central national plans and overarching blueprints. These are in turn gradually divided into subsequent/lower level -usually sectoral- guidelines and plans, consisting of more details and applicable at the provincial and civic level[1]. Five of the most prominent high-level plans are Made in China 2025, the Belt and Road Initiative (BRI), Supply side and structural reforms (SSSR), China's central 13th Five Year Plan (FYP), Internet + and Decision No 40.

Made in China 2025 is a long-term program which focuses on moving Chinese manufacturing higher up the value chain and hence mainly includes innovation objectives. To achieve such a 'value chain shift', the plan lists ten main industries for which detailed strategic tasks and goals are specified. Considering China's overall economic development, China 2025 envisages three major stages. By 2025, China should be a major manufacturing power. Ten years later, the country should reach the intermediate level among the global main manufacturers and by 2049, China is supposed to be *the* global manufacturing leader. While the plan mentions the necessity to grant the market a decisive role in this process, it stresses the role of governmental support as a driving force behind China's economic trajectory. This implies not only financial help and other support measures, drawn up by governmental bodies such as the Ministry of Industry and Information Technology (MIIT), but also a preferential treatment for domestic companies in order to develop national champions and strong Chinese international brands.

In 2013, Xi Jinping visited Kazakhstan where he announced China's **BRI,** a large-scale initiative to reconnect the Asian, European and African continent through infrastructure, investment and trade. While there exists a close connection with *China 2025* in the sense that the *BRI* too wants China to avoid the middle-income trap by developing its high-end industries, it encompasses other goals as well, among which the development of China's poorer western provinces and tackling persistent overcapacities in several industries. The plan regularly mentions China's further opening up, conveying the impression that China will elevate some barriers to grant better access to its market for foreign market players. However, so far it seems that nothing could be further from the truth, as the BRI mainly focuses on the creation of national champions, the global expansion of Chinese brands and the opening up of foreign export markets. These goals should be reached with the support of several governmental instances, among which the Ministry of Finance, the Ministry of Commerce and the State Council.

[1] for an example see p. 42-48.

As overcapacities and inefficiencies in several Chinese industries became problematically pressing, China's leadership launched its **SSSR** in 2015, focusing on tackling industrial overcapacity, housing inventory, corporate debt, corporate costs and the position of Chinese producers in the industrial value chains. While it put forward some ambitious goals such as severely cutting production capacity, in practice, a considerable gap remains between ambitions and results. It seems that the SSSR ended up being another tool for the government to steer the economy. Moreover, the focus of the reforms has been largely on private owned companies, having only a minor stake in the issues that the SSSR are supposed to resolve. In short, SSSR might have concealed some of the symptoms that are a consequence of the continuous misallocation of capital, the lack of protection of intellectual property rights, severe governmental interventions, proliferation of non-performing investments and inefficient SOE's. But, as long as these underlying problems are not fully addressed, the SSSR is no more than a wooden leg in a plaster and might, in fact, make matters worse if it gives leeway to even more distorting government intervention.

While putting forward some precise quantitative targets such as an annual GDP growth rate of 6,5 per cent, **China's 13th FYP** remains quite vague and open to interpretation. It refers to the important balancing exercise between government and market but it equally stresses the governmental implementation of plans, such as *China 2025*, and the State's task to guide market behavior. Moreover, it mentions the importance of China's so-called strategic emerging industries (SEI's) and confirms governmental support for their further development. Prime Minister Li Keqiang mentioned that, next to significant funding from state-controlled banks and investment funds, in 2016, the central investment budget would cover RMB 500 billion (EUR 64,5 billion) for projects related to the 13th FYP. One of the key objectives of China's 13th FYP crystallized into a State Council initiative to integrate traditional industries with the internet. For this **Internet Plus** plan, the Ministry of Finance earmarked an investment fund of RMB 100 billion (EUR 13 billion) in 2017.

One of the most important provisions in the context of China's industrial restructuring is the so-called **Decision No 40**, published by the State Council in 2005. Among other things, it includes the *Guidance Catalogue for the Industrial Structure Adjustments*, which is an important tool for the government to navigate investment into the right direction. On the basis of three categories – encouraged, eliminated and restricted areas– capital is allocated according to the Chinese State policies.

Once these overarching guidelines, blueprints and plans are developed, they trickle down to the lower governmental levels resulting into **sectoral plans at the national level, provincial general plans and provincial sectoral** plans, containing much more far-reaching and detailed objectives, guidelines and measures.[2] The examples

[2] Examples are available from p. 58-70.

provided in this report give an indication of just how far Chinese government guidance can reach.

The lack of a precisely defined status of the FYP's within China's legal order questions the **binding nature** of the country's planning system. However, external pieces of legislation such as the *Organic Law of the Local People's Congresses and Local People's Governments of the PRC* ensure the implementation of the state plans and budgets. Such legislative requirements are attached to the guidelines at all levels of the administration and hence guarantee a strict implementation. Moreover, this implementation is closely monitored and evaluated. Some of the FYP targets are provisionary while others are mandatory, and the extent to which they are met regularly has to be reported to the central governmental bodies by their local counterparts. Next to several legal provisions, the Chinese cadre and admission system (see p.2) acts as additional incentive for local officials and managers to meet the targets and objectives put forward by the planning system of the Chinese leadership. Being consistent with the higher-level prescriptions usually results into a favorable treatment by the authorities or can avoid a career advancement veto and hence severely triggers the intrinsic motivation of practitioners in the field.[3]

STATE-OWNED ENTERPRISES

China's SOE's play a vital role in the country's economy. While, within the Chinese context, it is not convenient to draw a clear line between state-owned, mixed-owned, state-controlled and private-owned companies, it is estimated that SOE's cover for 38 per cent of China's industrial assets and provide between 25 and 30 per cent of the country's industrial output. According to IMF estimates, the size of the state-owned sector is currently increasing, and particularly in strategic industries, SOE's retain a significant share. This consequently offers a favorable platform for the government to exert control over the economy. The task of the state-owned sector to serve the interests of the nation is **legally anchored** by the *Constitution* as well as by the *SOE Law* and the *Company Law*. When it comes to the state-owned section of the economy, the overarching governmental body is China's State-owned Assets Supervision and Administration Commission (SASAC). In its regulations, it confirms to pursue industrial policy and other public policy objectives.

During the 18th Party Congress in 2013, the Third Plenum Decision was launched. Its first section includes some serious intentions to fundamentally **reform and modernize** the state-owned industry according to market-oriented principles. However, as the document proceeds, the second and third section reconfirm and even further strengthen the dominant role of SOE's in serving strategic goals and developing SEI's. When broken down into a number of concrete guiding opinions, the Decision further stresses the role of the CCP in the operation of SOE's. In a second set of Guiding

[3] For an overview of how China's planning system materialized in the photovoltaic, robotics and new energy vehicles industry see p. 79-84.

Opinions called the *Classification GO*, it becomes particularly apparent that these companies are vehicles for the implementation of government policies. While these opinions make a distinction between competitive sectors and strategic sectors, it posits that both commercial and strategic SOE's are subservient to the government. The only difference concerns the extent to which these firms have to serve the national interests. This is a clear indication that, while SOE's may formally be subject to corporatization, political objectives continue to prevail over commercial considerations, which results in inefficiencies and overcapacities in several industries.

Considering the size of the state-owned industry, keeping all SOE's in line is not as convenient as it seems. The Chinese government has a range of tools at its disposal to **keep control** over the management China's state-owned economy. As mentioned before, SASAC and its local subsidiaries are at the core of China's SOE's. SASAC holds a list of companies in industries where absolute state control should be maintained[4]. To keep a close eye on the activities and decisions of the SOE's, SASAC also works out several **consolidation and restructuring** plans, which determine the competitive landscape of the state-owned industry. Through mergers and organizational shifts, the government regroups several central SOE's, resulting in a relatively small group of big national champions, which are simultaneously prepared to conquer overseas market share. This streamlining process creates a handful of large industrial groupings that are even easier to keep under the government's thumb.

The CCP's Central Organization Department and SASAC have a major say in **appointing top executives and other personnel** for the SOE's. The former appoints top executives of some fifty core SOE's, while the latter decides upon the top management of the remaining central SOE's. The distance between a high-level position in a major Chinese SOE and a governmental one is particularly small, which results into high overlap between the political leadership of China and the economic leadership in the Chinese state-owned industry. That the SOE's management and government officials are two peas in a pod does not have to be a surprise. As they appease the government with their economic decisions and activities, SOE's enjoy preferential access to bank finance and other inputs, privileged access to business opportunities and protection against competition, often at the expense of their private counterparts.

Local and Party organizations are a third channel for the CCP to claim leadership over SOE's. Next to the *Constitution* and the *Company Law*, the *Corporate Governance GO* formalizes the central role of these bodies, which is to act as 'the leadership core and political core of the SOE, which should bring the management in accordance with the guidelines and policies of the State and the Party'. Moreover, these organizations are increasingly finding their way into private owned firms as well as into joint ventures between SOE's and private entities.

[4] For an overview of these SOE's, see p. 97.

Several government documents indicate how, despite the Third Plenum decision's reference to the role of the market, **SOE's remain key vehicles in the implementation of China's industrial policy**. With respect to the state-owned sector, the primary goal of the 13th FYP is to make it bigger and stronger. This objective is further elaborated upon in sectoral, provincial and municipal FYPs. Several guiding opinions reiterate the goal of consolidating SOE's in order to develop (inter)national champions and maintaining the state-owned economy as means to pursue numerous policy objectives, again indicating the prevalence of strategic and security interests over commercial considerations.

THE FINANCIAL SYSTEM

Since China's reform and opening up, the country has undergone a major transformation from a monobank system –with the People's Bank of China (PBOC) as its primary financial intermediary- to a **multi-layered financial system**[5]. However, this has by no means heralded the end of State interference in China's financial system.

China's financial sector mainly consists of the banking sector, the bond market and the stock market. The first category is by far the largest and is dominated by the state-owned banks, some large commercial banks and the State policy banks. To give an indication of how decisive they are, it suffices to say that, together, these banks represent almost 70 per cent of China's total banking assets. The remaining 30 per cent mainly consists of smaller city and rural commercial banks and foreign-invested banks, the latter playing a negligible role in China's financial system due to very strict limitations regarding foreign investors' ownership and other informal obstacles.

In the 80's, China's so called 'Big Four' were born. These four **commercial State banks** were introduced in order for the traditional PBOC to focus on the classical task of being a central bank rather than functioning as a commercial actor. The Agricultural Bank of China (ABC), the Bank of China (BOC), the Industrial and Commercial Bank of China (ICBC) and the China Construction Bank (CCB) together with a fifth commercial bank, named the Bank of Communications, are mainly controlled by the Chinese government and represent around 40 per cent of China's total financial market. **Joint-stock commercial banks** are the second most important type of credit institution of the country and represent around 14 to 19 per cent of total banking assets. Either through direct investment by Central Huijin Investment or through state-owned legal entities, these banks are equally characterized by significant state participation. Finally, **State policy banks,** covering 10 per cent of China's financial sector, were introduced in the 90's and took over the policy portfolios of the Big Four. The Agricultural Development Bank (ADB), the Export-Import Bank (Exim) and the State Development Bank (SDB) are entirely state-owned.

[5] For an overview of China's current financial system, see p. 112.

Similar to choosing the top management of China's state-owned industry, the Chinese government (i.e the State Council and the Organization Department of the CCP) has the authority to appoint the twenty largest Chinese banks' leadership. This leadership is responsible for taking decisions on the business strategy and the budget of the bank, taking investment decisions, deciding on senior management, appointing mentor dismissals, and formulating the risk management system of the bank. Moreover, as the case with China's SOE's, the role of party organizations in the business activities of state-owned banks has been strengthened since 2017. An example is the ICBC's inclusion of a Party Committee, which has the mandate to implement Party and State decisions in the bank and has a say on the appointment of personnel. Lastly, the highest executives of China's financial institutions have a political rank, which brings them on the same level as a vice governor of a Chinese province. **The overlap and tight connection between the bank personnel and the government** indicates the State's institutional control over China's financial world.

Next to the institutional state control, the financial system's dedication to follow the State policies is **legally formalized**. The so-called *Banking Law* literally posits that commercial banks shall conduct their lending business according to the needs of the national economic and social development and under the guidance of the industrial policies of the State. Moreover, it determines that the range of interest rates, which a commercial bank may charge, can only fluctuate between the lower and upper limits set by the PBOC. While abandoned in 2015, the *Banking Law* guarantees that these limits may be re-imposed at any time. *The General Rules on Loans* regulate so-called special-purpose loans, which need approval of the authorities when granted. The rules also establish that interests on loans may be subsidized in accordance to State policies. Furthermore, the banks are obliged to follow *Decision No 40*, indicating whether certain types of investment should be encouraged, restricted or prohibited.

As is the case for the banking sector, **the Chinese bond market** is dominated by government-related players, accounting for around 75 per cent of the market. While the share of POE's on the non-governmental public bond market has been increasing from 12 to 25 per cent between 2009 and 2015, the majority of firms remain state-owned. When issuing bonds, permission from several regulators is needed. Enterprise bonds, for example, need approval from the National Development and Reform Commission (NDRC) to issue bonds. Currently, China's main commercial banks are by far the largest holders of corporate bonds, which creates a huge overlap between the creditors that provide capital in the form of bonds and those providing capital in the form of loans. In short, bonds can largely be considered yet another means to provide corporate loans. Connections between the personnel of banks and other financial institutions in the corporate bond market are numerous, exacerbating the **governmental grip over China's bond market**.

This grip becomes even more apparent when looking at the **credit rating and pricing of credit risks**. Around 60 per cent of all rated corporate bonds in China are rated by state-owned rating agencies, which do not provide a reliable estimation of the asset's

actual credit risk. Using very broad rating scales, the state-owned agencies tend to rate way too high. Free choice for borrowers to choose any agency they want is an important trigger for this perverse effect. However, even more important is the intense State presence on the Chinese bond market, which avoids bond defaults to happen. While growing, bond defaults remain very exceptional on the Chinese bond market as the Chinese government prefers bailing out companies over letting them go bankrupt. This, in turn, creates expectations and further distorts credit assessments.

China's stock market consists of three major stock exchanges, the Shanghai Stock Exchange (SHSE), the Shenzhen Stock Exchange (SZSE) and the Hong Kong Stock Exchange (HKSE). Similar to the bond market, China's stock market is dominated by SOE's, accounting for 49 per cent of all shares on the market. Moreover, the fact that shares are listed on a stock exchange, does not imply that they are easily accessible. 53 per cent of the state-owned shares are non-tradable. Furthermore, entering China's stock market is anything but convenient as its access is heavily regulated by the Chinese authorities. Next to the registration criterion for IPO's –which exists in other countries too- IPO's in China need specific approval from the China's Securities Regulatory Commission (CSRC).

The system to protect investors on the stock market, at first sight, looks similar to the western protection models, which are based on the investor's right to vote, sell and sue. However, in China, block holders usually hold controlling blocks of shares, which often makes voting irrelevant. In SOE's, the controller of these blocks is state affiliated. Moreover, the lack of a proper legal framework in the case of misbehavior in Chinese listed companies, impedes the investor's right to sue, weakens the protection of shareholder rights, and hence refrains the latter from going to court in the case of anomalies. All these elements prevent an effective allocation of resources in the Chinese economy through stock markets.

While a majority of its assets is funded overseas, China's **private equity market** is increasingly entered by the Chinese government, which establishes investment funds, specifically focused on the development of priority industries (SEI's) and major policy programs. By the end of 2015, the government held 780 state-linked investment funds covering around RMB 2,18 trillion (EUR 1,2 trillion). But also in the export credit insurance market, the State plays a major role as Sinosure, a big Chinese SOE, mainly covers the export of high-value added Chinese goods and virtually holds a monopoly over Chinese export credit insurance. Hence, this company has a powerful position in the market and is directly controlled by the SASAC administration. It can be considered a tool of the State to promote export, which the firm itself openly recognizes. As Sinosure is not a signatory to the *Arrangement on Guidelines for Officially Supported Export Credit of 1978,* it can offer insurance premiums at highly competitive rates compared to OECD members –who did sign the Arrangement-, giving it the opportunity to cover on very favorable terms.

China's so-called **shadow banks** may be less visible, but are no less important than the actors in the formal banking sector. As the previous paragraphs have illustrated,

China's formal financial system is strongly biased in favor of large and state-owned entities. Hence, if smaller private-owned borrowers are in need of capital, they have to turn to unofficial forms of financing. Besides the SOE bias, the limits considering lending, which are imposed on the official lending system, is an additional trigger for borrowers to rely on shadow banking. While China's shadow banks do grant some flexibility in the rigid and distorted Chinese financial system, the other side of the coin is the increased risk of a debt crisis due to unlimited off-balance sheet transactions.

Inflated levels of debt regularly bring companies to the brink of bankruptcy. In China, however, bankruptcy seems to occur only in exceptional cases. Unfortunately, this seems to be the consequence of strong governmental reluctance to let companies default, rather than of a healthy financial environment. In 2006, China's ***Bankruptcy Law*** was implemented, regulating the process of insolvency, liquidation or reorganization, requiring the intervention of a court and even the mediation of an independent administrator. However, firms in China are rarely delisted and insolvency cases almost always end up with restructuring plans. In 2016, China saw 5665 insolvency cases compared to 57,844 in France and 21,518 in Germany.

The reason for this imbalance is related to the **insufficient implementation of the *Bankruptcy Law*** and the **far-reaching influence of State authorities** on the fate of debt-loaded firms. Vague standards for determining bankruptcy, a waiting period of 15 days before the court accepts an insolvency case, considerable discretion in the appointment of administrators, the fear for accusation of mismanaging state assets among officials, the courts' discretionary power in accepting cases, their lack of independence, their reluctance to accept filings against SOE's, the absence of insolvency rules when it comes to financial institutions, the huge role of the State in the reorganizing processes, the existence of creditors' committees and the legal confirmation that judges should work towards avoiding defaults, all make the enforcement of the *Bankruptcy Law* weak and inconsistent, granting considerable room for manoeuvre to the State for restructuring, dispensing bail out loans, injecting capital, taking over bonds as well as intervening in a direct way.

This, however, leads to major distortions in China's financial and economic system. Keeping companies alive at all cost results in the survival of large numbers of unviable companies. These –usually state-owned- 'zombie companies' contribute to the persistence of unused production capacities, with grave consequences for China and its export markets. Moreover, this creates a vicious circle in which immortal companies are implicitly guaranteed to receive state support, which affects the costs of credit and their access to finance. A spiral of indebtedness follows, which is at the expense of private owned companies and, in turn, distorts the viability of the overall Chinese banking system, which - under the *Bankruptcy Law* - enjoy ostensible immunity against insolvency procedures.

PUBLIC PROCUREMENT MARKET IN CHINA

The Chinese government procurement market covers around 20 per cent of the country's GDP and the **main actors** involved are the Ministry of Finance (MOF), the NDRC, the Ministry of Housing and Urban and Rural Construction and MOFCOM. So far, China has not signed any multilateral agreement on market access for government procurement. Together with some specific regulations on government procurement and concession rules, two major laws, *The Government Procurement Law (GPL) and the Tendering and Bidding Law (TBL)* are at the basis of Chinese public procurement[6]. While these **laws** are supposed to increase the effectiveness of public procurement and to allocate contracts in a competitive way, several **distortions** persist as China's public procurement policies discriminate in favor of domestic suppliers.

The Government Procurement Law literally posits that the government shall procure domestic goods, construction and services. This **'Buy Chinese' policy** is reinforced by the State Council and the NDRC *2009 Notice on Implementing the Decision and Deployment of Promoting Economic Growth by Expanding Domestic Demand and Further Strengthening Supervision and Administration over Engineering Construction Bidding*. As this policy clearly excludes foreign bidders and could lead to a higher award price, it is in strong contrast with market-based procurement. But the discrimination is not limited to foreign contractors. Non-key domestic providers regularly have to give way for national champions, a practice which is also literally encouraged in MOFCOM's *Notice on Issuing the Opinions on Protecting and Promoting the Development of Time-honored Famous Brands*. By **lack of a clear definition of 'domestic'**, foreign invested enterprises (FIE's) are discouraged to apply in procurement processes. A transparent definition is crucial for the latter to know whether or not they would qualify for consideration. This distortion is reinforced by the *de facto* substantial discretion of procuring entities in choosing candidates and offers for public tenders.

While the **other basic laws and secondary legislation** do not explicitly confirm discrimination (in contrast with the GPL), they do generate several discriminatory distortions. In line with the government's overall objective to promote indigenous innovation, the *BTL* often requires that FIE's obtain a license in order to participate in bidding procedures in China. A study conducted for the European Commission DG for Trade screened a pile of measures after which it concluded that at least 54 of these measures contained one or more restraints favoring domestic investors over foreign ones[7].

Last but not least, a **complaint system** is provided under the GPL and guarantees bidders the right of defense in case of irregularities. Due to the complexity of both laws, it is often unclear under which regulation a certain procurement project exactly falls. Moreover, when construction projects are conducted with fiscal funds and when they fall under the TBL, an overlap exists between the two sets of legislation (GPL and TBL). The potential inconsistency in the application of one or the other legislation

[6] For an overview of the content of this legal framework and how it is implemented see p. 152-155.
[7] For a concrete example in the rail industry see p. 162

generates severe uncertainties for procuring entities and suppliers. Moreover, - due to the literal reference to the 'Buy Chinese' policy in the GPL- foreign providers face a concrete risk of being discriminated if the procuring entities opt for the application of the GPL, rather than the TBL[8].

INVESTMENT RESTRICTIONS FOR CHINESE AND FOREIGN COMPANIES

Since the initiation of China's reform and opening up policy, Chinese authorities have repeatedly expressed their intentions to liberalize market access for domestic and foreign investment. Nevertheless, significant barriers remain in place due to the desire of the Chinese leadership to hold control over the country's economic development. Through regulations, approval procedures, incentives, restrictions and prohibitions the NDRC, MOFCOM, the State Administration for Industry and Commerce (SAIC), and various other industry regulators, closely manage the amount and direction of investment.

To maintain **control over key industry sectors**, the Chinese state regulates all private investment activity in sensitive industries such as telecommunications and national defense. By means of the *Project Approval Catalogue* and by applying several specific laws such as the *Anti-Monopoly Law of the PRC (AML)*, the Chinese government creates space for SOE's to develop their business activities in these industries. A similar preferential treatment continues after the enterprises have been established, consisting of free land allocation, direct financial support, etc.

Beyond seeking to shore up the strength of SOE's in key industries, China seeks to scrutinize investment in a way that **advances the capabilities of China's domestic sectors**. Several plans, such as *the National and Long-Term Plan for Science and Technology Development (2006-2020) (S&T MLP),* posit the **promotion of indigenous innovation** by guiding enterprises to increase investment in research and development through a diversity of measures, among which fiscal and financial policies. The level of detail found in the S&T MLP exemplifies the extent to which such governmental measures are carried out. Other plans, notices and guidelines, such as the *Strategic Emerging Industry 13th FYP*, demonstrate the goal of **promoting the development of national champions** through fiscal development funds and priority treatment in procurement processes. Besides bolstering a strong domestic industry, industrial policies are also used to **restructure the existing industry**. Catalogues, such as the *Restructuring Catalogue*, go into considerable detail when indicating how industrial policy in certain industries should proceed. These catalogues mirror the deep and systematic State influence on China's industrial structure[9].

Despite several claims of opening up the internal market to foreign capital and of creating a level playing field for investment, the Chinese State remains a key

[8] On p. 165- 167 several examples of distortions are outlined in the medical, energy, automotive industry, among others.
[9] For a detailed overview of how these instructions materialize see p. 176-178.

gatekeeper for foreign capital. A central document in this regard is China's **Foreign Investment Catalogue**, which categorizes investments in an encouraged, a restricted and a prohibited area, dependent on whether the investment supports or contradicts Chinese industrial policy. Next to this key document, there exists a pile of other legal notices, regulations and documents which steer foreign investments towards certain geographical areas, in order to stimulate technological transfers and to establish joint ventures or shared equity ownership. Many of the arrangements that come with accessing the Chinese market, are consented and fair. Still, concerns about inequitable practices, unfair technology and intellectual property transfers have already led to trade defense cases.

The investment approval process is an additional tool for the Chinese authorities to micromanage investment on a case-by-case basis. Currently, China is in the process of reforming its system for managing investments. The idea is to release a national negative list for market access, applying to all investment activity in 2018. However, at the moment, a negative list for domestic investment and a separate list for foreign investment - composed of the restricted and prohibitive lists of the *Foreign Investment Catalogue (FIC)* – are still in place. Together with the *Project Approval Catalogue*, the FIC includes very specific prescriptions for investments[10]. There are numerous legal approval requirements and substantive criteria. However, even more problematic is the vagueness of these criteria and the high level of discretion granted to authorities tasked with applying them. This **administrative discretion** allows for additional criteria and conditions on investors, even if they are not legally required.

Part II: Distortions in the production factors

LAND

According to the Chinese Constitution, land cannot be privately owned. The Chinese land consists of urban land, belonging to the State and rural land, belonging to the collectives. This however, does not mean that land cannot move from one holder to another. Individuals and organizations can hold land use right (LUR), which have a minimum price and can be auctioned. While there is a possibility to do this on the basis of market principles, these market-based rules are regularly ignored. Several **Trade Defense Investigation (TDI) cases** have found evidence of free land allocation to SOE's by the government and of tender procedures in which no real auction ever took place[11].

The **legal framework** for LUR and their transactions makes a clear distinction between urban and rural land, sets out the duration and conditions of LUR and determines the differences between ownership rights and LUR. Considering the possibilities of exploiting the land and making profit out of it, urban land holders enjoy a favorable

[10] For a list of the FIC's categories and for an example of its instructions see p. 189-197.
[11] For examples of these practices see p. 213-215.

treatment compared to their rural counterparts. Several other legislatorial documents, among which the *Land Administration Law*, govern the **land-use right provisions and** organize **their transactions**. It puts forward the time limitations of LUR, for which renewal application is possible. Moreover, these regulations indicate how LUR can be allocated through auctioning, bidding and bilateral agreement. Local governments can grant LUR in exchange for a compensation or a resettlement fee, however, they can also provide the rights for free. This process often lacks transparency and some official documents, such as the *Opinions of the Ministry of Land and Resources on Further Control over Land Assets and Promotion of the Reform and Development of SOE's*, literally favor SOE's when it comes to land allocation. ***The 13th FYP on Land Resources***, in turn, encourages free land allocation for developing SEI's.

As it has the authority to decide upon which and how many land can be acquired for which purposes, the Chinese government controls the supply of land. Similar to bidding procedures for governmental procurement, the bidding procedures for **acquiring LUR** is not open to all and is biased towards the strategic and economic needs of the country. Moreover, in line with several State policies, among which the Decision No 40, access to land can be either encouraged or restricted[12].

In a market-oriented land allocation system, the **pricing of land** happens independently and usually corresponds to the actual market value. However, China's *Urban Land Evaluation System* is the main tool of the authorities to set the prices, and, in particular, the floor prices for LUR. The system allows for the government to take into account industrial policy when deciding upon the value of LUR. The Ministry of Land and Resources monitors the price of urban land through a dynamic system, based on market-principles. The remarkable difference between the prices indicated by this system and those set by the urban land evaluation system shows that minimum prices set by the State are far below the market value of the LUR. Within the WTO, the State Council has recognized the issue of preferential land pricing and put forward some efforts to move towards a fairer allocation system, however, the issue was postponed by several notices.

Agricultural land tenure is based on a household contract system. At any time, the government has the right to expropriate land from farmers. While this is financially compensated, land compensation fees are usually far below the real market value of the expropriated land. Moreover, many restrictions considering LUR and the impossibility to sell them creates so- called 'minor property rights', which implies that rural owners illegally sell their LUR to private developers. That such semi-legal transfers are common indicates that China's land allocation system remains in flux.

ENERGY

[12] For an example of how land allocation is managed in the steel sector see p. 208.

China is the world's largest electricity producer and its energy consumption growth is accelerating. While the Chinese energy market has undergone some profound reforms and changes, several prices relevant for the energy system still lack a market-oriented basis. Moreover, 50 per cent of China's generation capacity is state-owned, and China's transmission grid is in the hands of two SOE's, State Grid Corporation of China and China Southern Power Grid. By consequence, a lack of competition impacts the entire energy sector[13].

A multiplicity of **plans, regulations and other legislatorial documents** put forward the main goals for the Chinese energy market. *The Energy Development Strategy Action Plan*, for example, stipulates that Chinese energy self-sufficiency should be kept at around 85 per cent. The comprehensive *13th FYP on Electricity Development*, on the other hand, calls for price liberalization but simultaneously highlights the role of the Chinese government to shape the energy market and to guide private capital investments. Other goals include the limitation of coal consumption and the encouragement of wind and solar power.

The NDRC centrally sets prices for electricity and domestic natural gas on the basis of several indicators such as purchasing costs, government surcharges etc. However, depending on the provincial situation and policy objectives, local **prices** can **differentiate** from this central price. Differentiation in energy prices happens according to the kind of costumers that pay them. Residential customers, for example, will pay a different energy price than their industrial counterparts. Differentiation also materializes on the basis of a three-tiered system, which follows the categorical subdivision of the Decision No 40. At provincial level, special electricity in some selected industries can result into a favorable treatment for certain energy consumers. Next to these tariffs, economic zones are established in which companies enjoy preferential prices and subsidies[14]. The attempts of the Chinese State Council to cancel some of these preferential treatments have been disappointing and governmental influence over energy prices remains widespread.

One way to increase the market-oriented character of the energy market is to encourage **direct power purchase**, a practice the Chinese government currently tries to perpetuate. By introducing new buyers to the market, other than the two dominant state-owned grid companies aforementioned, competition in the Chinese energy market should be triggered. While the introduction of an auctioning mechanism ensures a degree of fairness, direct bilateral negotiations are common with regards to direct power purchase and provide little transparency, questioning the integrity of such transactions. Moreover, as with procurement and investment in China, the eligibility criteria to join in the direct trade of electricity are set out by the NDRC and the NEA, who clearly give a preference to companies in SEI's. Firms in these sectors consequently enjoy lower electricity prices.

[13] For an overview of China's central SOE's on the energy market see p. 219.
[14] For examples of these practices see p. 222-224.

Government involvement does not stop with price setting and defining criteria for trade in energy, the State also **supports negotiations between power companies and enterprises**, especially if the latter play an essential role in SEI's and the production of priority products. Several **SSSR plans**, worked out at the provincial level, profoundly regulate the cost of electricity in several industries, such as the aluminum sector, where smelters have their own **captive power plants**, visibly reducing the cost of energy transmission. On top of that, such captive power plants benefit from a low, subsidized price of coal[15].

Coal subsidization has so far created serious distortive effects in the Chinese industry and energy sector. **Overcapacity** of coal made coal prices tumble, which in turn created an incentive for the establishment of new coal-fired power plants. The Chinese State has recognized the issue of coal overproduction and imbalanced coal-fired power generation, and targets lower coal production capacity through several programs such as the *13th FYP on the Coal Industry Development.* As utilization rates of coal-fired power plants are rapidly falling, these efforts seem to work. Still, they are incompatible with the fact that in 2016, more than 110 GW of plants were still in construction. Currently, new investment proposals are being launched to add additional coal capacity and considerable subsidy programs to coal and coal-fired electricity generation remain in force.

CAPITAL

The overview of China's banking sector has indicated the State presence when it comes to China's financial landscape. As a consequence, **SOE's and enterprises with close government ties have easy access to capital** compared to their private and independent colleagues who are forced to live on the crumbs provided by Chinese shadow banks. The positive correlation between access to capital and proximity to the Chinese government is reflected in several studies and statistics. Almost half of the share of outstanding loans flows to the state-owned industries. Moreover, despite the fact that its profitability falls, the state sector's corporate leverage is growing. On the other hand, while the profitability of POE's is on the rise, investment in the sector has decreased. This remarkable trend indicates that China's banks may have been unusually lax in extending credit to SOE's, a conclusion which is supported by IMF research.

The lack of a level playing field for private industries in China is further endorsed by the central policies in Beijing. Planning documents, such as *China 2025* and the *13th FYP*, seek to direct capital towards strategic enterprises and sectors. Loan interest subsidies, loan guarantees and other measures to reduce the cost of capital are used to get the money where the authorities think it belongs. Moreover, banks are expected to

[15] All concrete examples of these distortions can be consulted on p. 222-231.

modify their decisions in accordance with central policy. In this regard, the PBOC meets on a regulate basis with large banks to align lending strategies and credit with government objectives. This policy is legally established in several documents (see p. 6-7). The same accounts to bond and stock markets, which neither have the capacity to allocate capital in an efficient and market-based manner.

The Chinese habit to maintain caps on deposit and loan rates, artificially keeping the **capital cost** low, has been abolished in 2015. While the PBOC continues to refer to 'benchmark interest rates', credit pricing seems to have improved, as the share of loans well above the benchmark rates has considerably increased. Still, according to IMF calculations, the practice of putting pressure on the capital price to favor the development in specific industries continues. Several European trade investigations have shown that loans are being provided to Chinese companies below normal commercial market rates. Each of these investigations concerned products in industries that were considered to be key areas by the Chinese State.

After the 2008-2009 financial crisis, China's economic growth became increasingly credit-intensive, raising significant systemic risks. The initial inefficient allocation of capital initiated a vicious circle of debt acceleration. The excessive use of debt instruments due to credit-based stimulus policies contributed to massive overinvestment in certain Chinese industries. While corporate profits were deteriorating as a consequence of the economic crisis, credit kept flowing, which put pressure on the returns on investments. This, in turn, decreased the quality of banks assets resulting in a higher amount of **debt-at-risk** and pushed the credit intensity of Chinese growth up.

Local governments played a major role in this process. The financial crisis triggered major spending projects on the local level, financed through so-called 'local government financing vehicles' (LGFV). The main problem with these vehicles is that the debt does not show up on the balance sheet of the central government. Hence, the strict top-down limitations and regulations considering on-budget local borrowing do not apply. As a result, local government debt boomed in the aftermath of 2008-2009. According to *The National Audit Office*, debt exceeded RMB 10 trillion (EUR 1,3 trillion) and IMF estimates even reach RMB 33 trillion (EUR 4,2 trillion). These figures raised serious concerns about the local capacity to return this money. Hence, LGFV's have largely contributed to the misallocation of capital in China's economy.

These proceedings seem incompatible with Chinese figures on **non-performing loans (NPL)**, which officially cover only 1,9 per cent of the total outstanding loans in China. However, the/these data should be regarded with some suspicion, as the classification of loans, which is at the basis of the calculations, does not follow international standards. Taking into account these standards, and the fact that a substantial amount of loan risk has been moved off balance sheet through shadow banking, estimates of a NPL ratio between 6 and 19 per cent are closer to reality. Particularly in sectors that suffer from severe overcapacities, such as the coal and steel sectors, NPL's are prominent.

The initial response of Chinese authorities and financial institutions was to 'weather out' the debt issues by rolling over debt and providing bailouts or debt restructuring to avoid defaults. Such **evergreening** practices where imposed with the consideration that the indebted companies would return to health. However, the result has been a growing group of **zombie companies** (i.e. loss-making firms that keep on obtaining loans). Such zombie firms cover for 14 per cent of all Chinese corporate debt and are particularly problematic in the state-owned industries of less developed regions. While efforts to reduce the number of zombie companies have started, SOEs still account for 50 per cent of zombie debt[16].

Another solution to cope with problematic debt piling is to transfer NPLs towards bad banks, which slowly sell them off to recover part of the losses. This is what happened during the previous financial crisis in 2000, when the Chinese government launched several Asset Management Companies in order to grant the financial system some oxygen. While this approach does not tackle the underlying issues, China's current policy mix, aiming to solve high debt levels, is based on a similar idea as it shifts and restructures debt via **mergers and acquisitions (M&A)** and via so-called **debt for equity swaps (DFES)**.

Several opinions, such as the *Guiding Opinion on Promoting Structural Adjustment and Restructuring of Central SOEs*, and other regulations emphasize the need for M&A's in order to reduce risks in the Chinese financial system. Preferential tax policies were launched to encourage this kind of consolidation. However, question marks surround the idea that the merger of several inefficient groups will lead to higher efficiency and less debt[17]. A second measure to lower debt ratios, which the Chinese State Council initiated, were DEFS. By replacing high-interest rate bank loans with relatively cheaper equity capital debt, pressure should decrease. These kinds of transfers are also common in other countries, however, usually on a market- oriented basis. In the Chinese case, this process is essentially state driven. Distressed companies have to appoint *Implementing Agencies*, which are supposed to convert bank loans into equity. This policy has been mainly implemented by China's Big Five banks, which created their own special-purpose subsidiaries, serving as initial investors for equity funds. Banks lack the know-how and the incentives to manage company restructuring and hence fail to deal with the underlying structural problems in a company. Thus, while avoiding **bankruptcies** and unemployment on the short term, the DFES even add to the overall systemic risks plaguing China's financial sector. The government's fear for defaults and liquidation is, as pointed out in the section on bankruptcy, at the core of this distorted situation.

RAW MATERIALS

[16] For a step-by-step overview of how blind investments results into debt piling see p. 255.
[17] For an example of a state-led corporate restructuring in the steel sector see p. 257.

Raw materials are among the most important factors of production for China's economic growth miracle. Security of supplies, hence, remains a spearhead in China's State policies. It is the global leader in production and export of raw materials, but at the same time consumes and imports large quantities of them. The Chinese government profoundly tries to influence the supply and thus the price of raw materials, making overcapacities a common issue in the industry. Moreover, Chinese government intervention does not only impact domestic prices but also affects foreign prices, which can have devastating effects for entire industries overseas[18].

Dozens of FYP's, sectoral plans, guiding opinions and notices for different kinds of raw materials, often excelling in their level of detail, are issued by several Chinese government bodies at the national level. The *Mineral Resources Development Plan 2016-2020,* the *Non-ferrous Metal Industry Development Plan 2016-2020,* the *Construction Material Industry Development Plan 2016-2020,* the *Textile Industry Development Plan 2016-2020 and* the *Forestry Development Plan 2016-2020* are just a few examples of China's 13th FYPs on raw materials[19]. They each set out the present state of the sector, referring to some working points, after which they indicate specific development goals, quantitative targets and forecasts with regards to the demand and supply of particular materials and several policy measures to steer the evolution of the industry.

On the provincial level, a similar planning system enters into force when the national guidelines are established. While there is considerable overlap between the overarching and local plans (similar structures are followed) the latter are even more detailed and include very intense and specific interventions by the local authorities. One example is the *Hebei 2016 New Material Industry Development Plan*, containing specific supply and demand targets, production goals, lists of companies, support measures for specific firms and instructions of how to establish key industry bases in the province[20].

As the price of raw materials is directly influenced by their supply on the Chinese market, the Chinese government has several tools at its disposal to manage the amount of raw materials available to Chinese companies This, in turn, can tilt the level playing field in favor of domestic downstream industries. First of all, **export restrictions** can be imposed through export taxes, export quotas, export restrictions, VAT tax refund reductions, among other measures. These measures drive domestic prices of raw materials down due to large domestic supplies and create a comparative advantage for domestic producers[21]. Foreign complaints against such practices have already reached the WTO, as the Chinese management of raw materials supply can have grave repercussions for global commodity prices. Whereas China, consequently, has abolished export restrictions with regards to the products that were the subject of these

[18] For an overview of which materials are considered raw materials in the Chinese context see p. 266.
[19] For a detailed review of these plans see p. 267-288.
[20] For a detailed review on the *Hebei 2016 New Material Industry Development Plan,* see p. 288-297.
[21] For a list of measures used to restrict exports of raw materials see p. 298.

disputes, the supply of other products remains controlled through severe restrictions[22].

Export duties are one of the main means through which China manages the supply of more than 200 products[23]. A second tool for the Chinese government to keep exports restricted are **quotas**, prescribing the maximum volumes of exports. While the GATT officially prohibits their use, the OECD export restrictions inventory found around 40 different product groups that were subject to Chinese quotas in 2014. In collaboration with Customs, MOFCOM is responsible for the administration of export quotas. These can be allocated directly by the State or through a bidding process. A third measure for the government to restrict export are **non-automatic export licensing requirements**. For certain goods, exporters need to obtain export permits, which are granted by the government. Other materials might be selected by the government as 'only tradable by **State Trading Enterprises(STE)'**. As these STE's are the only ones allowed to sell or buy certain commodities, China indirectly controls the im- and export of these goods. While condemned by the WTO, many products remain exclusively tradable by authorized Chinese firms[24]. Last but not least, **VAT refund withdrawals** by the government can discourage exporters from selling their products abroad, hence, constituting another measure to influence the domestic supply of raw materials and lower their cost.

Discouraging export is one way to put pressure on domestic prices, but the range of means that the Chinese government uses is broader than that. The Department of Price is an entity of the NDRC and regulates **price policies**. Floor and ceiling prices for petroleum are determined to cushion possible fluctuations. In all provinces, China sets the gate station prices for domestic onshore natural gas and also develops a water pricing framework including specific fees and charges. The government has furthermore created a price zone system for coal to limit coal price fluctuations. For most of these products, the government recognizes the lack of a market based pricing system. Some reforms have improved the situation but governmental pricing so far did not die out. If pricing is not an option, the government can still influence the price of raw materials via **stockpiling**. The State Reserve Bureau manages strategic material reserves, including its assets, funds, infrastructure etc. There is no official list of which raw materials are subject to stockpiling, however, their existence can have a considerable impact on domestic and foreign prices of metals such as copper and aluminum but also of oil and agricultural commodities[25].

The Shanghai Futures Exchange (SHFE) is a market place for trading commodities. It is strongly biased towards Chinese-registered companies and citizens as their foreign counterparts have no access to the SHFE. Plans to open the crude oil market have been

[22] Three examples can be consulted on p. 299-300.
[23] A full list of the products is available on p. 302-307.
[24] An overview of these materials van be found on p. 310-311.
[25] For several examples see p. 316-319.

announced but are not operational yet. Previous investigations of the European Commission have found a number of price irregularities. Prices are often lower than world market prices due to the bias mentioned before and the fact that rules, particularly targeting price limits, apply in the SHFE. The fact that only physical exchanges can take place on the SHFE further insulates the Chinese market for SHFE traded commodities, which adds to a distorted price allocation of commodities.

In several raw material industries, Chinese **SOEs** represent a large majority, not to say a monopoly. As the Chinese government pulls the strings when it comes to this part of the economy, SOEs distribute quota on the basis of the guidelines it received from Chinese authorities. Last but not least, **investment restrictions** on a number of businesses related to raw materials and applicable on both domestic and foreign capital, are equally useful for influencing prices. In this vein, the Chinese government included some specific raw materials in the 2016 foreign investment project catalogue and implemented very detailed requirements for foreign investors.[26]

LABOUR

Historically, China's workforce was highly segmented, as urban residents lived in the *danwei* and rural residents in the *dadui*. The so-called *Hukou* system assigned workers to a specific geographical location, which simultaneously gave them a separate social status. This system, however has undergone serious reforms, implying more rights for workers with respect to compensation and choice of employment. Still, many heritages of the Chinese *Hukou* system live on today, and have an impact on the mobility of workers, their right to strike and the overall shortcomings in Chinese collective bargaining.

Together with the *Employment Contract Law*, the *Employment Promotion Law* and the *Labour Disputes Mediation and Arbitration Law*, China's *Labour Law* has replaced the previous *iron rice bowl cradle-to-grave social security system* and provides the **legislatorial basis** for China's labour market. Considering the **international standards** drawn up by the International Labour Organization (ILO), China applies only 23 out of the 71 labour conventions that have been recommended by the ILO. Out of the eight conventions, which the ILO considers as fundamental, China ratified only four.

[26] For an overview of the catalogue see p. 323-325.

Similar to the previous factors of production, the Chinese government tries to influence the cost of labour. A first important instrument to do so is the local minimum wage. This can be fixed by provincial, regional or municipal governments and is reported to the State Council. The minimum wage is decided upon on the basis of several indicators, among which living expense, employment situation etc. While the real wage growth in China's urban units has increased at an enormous speed, the minimum wage in most provinces only increased two and a half times between the 1990's and 2013. This gap results from local concerns that too much wage growth would decrease the competitiveness of local businesses.

In SOE's, the recruitments nor the salaries are market-lead. Moreover, when scrutinizing the Chinese figures considering labour contracts, the disadvantages of being a migrant worker become apparent. According to Chinese authorities, 90 per cent of enterprise employees among urban workers have signed labour contracts, compared to only 35,1 per cent of migrant workers. The latter are thus not legally entitled to the minimum wage nor covered by China's labour laws. This constitutes a significant cost advantage for their employers, as migrant workers represent almost 36 per cent of China's total workforce. Moreover, as a consequence of high labour taxation, Chinese employers tend to selectively formalize employment contracts, which leads to a high rate of informal employment.

Several laws and regulations were issued to organize **collective bargaining of wages between labour and enterprises**. However, this legislatorial framework falls short in many respects. First of all, the Chinese State legally only recognizes one trade union at the national level, namely the ACTFU, founded in 1925. This overarching union ultimately leads all other legal trade unions. These trade unions are, in turn, subject to the leadership of the CCP, a competence that is legally anchored in the *Constitution of the Chinese Trade Unions.* It is hence the CCP who decides upon the management of all ACTFU-related unions.

Since 2008, efforts have been made to boost collective bargaining in China, both on the national as well as the local level. To give an example, a legal foundation for tripartite and bipartite consultations at various levels to address labour issues, was included in the *Trade Union Law.* Despite such reforms, the government remains in full control over the unions, questioning their role to defend labourers' rights in China.

Other flaws further weaken the system. The freedom of association and the right to strike are fundamental to arrive at an equitable labour market. But the absence of official recognition of the right to strike in China's legislatorial landscape, and the requirement for governmental approval when it comes to creating a union, indicate that these fundamental principles are anything but guaranteed. Moreover, many provisions in the *Trade Union Law* are even contrary to the fundamental principles of freedom of association. The absence of a detailed procedural framework as well as the fact that public and private firms have much more power than their employees, strongly undermine the practical implementation of collective bargaining. This is

further reflected in research showing that the presence of a union in China has practically no influence on wages and working conditions in a company.

Nevertheless, recently, ACTFU has been showing some improvement when it comes to efficiency and securing benefits such as higher wages, shorter working hours and better insurance coverage in some localities. On several levels, it has been taking a more progressive approach towards advocacy and even started some attempts on democratization of the union leadership. Moreover, evidence that successful labour unrest in China is growing, indicates that, even though there is no official recognition of the right to strike, the bargaining power of Chinese workers is increasing. Several documents, such as the *13th FYP,* include provisions on further developing collective bargaining in China.

When it comes to the mobility of China's workforce, the prospects are less positive. The hukou system, which was implemented in 1958 and restricted migrant workers between rural and urban areas and across regions, left some serious marks on China's current labour market. While a new system based on national resident registration has added to the flexibility of the labour market, the principle of population control is largely maintained and rural migrants are encouraged to settle down in smaller cities. While moving between rural areas and towns is already much easier in the new system, criteria for gaining residency in the most popular destination cities are prohibitively strict for migrant workers, which makes it very difficult for them to get an urban *hukou* for the largest Chinese cities.

This, in turn, has serious social repercussions for migrant workers as they have difficulties obtaining access to education for their children, health care, pension, welfare and affordable housing in their place of work. Moreover, their income is still lagging behind the average urban income. While the age of a massive cheap Chinese labour reservoir is coming to an end – In the 1990's migrant workers accounted for 70 to 80 over cent in the special economic zones-, the fact that only one third of this group signs a contract with their employers still provides a serious labour advantage for Chinese companies.

Provided that a contract is signed, labour regulations in China are very strict and hence put a strong burden on Chinese employers. The *2008 Labour Contract Law* in this sense positively influenced the labour market. Still, while the number of workers covered by general collective agreements has risen, the number of workers covered by specific wage agreements has grown at a slower pace. More problematic though, are the efforts of several Chinese employers to evade the legal requirements of the law through subcontracting, disrespecting the provisions of the contract, forcing workers to sign blank contracts or contracts drafted in languages they could not understand and avoiding minimum wage provisions by raising canteen prices and fines. The labour dispute resolution system, which was launched within the framework of the law, should give more rights to employees. However, the persistent lack of resources to enforce the system impedes its operationalization.

Part III: Distortions in selected sectors

STEEL SECTOR

The **regulatory framework** underpinning China's steel industry consists of several plans, guidelines, policies and other documents. *China's 13th FYP on Economic and Social Development and Related Measures* puts forwards some general objectives for the steel sector, among which the importance of dissolving excess steel capacity and the need for measures improving environmental protection. China's *Steel Industry Adjustment and Upgrading Plan* for 2016-2020, on the other hand, is a much more detailed legal cornerstone for the Chinese steel sector, which the plan describes as one of the most important pillars of the Chinese economy. The high degree of intervention exerted by the government is reflected by the level of detail and the fact that the plan covers literally all aspects of the industry[27]. It includes, among other things, specific measures to reduce production capacity, detailed quantitative targets, fiscal, tax and financial policies to support the adjustment of the industry and means to geographically, qualitatively and environmentally reorganize the sector, on national and provincial levels. Such sectoral plans are not new, previous plans and policies such as the *2003 Development Policies for the Iron and Steel Industry* and the *Blueprint for the Steel Industry Adjustment*, include equally far-reaching support measures for the industry such as export encouraging policies, reorganization and restructuring strategies[28].

The Chinese government holds a grip on the industry through planning but also through the **control of SOE's** which play a major role when it comes to the production of steel. Five Chinese state-owned steel companies are ranked in the global top ten of steel producers. Moreover, the Chinese mining industry is dominated by SOEs, which further strengthens the commanding position of the State in the sector. It also became clear that the government pulls the strings when it comes to SOEs' business activities in the steel industry during the nonviable merger of Baosteel and Wuhan. These two steel giants created the second largest steel producer in the world. Such extensive government intervention, in turn, prevents POEs from operating under market conditions, as the latter are forced to follow the extremely competitive prices of their state-owned competitors.

State-owned steel companies are not only backed by the government, but also by the entire Chinese **financial system**, which supports steel companies according to China's State policies. This support may comprise low interest rates, cheap loans and bonds but also financial sources to encourage certain mergers and acquisitions for example. This explains how China's 'Big Five' have a major stake in the creation huge overcapacities and zombie companies in the steel sector.

[27] For a comprehensive overview of the objectives put forward by the plan see p. 348-354.

[28] On p. 354-358, the content of these plans can be consulted.

The government's wide array of **State support measures** to promote the steel industry according to the established plans and guidelines have accelerated this trend. Preferential tax policies, subsidies, cheap energy, free land use rights, grant programs, tariff and VAT exemptions, awards, debt for equity swaps and debt cancellations are just a few examples of the tools that the Chinese State has used to support the development of the steel industry. Moreover, the State's control over the supply and the price of certain **raw materials**, which are at the basis of the industry, has been decisive for the development of the steel sector. Export restrictions, for example for coke, have negatively influenced the steel price and hence the price of downstream products such as seamless stainless-steel pipes and tubes. Trade defense investigations from Europe, Canada and Australia confirm these practices, which seriously harm foreign industries too[29].

The infrastructure boom, which China saw between 2006 and 2016, boosted the production of Chinese steel. The intensive government intervention described above, led to irrational investment, huge **overcapacities** and an increasing amount of zombie companies. This, in turn, caused a surge of exports and the depression of steel prices world-wide. This not only negatively affected profitability among steel companies but seriously destabilized global steel markets. There have been several Chinese notices and opinions to tackle the overcapacity issue such as the *Circular on Accelerating the Structure Adjustment of the Industry with Production Capacity Redundancy* and the *Guiding Opinion of the State Council Regarding Resolving the Contradiction of Serious Overcapacity*, however, as the proposals lack market-based policies, attempts by the Chinese authorities have so far failed to curb overcapacity. On the contrary, some measures, such as state-controlled M&A's have even added capacity to the already over-satisfied steel industry.

ALUMINUM SECTOR

The **regulatory framework** underpinning the aluminum sector is similar to the one covering the steel industry and comprises of the *13th FYP for the Non-Ferrous Metals Industry,* the *Standard Conditions applicable to the Aluminum Industry,* the *Non-Ferrous Metals Industry Adjustment and Revitalization Plan, the Entry Conditions to the Aluminum Industry* and the *Guidelines for Accelerating the Restructuring on the Aluminum Industry*. Next to dozens of other notices and guidelines, this legislatorial core is at the basis of how the Chinese government has paved the way for the industry to evolve[30]. They include, among other things, specific quantitative targets, policies to organize the geographical distribution of aluminum production, research and development targets, stockpiling forecasts, standardization, management and restructuring goals,

[29] For a detailed overview of these investigations see p. 365-369.
[30] For a comprehensive overview on the content of these legislatorial pieces see p. 377-387.

provisions on access to capital, electricity related measures and guidelines to eliminate outdated capacity.

A second similarity with the steel sector is the prominent **presence of aluminum-producing SOE's**, which account for over 50 per cent of the total primary aluminum output in China, offering the State a favorable platform to implement its policies. As with the steel sector, the application of a variety of **specific policy instruments** were revealed during trade defense investigations by foreign countries, ranging from export taxes, duties and quotas on raw materials to VAT rebates policies, favorable electricity and energy policies, stockpiling efforts and biased practices on the SFHE. Other **State support measures** include brand development funds, grants, preferential loans, tariff exemptions, free land, and other policy tools[31].

Due to an upward trend in the domestic and global demand for aluminum products, production accelerated between 2013 and 2017. However, it were mainly the artificial advantages provided to Chinese producers by the government which increased capacity to such an extent that the sector suffocated. In 2015, the total alumina capacity doubled compared with the production in 2008, creating 9,2 million tons of overcapacity. Attempts to curb production in the aluminum sector have been recorded in a variety of notices and guiding opinions, however, similar to the remedies in the steel sector, they seem to add to overcapacity instead of reducing it. Fear for unemployment and social unrest exists among provincial authorities, triggering strong reluctance to take concrete measures against overcapacity on the local level.

CHEMICAL SECTOR

China represents almost 40 per cent of the world chemicals market. In 2016, the country also topped the world chemicals investment ranking with an amount of EUR 99,2 billion of invested capital. China's trade position when it comes to chemicals, is largely in balance with USD 151,64 billion of chemical imports and USD 141,29 billion in exports. Still, the picture looks less balanced when scrutinizing the **main industry segments** separately. Imported Chinese chemical products are mainly high-end, while Chinese low-end chemicals suffer from severe overcapacities[32]. The EUCCC identifies different causes for this issue, such as China's obsession for self-sufficiency, local government measures to support the development of specific chemicals such as low electricity policies, rail freight and tax incentives, and the continued protection of outdated plants by provincial authorities. Similar to the steel and the aluminum sector, the chemical industry is recognized by a strong **SOE presence[33]**, which might be an additional explanation for the distortions and inefficiencies plaguing the sector.

[31] A comprehensive overview of the TDI investigations and a list of support measures can be found on p. 388-395.
[32] Specific figures on overcapacities of different chemical products can be consulted on p. 405.
[33] A list of the 20 biggest Chinese SOEs in the chemical sector is provided on p. 404.

The 13th FYP for the Petrochemical and Chemical Industry, the State Council Guidelines on Structure Adjustment, Transformation, and Profitability Growth of the Petrochemical Industry, the State Council Guidelines on Promoting Enterprise Technological Transformation and a range of in-depth provincial plans represent the **policy backbone** of the Chinese chemical industry. They lay down very specific quantitative and sectoral targets, they put forward several industrial goals such as tackling overcapacities, creating national champions, building industrial bases and parks, encouraging technological transfers through international cooperation, and they draw some guidelines to support the sector via financial, tax and funding channels[34].

The **policy instruments**, designed to implement all these policy guidelines mainly consist of government-backed investment funds, government-driven M&A's and financial support and fiscal incentives. The first support vehicle is quite new in China's policy toolkit. The *National Advanced Manufacturing Industry Investment Fund*, for example, set up in 2016, covers around EUR 2,7 billion for investments in all industries mentioned by *Made in China 2025* and hence financially backs the chemical industry. Governmental bodies such as the MIIT also work together with policy banks to provide additional funding for industries related to *China 2025.* Last but not least, Chinese chemical companies enjoy financial incentives such as regulated gas prices, production subsidies for shale gas and VAT rebate policies to encourage exports.

There are more and more overseas mergers and acquisitions between Chinese companies and European competitors. When such transfers are market-based they are not necessarily problematic. However, in China's case, overseas acquisitions are regularly backed by the State particularly when the acquiring companies that are state-owned or state-controlled. This does not only provide the SOEs with more market share, it also allows them access to foreign technology, brands and management expertise. To date, China's biggest overseas deal took place in the chemistry industry when ChemChina took over Syngenta AG for EUR 41 billion in 2016. Currently, the involvement of the State in the deal is being scrutinized as well as the problematic debt level ChemChina faces.

Obviously, all these intervening policies and measures have distortive results on the industry and the market. European and American trade defense investigations have uncovered some of the Chinese price distorting practices, among which preferential lending, tax programs, governmental provision of goods and grants to, among others, the melamine industry. While the Chinese State has recognized that severe interventions can destabilize the domestic and global market in chemical products, supportive policies have anything but disappeared.

CERAMIC SECTOR

[34] For an overview of the content of these plans and for an example of how they materialize in the Hebei province see p. 406-424.

China is the world's largest producer of ceramic tiles and represents almost 50 per cent of the global ceramic tile production. Contrary to the three previous industries, the Chinese construction ceramic industry is recognized by a low market concentration, with the top ten Chinese manufacturers accounting for no more than five per cent of China's total capacity. This capacity has been following an ever-steeper upward trend, resulting in a strong imbalance between supply and demand on the domestic market. This aggravated the structural overcapacity problem in Chinese ceramics. Unutilized production capacity expanded from 20 per cent in 2011 to 35 per cent at the end of 2016.

The issue of structural **overcapacity** has been confirmed by several regulatory documents such as the *Guiding Opinions for the 13th FYP on the Development of Construction Ceramics and Sanitary wares.* Due to the Chinese misperception that market share is more important than profitability – and overcapacity is viewed as an opportunity to gain market shares – many ceramic tile companies cut down product prices, which causes price wars in which products are sold nearly without any profit.

At the basis of this long-term structural problem is China's **regulatory framework** consisting of the 13th FYP for the Construction Materials Industry, the State Council Guiding Opinions on the Construction Materials Industry, the Industry Guiding Opinions for the 13th FYP on the Development of Construction Ceramics and Sanitary wares, the 13th FYP for the Light Industry and a pile of local guidelines and plans[35]. These plans grant the government full control and guidance over macroeconomic evolutions. They put forward some overarching goals, among which enhancing efficiency, expanding industrial parks, encouraging technological transfers, triggering overseas M&A's, reaching some quantitative targets and shifting towards the development of high-end products. The 13th FYP for the light industry goes quite far when it comes to resolving the overcapacity issue, as it puts forward a Chinese two-children policy to stimulate consumption and hence steer demand. Next to this remarkable objective, it stipulates specific production objectives, several means to encourage exports, the role of the BRI, and very detailed provisions on product development. The policy measures to reach the aforementioned objectives consist of funds, such as the national fund for small and medium sized enterprises to boos SME's investments, funding channels, export credit insurance, the support of industrial associations, etc.

If these plans come across as far-going and quite detailed, the local plans go even further in managing targets, capacities, business organizations, etc. The *13th FYP for the Economic and Social Development of the City of Chaozhou* as well as the *Roadmap and Action Plan of the City of Chaozhou for the Transformation and Technological Upgrading of the*

[35] For an overview of the national policy framework in the ceramic sector see p. 440-453.

Ceramic Sector, are very specific and clear about which objectives need to be aimed for and how they should be accomplished[36].

Some **State support measures** have already been mentioned, but the toolkit of the Chinese government seems endless when it comes to the ceramic sector. Subsidies, patent-related financial transfers, rewards, specific funds, export credit insurance and tax incentives are all used by the Chinese government to get the sector where it should be according to the plans.

This large-scale intervention is the main reason behind overcapacity in the ceramic industry, which has shifted the focus towards exports markets. A number of countries, among which the US and Brazil, as well as the EU, have already launched trade defense investigations against dumping and illegal subsidizing of Chinese ceramic products. A 2011 EU case against the dumping of Chinese ceramic tiles has revealed how sales decisions where a consequence of State objectives rather than market-based business decisions. Moreover, it demonstrated that several Chinese producers were unable to prove that they had paid for land use rights. Two groups of producers were equally unable to report the origin of the initial capital used in their establishment. A 2013 EU case against dumping of Chinese ceramic tableware and kitchenware discovered similar mysterious transfers concerning land use rights and purchases of raw materials by producers as the costs of these production factors were far from their market-based value.

[36] For a detailed overview of the content of these local initiatives see p.453-457.