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DATE: October 26, 2017

SUBJECT: China's Status as a Non-Market Economy

Contents

EXECUTIVE SUMMARY

The Department of Commerce ("Department") concludes that China is a non-market economy (NME) country because it does not operate sufficiently on market principles to permit the use of Chinese prices and costs for purposes of the Department's antidumping analysis. The basis for the Department's conclusion is that the state's role in the economy and its relationship with markets and the private sector results in fundamental distortions in China's economy.

At its core, the framework of China's economy is set by the Chinese government and the Chinese Communist Party (CCP), which exercise control directly and indirectly over the allocation of resources through instruments such as government ownership and control of key economic actors and government directives. The stated fundamental objective of the government and the CCP is to uphold the "socialist market economy" in which the Chinese government and the CCP direct and channel economic actors to meet the targets of state planning. The Chinese government does not seek economic outcomes that reflect predominantly market forces outside of a larger institutional framework of government and CCP control. In China's economic framework, state planning through industrial policies conveys instructions regarding sector-specific economic objectives, particularly for those sectors deemed strategic and fundamental.

The Chinese government and the CCP's legal and actual ownership and control over key economic actors and institutions pervades China's economy, including the largest financial institutions and leading enterprises in manufacturing, energy, and infrastructure. China's authorities use this control selectively to affect the interaction of supply and demand and accordingly distort the incentives of market actors. This ability to affect these market forces is apparent in crucial facets of the economy, from the formation of exchange rates and input prices to the movement of labor, the use of land, the allocation of domestic and foreign investment, and market entry and exit. Because of the significant distortions arising from China's institutional structure and the control the government and the CCP exercise through that structure, the Department finds that China remains a NME country for purposes of the U.S. antidumping law.

The Department's overall conclusion is based upon its analysis of six factors established in U.S. law. In determining whether a country is an NME under section 771(18)(A) of the Tariff Act of 1930, section 771(18)(B) requires that the Department take into account (1) the extent to which the currency of the foreign country is convertible into the currency of other countries; (2) the extent to which wage rates in the foreign country are determined by free bargaining between labor and management; (3) the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country; (4) the extent of government ownership or control of the means of production; (5) the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and (6) such other factors as the administering authority considers appropriate.

Under Factor 1, with respect to currency convertibility, the Department observes that the renminbi (RMB) is convertible into foreign currencies for trade purposes, the Chinese government has made market-oriented modifications to its capital account and exchange rate system, and has taken steps to develop its foreign exchange (FOREX) market. However, the Chinese government still maintains significant restrictions on capital account transactions and intervenes considerably in onshore and offshore FOREX markets. The Chinese government also maintains approval requirements for all major capital account transactions; does not disclose the weights attached to price quotes that are used to calculate the central parity rate for the RMB; and intervenes to limit the extent of price divergence between the onshore and offshore FOREX markets.

Under Factor 2, the Department observes variability in wages across regions, sectors, and enterprises in China. However, the Department continues to find significant institutional constraints on the extent to which wage rates are determined through free bargaining between labor and management. The Chinese government prohibits the formation of independent trade unions to represent labor, and workers do not have the legal right to strike, which is an important lever in collective action and negotiation with management over wages. Labor unions are under the control and direction of the All-China Federation of Trade Unions (ACFTU), a government-affiliated and CCP organ. Certain legal remedies exist for an individual to challenge labor contract and wage-related violations in particular cases; however, significant institutional barriers exist that limit their effectiveness. In addition, government restrictions on labor mobility imposed by the *hukou* (household registration) system continue to inhibit and guide labor flows, causing distortions on the supply side of the labor market.

Under Factor 3, the Department finds that the Chinese government's foreign investment regime is particularly restrictive relative to that of other major economies. Despite some government efforts to streamline procedures, China continues to impose significant barriers to foreign investment, including equity limits and local partner requirements, opaque approval and regulatory procedures, and technology transfer and localization requirements. It is the Chinese government's foreign investment regime, not the market primarily, that channels foreign investment to sectors and technologies the Chinese government determines to support, while limiting foreign investment in those sectors that the Chinese government finds strategically important to maintain under its control alone.

Under Factor 4, the Department finds that the Chinese government continues to exert significant ownership and control over the means of production, as demonstrated by (1) the role and prevalence of state-invested enterprises (SIEs)[1] throughout the enterprise sector and (2) the system of land ownership and land-use rights. The prevalence of SIEs in China's economy is significant, and their relative "economic weight" is substantial in comparison with other major economies. The size of the SIE sector may also understate the actual extent of government ownership and control. The Chinese government allocates resources to SIEs in what it deems strategically important sectors, such that SIEs are not strictly disciplined by market principles of supply and demand. At the same time, however, the government requires that SIEs undertake large-scale investments to help stabilize China's macro-economy. The government also intervenes extensively in the enterprise sector to shield SIEs from the consequences of economic

[1] This determination uses the term "state-invested enterprise" or "SIE" when referring to an enterprise in which the Government of China has any ownership stake. Though the term generally has the same meaning as "state-owned enterprise" or "SOE," the definition of "SOE" sometimes varies depending on the context in which it is used, and the Department has adopted the term "SIE" to avoid confusion. This determination will use the term "SOE" when citing others' use of that term. The Department used the same approach in its *Memorandum on Public Bodies, Section 129 Proceeding: United States – Countervailing Duty Measures on Certain Products from the People's Republic of China* (WTO/DS437), October 15, 2015.

failure, facilitates mergers and acquisitions to achieve government, not enterprise, objectives, and enables the rise of large enterprise groups under government ownership and control. An important channel for government influence over firm decision-making is the CCP's ability to appoint key personnel in enterprises and participate in corporate decision-making through Party Committees in those enterprises.

The Chinese government exercises significant control over land, another key means of production analyzed under Factor 4. All land in China is property of the state, as either collectively-owned rural land or state-owned urban land. Because the government controls rural land acquisition and monopolizes the distribution of urban land-use rights, the government remains the final arbiter of who uses the land and for what purpose. Government decisions in distributing land-use rights are informed, on one hand, by incentives to generate revenue for local governments, and on the other, by national policies that allocate construction quotas and restrict the use of arable land for non-farming purposes. Land-use rights holders, in turn, face limits with respect to the tenure and the scope of use. Rural land-use rights holders face the additional challenges of incomplete documentation and inadequate compensation for the loss of use rights. The result of these dynamics is an inefficient land market in which rural and urban land are segmented and large swathes of land are misallocated either to small farm plots or to underutilized urban infrastructure.

Under Factor 5, the Department finds that the Chinese government plays a significant role in resource allocations. State planning remains an important feature of the Chinese government's industrial policies, as evidenced by formal mechanisms of plan formulation, tasking, and review, and the scope and specificity of sectoral-level plans. Various institutions participate in plan formulation and execution, including central agencies with legislative and regulatory authority, thousands of local government authorities, various organs of the CCP, and the enterprise sector. The Chinese government employs numerous mechanisms to implement industrial policy objectives, including, *inter alia*, investment approvals, access standards, guidance catalogues, financial supports, and quantitative restrictions. Science and technology development, industrial restructuring and upgrading, and the geographic distribution of industry are three areas that demonstrate the extent to which the government uses industrial policies to influence economic outcomes.

The Chinese government exerts a high degree of control over prices it deems essential or strategic. Its ability to set and guide factor input prices, in particular, results in distorted costs and prices throughout the economy. In the electricity sector, for example, the government owns the largest grid operators, formally sets prices, and employs "differential pricing" as a policy tool to achieve capacity shedding and other industrial policy objectives.

The financial sector plays a pivotal role in misallocating resources in China's economy. The government retains ownership and control over the largest commercial banks, while the majority of bank and interbank loans, as well as corporate bond transactions, occur between state-owned and -controlled parties. Credit continues to be allocated to SIEs in spite of high levels of corporate debt, giving rise to soft budget constraints and implicit government guarantees that undermine the market-determined pricing of risk. The emerging "shadow banking" sector, in turn, serves largely as a means for state-owned and -controlled parties to lend and borrow capital through opaque institutions and channels outside the formal banking sector. These fundamental distortions permeate throughout China's financial sector.

Under Factor 6, the Department finds China's legal system continues to function as an instrument by which the Chinese government and the CCP can secure discrete economic outcomes, channel broader economic policy, and pursue industrial policy goals. Key legal institutions, such as the courts, are structured to respond to their direction, whether broad or case-specific. Individuals and firms are constrained in their ability to have meaningful independent input into administrative rulemaking or to challenge administrative decisions. As a general matter, to the extent that individuals and firms seek to act independently of government or CCP direction, the legal system does not provide the venue for them to achieve these objectives on a systemic or consistent basis. In addition, firms continue to face challenges in obtaining impartial outcomes, either because of corruption or local protectionism.

After assessing the six factors, the Department finds that the Chinese government continues to maintain and exercise broad discretion to allocate resources with the goal of achieving specific economic outcomes. China's institutional structure and the control the Chinese government and the CCP exercise through that structure result in fundamental economic distortions, such that non-market conditions prevail in the operation of China's economy. These non-market conditions are built upon deeply entrenched institutional and governance features of China's Party-state, and on a legal mandate to "maintain a leading role for the state sector." Accordingly, China is a NME country. It does not operate sufficiently on market principles to permit the use of Chinese prices and costs for purposes of the Department's antidumping analysis.

INTRODUCTION AND BACKGROUND

The Department initiated an inquiry into China's status as a non-market economy (NME) country. The Department initiated this inquiry in the context of the less-than-fair-value investigation of certain aluminum foil from the People's Republic of China,[2] pursuant section 771(18)(C)(ii) of the Tariff Act of 1930, as mended (the Act), which states that the Department may make a determination with respect to a country's NME status "at any time." To ensure full public and interested party participation in this inquiry, the Department invited public comment on China's economy and ongoing reforms, and all comments received by May 10, 2017, have been posted on the Department website at (https://www.regulations.gov/docketBrowser?rpp=25&so=DESC&sb=commentDueDate&po=0&D=ITA-2017-0002). The Department stated that it would issue its findings prior to the preliminary determination in the aluminum investigation and would decide at the time whether to seek additional information from interested parties concerning the calculation of normal value.[3]

This inquiry is being conducted pursuant to section 771(18)(A) of the Act, which defines the term "non-market economy country" as any foreign country determined by the Department not to "operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." Section 771(18)(B) of the Act lists six factors (see below) the Department must consider in any inquiry made under section 771(18)(A), and under section 771(18)(C)(i), a country's NME country status remains in effect until revoked. The Department's designation of a country as a NME country applies only to U.S. trade remedy proceedings.

The Department has treated China as a NME country in all past antidumping duty investigations and administrative reviews involving imported products from China. *See, e.g.,* Seamless Refined Copper Pipe and Tube From the People's Republic of China: Preliminary Results and Partial Rescission of Administrative Review; 2012-2013, 79 FR 71089 (December 1, 2014), unchanged in Seamless Refined Copper Pipe and Tube From the People's Republic of China: Final Results of Antidumping Duty Administrative Review; 2012-2013, 80 FR 32087 (June 5, 2015); Notice of Final Determination of Sales at Less Than Fair Value, and Affirmative Critical Circumstances, In Part: Certain Lined Paper Products From the People's Republic of China, 71 FR 53079 (September 8, 2006); and Final Determination of Sales at Less than Fair Value: Certain Paper Clips from the People's Republic of China, 59 FR 51168 (October 7, 1994). The Department last reviewed China's NME country status in 2006, in response to a request from a respondent, supported by the Chinese government. See Final Determination of Sales at Less Than Fair Value, and Affirmative Critical Circumstances, In Part: Certain Lined Paper Products from the People's Republic of China, 71 FR 53079 (September 8, 2006). In the lined paper investigation, the Department determined that reforms remained incomplete and the Chinese government's role in the economy warranted the continued designation of China as a NME

[2] *See Certain Aluminum Foil from the People's Republic of China: Initiation of Less-Than-Fair-Value Investigation*, signed March 28, 2017.

[3] *Certain Aluminum Foil from the People's Republic of China: Notice of Initiation of Inquiry into the Status of the People's Republic of China as a Nonmarket Economy Country under the Antidumping and Countervailing Duty Laws*, 82 FR 16162, April 3, 2016.

country for purposes of the U.S. antidumping law. See Memorandum for David M. Spooner, Assistant Secretary for Import Administration, "Antidumping Duty Investigation of Certain Lined Paper Products from the People's Republic of China ('China')—China's Status as a Non-Market Economy ('NME')" (August 30, 2006) ("*2006 PRC NME Determination*"), available at http://enforcement.trade.gov/download/prc-nme-status/prc-lined-paper-memo-08302006.pdf.

SUMMARY OF COMMENTS FROM PARTIES

Parties Who Support Revoking China's NME Country Status

Two parties have expressed support for graduating China to market economy status: Ministry of Commerce, People's Republic of China (MOFCOM); and Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt, LLP. Their positions are summarized below:

- MOFCOM urges the United States to comply with the expiration of Section 15(a)(ii) of China's Accession Protocol and explains that it would not submit comments in response to the notice of inquiry with respect to the criteria set forth in Section 771(18) of the Act because any determinations with respect to the criteria laid out in the Act would have no bearing on the United States' compliance with the General Agreement on Tariffs and Trade (GATT) and the Agreement on implementation of Article VI of the GATT ("Antidumping Agreement"). It also argues that the United States is obligated to no longer use a surrogate methodology with respect to all antidumping determinations targeting Chinese products after December 11, 2016.

- Grunfeld, Desiderio, Lebowitz, Silverman & Klestadt, LLP argue that China's economy has been sufficiently reformed that it should be considered a market economy according to the six factors stipulated in the Act. They assert that China has undertaken many banking reforms and that Chinese currency is fully convertible; wages in China are market determined; there have been several reforms in the area of foreign investment such as the relaxation of foreign investment approval requirements; the state has announced that it will increase privatization of companies in specific key sectors; loans to private enterprises have increased significantly when compared to state-owned enterprises; and China passed bankruptcy reform law and has had multiple reforms in the areas of rule of law and property rights. They also argue that the Antidumping Agreement requires the Department to graduate China to market economy status, even without any economic analysis.

Parties Who Oppose Revoking China's NME Country Status

Parties who have expressed opposition to graduating China to market economy status include the Steel Manufacturers Association; International Brotherhood of Teamsters; International Union; United Automobile; Aerospace and Agricultural Implement Workers of America; Association of American School Paper Suppliers; Southern Shrimp Alliance; American Iron and Steel Institute; American Shrimp Processors Association; Nucor Corporation; Solar World Americas Inc.; Byer Steel Group Inc.; American Federation of Labor & Congress of Industrial Organizations; United Steel Workers; Bio-Lab, Inc.; Chemtrade Solutions LLC; Clearon Corporation; ICL Performance

Products, LP; and Occidental Chemical Corporation; Maverick Tube Corporation; Schagrin Associates; Titan Tire Corporation; Diamond Sawblades Manufacturers' Coalition; Rebar Trade Action Coalition and its individual members; Verso Corporation; S.D. Warren Company d/b/a Sappi North America; Appleton Coated LLC and the United Steel, Paper and Forestry, Rubber, Manufacturing, Energy Allied Industrial and Service Workers International Union AFL-CIO, CLC; Coalition to Enforce AD/CVD Orders; Gerdau Ameristeel U.S. Inc; United States Steel Corporation; Coalition for Fair Trade in Hardwood Plywood and its individual members; Mid Continent Steel & Wire, Inc.; JSW Steel; AK Steel Corporation; the American Furniture Manufacturers Committee for Legal Trade; Anvil International, LLC; Appvion, Inc.; Archer Daniels Midland Company; Colombian Home Products, LLC; Elkay Manufacturing Company; the Laminated Woven Sacks Committee; the Magnesia Carbon Bricks Fair Trade Committee; PCI Nitrogen, LLC; P.H. Glatfelter Company; the Polyethylene Retail Carrier Bag Committee; Tate & Lyle Ingredients Americas LLC; Terphane, Inc.; US Magriesium LLC; Verso Corporation; and Zekelman Industries, Seaman Paper Company of Massachusetts, Inc.; Evraz North America; Manufacturers for Trade Enforcement; Commercial Metals Company; Alliance for American Manufacturing; Aluminum Extrusions Fair Trade Committee; Coalition for a Prosperous America; Chinalco Aluminium Co., Ltd.; Aluminum Association Trade Enforcement Working Group; and Wiley Rein LLP. Members of Congress have also expressed opposition to China's graduation to market economy status, including: Senator Al Franken, Senator Tammy Baldwin, Senator Sherrod Brown, and Senator Amy Klobuchar. Their positions are summarized below:

- To a great extent, Chinese currency is not convertible into the currency of other countries; there is government manipulation and misalignment of the *renminbi* (RMB); and China's own leaders acknowledge that its currency needs to move toward convertibility.

- The only legal labor union in China, the ACFTU, is government-controlled. China does not enforce its labor laws and does not recognize International Labor Organization (ILO) rights.

- The government heavily controls foreign direct investment (FDI) flows and the overall investment climate remains challenging. There is a catalogue for foreign investment drafted by MOFCOM that lists industries in which foreign investments are "encouraged," "restricted," or "prohibited." Also, foreign investors worry about protecting their intellectual property in China because firms are forced to commit to significant technology transfers or face restrictions in their ability to complete an investment project.

- Land is cheaper for state-owned enterprises (SOEs) than for private companies because SOEs are state-owned. There is an abundance of SOEs that receive preferential treatment through subsidies and other incentives. The Chinese government manipulates raw material prices for non-Chinese competitors, and restrains exports of raw materials. Also, the government plays a large role in determining the terms of loans and credits to businesses.

- The result of the government's intervention in the market through its lending policies and large subsidies has been extensive excess capacity in many industrial sectors, such as steel, aluminum, paper, and tires. The government continues to maintain price controls on various products and services such as pharmaceuticals, fertilizer, natural gas, and others.

- State censorship restricts access to economic information; cyber security and intellectual property theft are areas of concern; corruption between business and governmental officials is quite widespread; there is inconsistent due process; and political connections distort market outcomes.

ANALYSIS

As noted above, a NME country for purposes of the U.S. antidumping law is defined in section 771(18)(A) of the Act as "any country that the administering authority determines does not operate on market principles of cost or pricing structures, so that sales of merchandise in such country do not reflect the fair value of the merchandise." In making a NME country determination under section 771(18)(A) of the Act, section 771(18)(B) requires that the Department examine an economy as a whole, as opposed to individual industries or companies, and take into account:

1. the extent to which the currency of the foreign country is convertible into the currency of other countries;
2. the extent to which wage rates in the foreign country are determined by free bargaining between labor and management;
3. the extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country;
4. the extent of government ownership or control of the means of production;
5. the extent of government control over the allocation of resources and over the price and output decisions of enterprises; and
6. such other factors as the administering authority considers appropriate.

Factor One: The extent to which the currency of the foreign country is convertible into the currency of other countries.

A country's integration into world markets is dependent upon the convertibility of its currency. This factor examines China's exchange rate regime and capital account restrictions. Part A briefly describes the framework governing China's exchange rate regime. Part B examines capital account restrictions, including statistical measures of capital account convertibility; key policies such as "window guidance" and the Qualified Foreign Institutional Investor (QFII) program; and the effect of capital account convertibility restrictions on the use of the RMB internationally. Part C examines the FOREX market and FOREX regime, including China Foreign Exchange Trade System (CFETS), modifications to China's exchange rate regime over the past decade, and the offshore RMB market.

China has moved from multiple (fixed) exchange rates and closed current and capital accounts to a more flexible, unified exchange rate, an open current account, and a somewhat open capital account. The government continues to develop its FOREX markets, internationalize its currency, and open its capital account. However, China still maintains instruments of control over the valuation of the RMB through the central parity rate-setting process and FOREX market interventions. China also continues to maintain approval requirements for all major capital account transactions, including investment, borrowing, and cross-border account holding.

A. Framework of the Foreign Exchange Regime

The RMB has been the sole official currency of China since the Chinese government adopted a unified exchange rate in 1994.[4] The primary legal instrument governing FOREX administration is the *Regulation on the Foreign Exchange System of the People's Republic of China*.[5]

The *Law of the People's Republic of China on the People's Bank of China* (*PBOC Law*), adopted in 1995, sets forth the current functions of China's central bank, the People's Bank of China (PBOC).[6] PBOC is responsible for conducting both monetary policy and FOREX policy, but delegates various powers over FOREX to the State Administration of Foreign Exchange (SAFE), which regulates day-to-day currency transactions.[7] PBOC operates under the guidance of the State Council, the highest authority in the Chinese government, to which PBOC must submit major decisions for approval.[8]

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[4] Economist Intelligence Unit, *Country Profile, China* (March 2006), 53.

[5] *Regulation on the Foreign Exchange System of the People's Republic of China* (State Council, Order No. 532, issued January 29, 1996, amended January 14, 1997, further amended August 1, 2008).

[6] *Law of the People's Republic of China on the People's Bank of China* (adopted by NPC on March 18, 1995, amended December 27, 2003).

[7] *PBOC Law*, Article 4. For currency functions of PBOC and SAFE, *see also* IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions 2016* (October 2016), China country chapter, 750-793.

[8] *PBOC Law*, Article 5.

B. Capital Account Restrictions

Compared to other major emerging economies, China's capital account remains one of the most tightly restricted.[9] While China has relaxed some restrictions and reduced regulatory burdens over time, restrictions remain on twelve of thirteen categories of capital account transactions.[10] For example, portfolio investment continues to be controlled by quotas and can only be done through QFIIs, foreign borrowing is still subject to a ceiling (short-term borrowing) or approval requirements (long-term borrowing), and holding cross-border accounts still requires SAFE approval.[11] The Chinn-Ito index measures capital account convertibility, ranging from 2.39 (highest level of convertibility) to -1.89 (lowest level of convertibility). China's score in 2015 was -1.19, which has not changed since the 1990s. According to the index, this score is below average even for developing and emerging markets.[12]

In addition, PBOC also appears to use "window guidance" to SIEs and state-owned commercial banks (SOCBs) to discourage capital outflows.[13] PBOC also appears to use window guidance to encourage SIEs to sell holdings of foreign currency, and to require banks who remit RMB overseas to import a certain amount of RMB based on the RMB remitted to control net capital outflows.[14]

Between 2004 and 2010, large capital inflows placed upward pressure on the RMB, resulting in the tightening of restrictions on FOREX inflows and an easing of restrictions on outflows.[15]

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[9] Mark Kruger and Gurnain Kaur Pasricha, *What to Expect When China Liberalizes Its Capital Account* (Bank of Canada, April 2016), 2.

[10] IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions* (October 2016), 58. The indicators used by the IMF are binary and indicate whether such a restriction exists, but do not indicate the degree to which restrictions in each category may have changed.

[11] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 25.

[12] Hiro Ito and Menzie Chinn, *Notes on the Chinn-Ito Financial Openness Index 2014 Update* (June 30, 2016). *See also* Hiro Ito and Menzie Chinn, "What Matters for Financial Development? Capital Controls, Institutions, and Interactions," *Journal of Development Economics* 81(1) (October 2006): 163-192.

[13] Hongyi Chen et al., *To Guide or Not to Guide? Quantitative Monetary Policy Tools and Macroeconomic Dynamics in China*, BOFIT Discussion Papers (Bank of Finland, March 2017). *See also* Diego Anzoategui, Mali Chivakul, and Wojciech Maliszewski, *Financial Distortions in China: A General Equilibrium Approach*, IMF Working Paper (IMF, December 2015).

[14] Economist Intelligence Unit, *ViewsWire – China: FOREX Regulations* (February 24, 2017). *See also* Yusho Cho, "China Seeks Tighter Rein on Yuan-Selling, Capital Flight," *Nikkei Asian Review*, August 3, 2016. *See also Reuters*, "China's Tighter Capital Controls Impeding Western Firms' Payments, Dividends: Lobbies," December 7, 2016. *See also Financial Times*, "China Clamps Down on Banks Moving Currency Overseas," January 22, 2017.

[15] Mark Kruger and Gurnain Kaur Pasricha, *What to Expect When China Liberalizes Its Capital Account* (Bank of Canada, April 2016), 2.

After 2011, certain restrictions were eased, such as RMB raised offshore could be invested onshore. Companies based in China were also given greater access to foreign currency loans and were permitted to issue RMB bonds abroad.[16] However, since 2014, in the face of slowing economic growth, the government re-imposed restrictions on FOREX transactions and FOREX accounts for residents, companies, and financial institutions.[17] In addition, SAFE appears to have stopped issuing new allocations for the Qualified Domestic Institutional Investor (QDII) program, which the government established to allow companies based in China to invest abroad.[18] Since the end of 2016, the government has reportedly increased scrutiny of the size and purpose of individual and company outbound capital account transactions.[19] An annual individual FOREX quota of USD 50,000 resets the first of each year.[20]

China's significant restrictions on capital account convertibility result in relatively low use of the RMB internationally, as shown through various indicators. First, trade with China is most often invoiced and settled in currencies other than the RMB. The share of China's RMB-denominated goods trade, as a percentage of China's total goods trade, fell to approximately 15% in December 2016 from over 34% in August 2015.[21] Second, in terms of global trade finance, the RMB's market share fell to 4.6% in November 2016 from a high of 8.7% in 2013.[22] Third, the RMB has fallen from its position in December 2015 as the fifth most widely used international payments currency to the seventh as of April 2017, accounting for 1.6% of international payments.[23]

C. Foreign Exchange Market and the Exchange Rate Regime

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[16] *Ibid*.

[17] *Ibid*.

[18] *Ibid.*, 25. *See also Financial Times*, "China Halts Overseas Investment Schemes," February 28, 2016.

[19] Allen & Overy, *China's New Restrictions on Outbound Investments and Remittances* (December 30, 2016). *See also* Hogan Lovells, *China's New Foreign Exchange Controls Create Fresh Concerns* (January 18, 2017).

[20] *Reuters*, "China Steps Up Scrutiny on Individual Forex Purchases in the New Year," December 31, 2016.

[21] Kelvin Lau, Becky Liu and Chidu Narayanan, *Offshore Renminbi – Market Shrank 10.5% in 2016* (Standard Chartered Global Research, February 2017), 2. For a discussion of the incentives to hedge currency risk by invoicing and settling trade in different currencies with companies operating in China, *see also* Kathleen Walsh, "RMB Trade Invoicing: Benefits, Impediments and Tipping Points," *JASSA The Finsia Journal of Applied Finance* 2 (2015).

[22] *Reuters*, "Cooling Growth Pulls China's Yuan Down to Third Place in Global Trade Finance: SWIFT," November 22, 2016. For a discussion of the decline in the RMB's market share in world finance, *see also* Eswar Prasad, "A Middle Ground," *Finance and Development* 54(1) (IMF, March 2017), 30.

[23] Society for Worldwide Interbank Financial Telecommunications (SWIFT), *RMB Tracker – Monthly Reporting and Statistics on Renminbi (RMB) Progress towards Becoming an International Currency – May 2017* (May 23, 2017), 3. The RMB, as of April 2017, ranked behind the U.S. dollar (42.1%), Euro (31.1%), British Pound (7.3%), Japanese Yen (3.5%), Canadian Dollar (1.9%), and Swiss Franc (1.6%).

FOREX transactions traditionally occurred in the CFETS, the centralized interbank FOREX market. All transactions in the CFETS were conducted through a single state-owned entity at state-determined rates until 2006, when an over-the-counter (OTC) FOREX trading system was introduced in which banks were to facilitate transactions on the exchange.[24] The system initially had 15 banks designated as "market makers," which are banks that conduct OTC FOREX transactions and report the rates to the CFETS, which are then used as a component of the PBOC-set exchange rate.[25] There are now 32 market makers, including policy banks, private banks, local-level city banks, and foreign banks.[26] At the end of 2015, 440 domestic and foreign banks were conducting spot FOREX settlement and sales operations in the interbank market. Since then, PBOC has also permitted foreign central banks, international financial organizations, and sovereign wealth funds to engage in FOREX transactions.[27]

Over the last decade, China has modified its exchange rate regime several times.

- From July 2005 to July 2008, China adopted a managed floating exchange rate regime, which was intended to incorporate market forces and be linked to a basket of currencies, rather than solely to the USD.[28] However, China did not disclose the currencies comprising the basket, leading to the widespread view that the RMB was in fact still pegged to the USD.[29] Indeed, one empirical study found that the RMB continued to follow the USD closely.[30]

- During the global financial crisis, from 2008 to 2010, China formally reverted to a USD peg.[31]

- In June 2010, PBOC again announced its intention to resume a managed float of the RMB against a basket of currencies, but it did not publish any information on the

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[24] IMF, *China: 2015 Article IV Consultation–Staff Report* (August 2015), Informational Annex at 2-3.

[25] *Ibid*.

[26] PBOC and CFETS, *RMB/FX Market Makers*, available at http://www.chinamoney.com.cn/english/mdtmmbfmm/, accessed May 25, 2017. *See also* IMF, *China: 2016 Article IV Consultation – Staff Report* (November 2016), 46.

[27] IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions 2016* (October 2016), China country chapter at 753.

[28] Yin-Wong Cheung, Cho-Hoi Hui, and Andrew Tsang, *The Renminbi Central Parity: An Empirical Investigation*, (Hong Kong Institute for Monetary Research, June 2016), 4-5.

[29] IMF, *China: 2015 Article IV Consultation – Staff Report* (August 2015), Informational Annex at 2-3.

[30] Yin-Wong Cheung, Cho-Hoi Hui, and Andrew Tsang, *The Renminbi Central Parity: An Empirical Investigation* (Hong Kong Institute for Monetary Research, June 2016), 5. *See also* Jie Sun, "Retrospect of the Chinese Exchange Rate Regime after Reform: Stylized Facts during the Period from 2005 to 2010," *China & World Economy* 18(6) (2010): 19-35.

[31] IMF, *China: 2015 Article IV Consultation – Staff Report* (August 2015), Informational Annex at 3.

basket.[32] As a result, the assumption remained that the exchange rate regime was in fact a crawling USD peg, and the International Monetary Fund's (IMF) *Annual Report on Exchange Arrangements and Exchange Restrictions* classified China's exchange rate regime as a "crawl-like arrangement" during that time.[33]

PBOC has gradually widened the trading band around the daily fixing rate, which was ±2% as of March 2014.[34] Within the trading band, banks determine buying and selling prices on the basis of supply and demand.[35] However, the Chinese government can and does intervene in the market through the buying or selling of FOREX by either PBOC or SOCBs in order to move the exchange rate.[36]

Prior to 2015, market makers provided price quotes to PBOC based on their "sense of the market in the morning" for purposes of setting the central parity (or fixing) rate each morning.[37] However, many of the market makers were state owned and the price quotes given to PBOC were not necessarily actual market transaction data. The process remained opaque and PBOC had wide discretion in setting the fixing rate.[38] As a result, the fixing rate during this period moved only negligibly from day to day.[39]

Since 2015, two notable changes appear in the calculation of the fixing rate. First, in August 2015, PBOC announced the daily fixing rate would reflect the closing rate in the FOREX market the previous day.[40] This change seems intended to bring market forces of supply and demand to bear directly on the daily fixing rate. Second, in December 2015, the CFETS began publishing an exchange rate index that reflects movements in the value of the RMB against a basket of currencies.[41] The CFETS also disclosed the currencies in this basket and the trade weights

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[32] *Ibid*.

[33] *Ibid.*, 2.

[34] Yin-Wong Cheung, Cho-Hoi Hui, and Andrew Tsang, *The Renminbi Central Parity: An Empirical Investigation* (Hong Kong Institute for Monetary Research, June 2016), 5.

[35] IMF, *Annual Report on Exchange Arrangements and Exchange Restrictions 2016* (October 2016), China country chapter at 753.

[36] *Ibid.*, Informational Annex at 2.

[37] *Ibid.*, 46.

[38] *Ibid*.

[39] *Ibid*.

[40] PBOC, *The PBOC Announcement on Improving Quotation of the Central Parity of RMB against USD* (August 2015).

[41] PBOC, *The Launch of the RMB Index Helps to Guide Public View of RMB Exchange Rate* (December 2015).

attached to each currency.[42] With these two changes, the daily fixing rate is now calculated using both a weighted-average of closing rates from the previous day and an adjustment designed to ensure stability in the value of the RMB against the currency basket.[43]

Although these changes are important, a lack of transparency obscures the extent to which market forces affect the rate-setting process. It is not clear whether PBOC collects closing rates from all market makers or only a subset, and if the latter, on what basis the subset is chosen. PBOC apparently calculates the daily fixing rate using only rates from 14 of the market makers.[44] In addition, although the CFETS now publishes the trade weights attached to the currencies in the basket, it still does not publish the weights attached to various closing rates of market makers used to set the daily fixing rate.[45] In fact, studies have found that administrative discretion explains a large percentage of the cumulative change in the fixing rate to date, and that the market-determined component has been small.[46] Indeed, opacity combined with interventions have lowered market participants' expectations in FOREX markets as a reliable measure of the RMB's value. Instead, they remain sensitive to signals from and interventions by Chinese government authorities.[47]

In May 2017, it was reported that PBOC will include, in the calculation of the fixing rate, a coefficient to limit or moderate the tendency toward pro-cyclical adjustment of the fixing rate based on exchange rate movements in the market.[48] What PBOC refers to as the "counter-cyclical coefficient" would effectively reduce the extent of market forces on the fixing rate.[49]

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[42] Yin-Wong Cheung, Cho-Hoi Hui, and Andrew Tsang, *The Renminbi Central Parity: An Empirical Investigation* (Hong Kong Institute for Monetary Research, June 2016), 6-7.

[43] Guan Tao, *8/11 Exchange Rate Reform: Review and Prospects*. [Presentation] Second CF40-PIIE China Economic Forum (Peterson Institute of International Economics, October 5, 2016), slide 26.

[44] Logan Wright, *Distrust but Verify* (Rhodium Group, June 6, 2016), 2. *See also* Logan Wright, *A Revealing PBOC Adjustment to the Yuan Fixing* (Rhodium Group, May 26, 2017).

[45] IMF, *China: 2015 Article IV Consultation – Staff Report* (August 2015), Informational Annex at 3.

[46] Logan Wright, *A Revealing PBOC Adjustment to the Yuan Fixing* (Rhodium Group, May 26, 2017), 2.

[47] *See e.g.*, U.S. Department of the Treasury, *Foreign Exchange Policies of Major Trading Partners of the United States* (April 14, 2017), 15; Tamim Bayoumi, *A Basket Case? The Future of the Renminbi Exchange Rate Regime: Part 2*, China Economic Watch Blog (Peterson Institute for International Economics, December 22, 2015); *Reuters*, "Spread Between Onshore, Offshore Yuan Widest Since September 2011," January 5, 2016.

[48] Barclays Bank, *Reportedly Fine Tuning the CNY Fixing Mechanism*, May 26, 2017. *See also* China International Capital Corporation Limited (CICC), *PBOC to Add 'Counter-Cyclical Coefficient' to CNY Fixing Formula*, CICC Macroeconomy Research – PBOC Watch (May 26, 2017). *See also* Logan Wright, *A Revealing PBOC Adjustment to the Yuan Fixing* (Rhodium Group, May 26, 2017). *See also Bloomberg,* "China Considers Changing Yuan Fixing Formula to Curb Swings," May 25, 2017.

[49] *Ibid.*

This change, if implemented, would signal a step back from PBOC's stated goal of greater exchange rate flexibility.[50]

In December 2015, the IMF began to include the RMB in the currency basket of the Special Drawing Right (SDR), along with the USD, the Euro, the Japanese Yen, and the British Pound.[51] The SDR basket consists of currencies (1) of the largest exporting member countries and (2) that the IMF has determined to be "freely usable."[52] Although this signals an important step toward RMB internationalization, in a report detailing initial considerations of including the RMB in the SDR basket, the IMF expressed some concerns regarding the "freely usable" criteria in the context of existing capital controls, and the observed deviation between onshore and offshore RMB exchange rates.[53] The IMF stated that if the RMB were accepted as an SDR basket currency, "a number of issues would need to be resolved."[54] Even after the IMF added the RMB to the SDR basket, the IMF emphasized that operational challenges remain and that China would need to continue to implement reforms.[55] Shortly after the IMF made its decision to include the RMB in the SDR basket, PBOC announced the components of the currency basket.[56] Analysts believe the inclusion of the RMB in the SDR basket will not, at least in the near term, have a significant effect on the demand for the currency or the allocation of global reserves of central banks, since the RMB is not yet fully convertible.[57]

Controls on many capital account transactions limit the purchase and sale of RMB in the onshore RMB (CNY) market, but the same is not true in the offshore RMB (CNH) market.[58] In addition, the CNH market rate is free-floating and not subject to a trading band.[59] The differences in capital controls and exchange rate regimes are what allow the exchange rates to diverge, and

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[50] Logan Wright, *A Revealing PBOC Adjustment to the Yuan Fixing* (Rhodium Group, May 26, 2017).

[51] IMF, *IMF's Executive Board Completes Review of SDR Basket, Includes Chinese Renminbi* (November 30, 2015).

[52] IMF, *Special Drawing Rights Fact Sheet*, available at http://www.imf.org/en/About/Factsheets/Sheets/2016/08/01/14/51/Special-Drawing-Right-SDR, updated April 21, 2017, accessed September 14, 2017.

[53] IMF, *Review of the Method of the Valuation of the SDR – Initial Considerations* (August 3, 2015), 40.

[54] *Ibid*.

[55] IMF, *Review of the Method of the Valuation of the SDR – Initial Considerations* (August 3, 2015), 1, 28, 30-31.

[56] *Xinhua*, "China Releases Yuan Exchange Rate Composite Index," December 12, 2015.

[57] Council on Foreign Relations, *China's Bond Market Can't Handle a Global RMB*, Geo-Graphics Blog (December 2016).

[58] Eswar Prasad, *China's Efforts to Expand the International Use of the Renminbi*, Report prepared for the U.S.-China Economic and Security Review Commission (The Brookings Institution, February 4, 2016).

[59] Wells Fargo, *Conducting Business in China: When to Use Renminbi instead of the U.S. Dollar*, Wells Fargo Global Focus (October 2014). *See also* J.P. Morgan Chase Bank NA, *One Currency, Two Markets Part 1: Markets, Navigate the Rise of the Global RMB*, Insights from J.P. Morgan (J.P. Morgan, 2013), 3-7.

without such controls, arbitrage would close the gap between the CNH and CNY. However, similar to the onshore CNY market, PBOC reportedly intervenes significantly in the offshore CNH market to prevent the offshore and onshore exchange rates from diverging significantly.[60] In comparison to the onshore CNY market, the offshore CNH market is quite small. The total CNY/CNH combined average daily trading volume in April 2016 was $202 billion,[61] of which CNH trading comprised approximately $30 billion.[62]

D. Assessment of Factor

The RMB is convertible into foreign currencies for trade purposes. China has made market-oriented modifications to its capital account and exchange rate system. China has also taken steps to develop its FOREX market. However, China still maintains significant restrictions on capital account transactions and intervenes considerably in onshore and offshore FOREX markets. Approval requirements remain for all major capital account transactions, including investment, borrowing, and cross-border accounts. Although participation in the FOREX market is more economically diverse and has increased, PBOC still maintains ultimate control of the value of its currency through FOREX market interventions and the central parity rate-setting process.

The central parity rate against the USD now reflects the closing FOREX market rate of the previous day and an adjustment needed to maintain stability against a basket of currencies. However, the CFETS does not disclose the weights attached to price quotes from the previous day used to calculate the central parity rate. Moreover, significant FOREX interventions are necessary for the RMB to follow the currency basket. For these reasons, it is not clear to what extent China's modifications to its system have brought market forces directly to bear on the exchange rate. Although the offshore CNH market is more open and market-oriented than the onshore CNY market, it is relatively small, and its openness must be qualified by the fact that the PBOC makes significant FOREX interventions that limit the extent of price divergence between the two markets.

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[60] Financial industry publications have published reports of Chinese government intervention in the offshore CNH market. *See* Neil Gough, "China, Seeking to Stop Weakening Currency, Issues Restrictions," *Deal Book, The New York Times*, January 5, 2017. *See also Financial Times*, "Intervention Speculation as Offshore Renminbi Volatility Rises," September 13, 2016. *See also Bloomberg*, "China Said to Intervene in Offshore Yuan Market to Curb Declines," June 29, 2016.

[61] Bank for International Settlements (BIS), *Turnover of OTC Foreign Exchange Instruments* (April 2016), available at https://www.bis.org/statistics/d11_1.pdf, accessed September 17, 2017.

[62] John W. Labuszewski and Sandra Ro, *Offshore Chinese Renminbi Market (CNH)* (Chicago Mercantile Exchange Group, March 4, 2014), 2-3.

Factor Two: The extent to which wage rates in the foreign country are determined by free bargaining between labor and management.

Wages are an important component of a producer's costs and prices. This factor examines the extent to which wage rates in China are determined by free bargaining between labor and management. The statutory language concerning "free bargaining between labor and management" reflects concerns about the extent to which wages in an economy are market-based, *i.e.*, about the existence of a market for labor services in which workers and employers are free to bargain over the terms and conditions of employment.

Part A of this section describes the legal and institutional framework governing labor relations in China, including the principal labor laws and the trade union, ACFTU. Part B analyzes the wage formation process in China, beginning with a discussion of wage growth trends, and then proceeding to analyze labor law dispute resolution, trade unions and collective bargaining, and the household registration ("*hukou*") system. Significant institutional constraints on the extent to which wage rates are determined through free bargaining between labor and management in China remain. In addition, the restrictions on labor mobility through the *hukou* system continue to distort the supply side of the labor market.

A. Legal and Institutional Framework

The *Labor Law of the People's Republic of China* ("*Labor Law*") applies to all enterprises, including SIEs, domestic private enterprises, and foreign-invested enterprises (FIEs).[63] The *Labor Law* grants enterprises the right to set their own wages above the government-set minimum wage.[64] Under the 2004 *Minimum Wage Regulations*,[65] minimum wages are set by locality (province or municipality) and each province must set a minimum wage that is between 40% and 60% of the local average wage.[66]

The *Labor Law* provides that employees may join or organize trade unions and negotiate collective contracts,[67] but Chinese law does not permit workers to organize or join unions not approved by the state. China's system of "collective consultation" is characterized by a top-down approach that diverges from the concept of worker-led collective bargaining that exists in many

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[63] *The Labor Law of the People's Republic of China* (adopted by NPC on July 5, 1994, effective January 1, 1995, amended August 27, 2009).

[64] *Labor Law*, Articles 47 and 48.

[65] *Minimum Wage Regulations* (Ministry of Labor and Social Security [now Ministry of Human Resources and Social Security], Order No. 21, issued January 20, 2004).

[66] *Minimum Wage Regulations*, Attachment, Section 2. In September 2016, nine regions in China raised the local minimum wage. People in Shanghai enjoyed the highest increase, of RMB 2,190 per month. *China Daily*, "China Anticipates Booming Job Market in 2016," October 27, 2016.

[67] *Labor Law*, Articles 7 and 33.

Western economies. Workers in China also do not have the right to strike under Chinese law.[68] While the *Constitution of the People's Republic of China* ("*PRC Constitution*") provides for the freedom of peaceful assembly, it also stipulates that such activities may not infringe upon the interests of the state.[69]

ACFTU has been China's official trade union since the founding of the People's Republic of China in 1949. ACFTU's legal monopoly on all trade union activities is codified in the *Trade Union Law of the People's Republic of China* ("*Trade Union Law*") adopted in 1992, and remains unchanged after amendments to the law in 2001 and 2009.[70] The Chinese government prohibits independent unions and has systemically and, in some cases, forcibly repressed efforts to organize independent unions.[71] The *Trade Union Law* provides for ACFTU to preside over a network of subordinate trade unions that are related to one another in terms of the Leninist concept of "democratic centralism," which subordinates lower-ranking unions to higher-ranking ones.[72] ACFTU is subject to CCP control, and trade union leaders concurrently hold office at a corresponding rank in the CCP or the government.[73] The current ACFTU chairman is a member of the CCP Politburo.[74]

Trade union officials are officially employees of the Chinese government, further underscoring their status as government actors under CCP control.[75] While the *Trade Union Law* provides that union leaders must be elected, in practice, nearly all leaders are nominated or vetted by

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[68] Kai Chang and Fang Lee Cooke, "Legislating the Right to Strike in China: Historical Development and Prospects," *Journal of Industrial Relations* 57(3) (2015): 444 and 448. *See also* Dongtao Qi, *Progress and Dilemmas of Chinese Trade Unions*, East Asian Policy Background Brief 537 (East Asian Institute, National University of Singapore, 2010), 21.

[69] *Constitution of the People's Republic of China*, Articles 35 and 51 (adopted by NPC on December 4, 1982, amended March 29, 1993, further amended March 15, 1999 and March 14, 2004).

[70] *Trade Union Law of the People's Republic of China*, Article 10 (adopted by NPC on April 3, 1992, amended October 27, 2001, further amended August 27, 2009). *See also* Cynthia Estlund, *A New Deal for China's Workers?* (Cambridge: Harvard University Press, 2017), 47.

[71] *Bloomberg*, "Beijing Wants One Union to Rule Them All," November 10, 2016.

[72] *Trade Union Law*, Article 9.

[73] *Trade Union Law*, Article 4. *See also* Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 8.

[74] Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 8. *See also* "ACFTU Leadership" on ACFTU website, available at http://en.acftu.org/28589/201408/15/140815173447455.shtml, accessed September 13, 2017.

[75] Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 10-11.

enterprise management.[76] ACFTU must organize and approve all union activity, but ACFTU is not required to reflect solely, or even primarily, the interests of workers in disputes. Unions are nominally required to safeguard the legitimate rights and interests of the Chinese worker[77] while simultaneously playing their proper role in China's socialist modernization[78] and safeguarding the socialist State power under the people's democratic dictatorship.[79] Because China's trade unions are part of the Chinese government's institutional framework, with a responsibility to preserve harmony and stability in industrial relations,[80] there is an inherent tension in the dual functions they serve.

Over the last decade, the expansion of labor market institutions has coincided with new labor legislation, including the *Labor Contract Law of the People's Republic of China* ("*Labor Contract Law*")[81] and the *Law on Mediation and Arbitration of Labor Disputes of the People's Republic of China* ("*Labor Dispute Law*").[82] The *Labor Dispute Law* codifies protections for workers, such as strengthening regulations on termination of employment and establishing penalties for employers that fail to provide written labor contracts, pay wages on a timely basis, provide overtime pay, or provide compensation for terminated labor contracts.[83]

Attempts to resolve individual labor disputes in China generally progress in stages. First, a worker and the employer may attempt to resolve the matter through informal consultations.[84] If consultations fail to resolve the dispute, the parties may submit the matter to the enterprise's mediation commission or to an external government or quasi-governmental mediation committee.[85] If mediation fails or if the parties forego mediation, the parties may apply to the

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[76] *Ibid.*, 18-19.

[77] *Trade Union Law*, Article 6.

[78] *Constitution of the ACFTU*, Section "General Provisions" (adopted by ACFTU on October 22, 2013).

[79] *Trade Union Law*, Article 5.

[80] Sarah Biddulph, "Responding to Industrial Unrest in China: Prospects for Strengthening the Role of Collective Bargaining," *Sydney Law Review* 34 (2012): 48.

[81] *Labor Contract Law of the People's Republic of China* (adopted by NPC on June 29, 2007, effective January 1, 2008, amended December 28, 2012).

[82] *Law on Mediation and Arbitration of Labor Disputes of the People's Republic of China* (adopted by NPC on December 29, 2007, effective May 1, 2008). *See also* Chang-Hee Lee et al., "What Sort of Collective Bargaining is Emerging in China?" *British Journal of Industrial Relations* 54(1) (March 2016): 220.

[83] *Labor Contract Law*, Articles 82 and 85. *See also* Chang-Hee Lee et al., "What Sort of Collective Bargaining is Emerging in China?" *British Journal of Industrial Relations* 54(1) (March 2016): 220.

[84] *Labor Law*, Article 77 and *Labor Dispute Law*, Article 4. *See also* James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 451.

[85] *Labor Dispute Law*, Article 5. *See also* James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 451.

local labor dispute arbitration commission for resolution.[86] The arbitration commission is comprised of representatives of the Ministry of Human Resources and Social Security (MOHRSS) or another government authority, the trade union, and the employer.[87] MOHRSS or another government authority is responsible for administering the arbitration in practice.[88] If a party disagrees with the arbitration commission's decision, the disputing party may file a claim in court within 15 days of receiving the decision.[89]

While the *Labor Contract Law* and the *Labor Dispute Law* have added important protections for employees under the law, they do not advance the fundamental rights of freedom of association and collective bargaining, deemed essential in the ILO's 1998 *Declaration of Fundamental Principles and Rights at Work.*[90]

B. Constraints on Wage Formation

1. Wage Growth Trends

Since the 1980s, China's economy has experienced an increased dispersion of wages across regions, industries, experience, education level, job tenure, migrant status and company ownership category. At the same time, wages are converging across sub-sectors of urban manufacturing, consistent with a decrease in the surplus labor supply and labor market tightening.[91] In the context of China's rapid and sustained economic growth, there has also been a steady rise in real wages over time.[92] According to ILO estimates, between 2008 and 2014, real wages in China's urban units grew at a compound annual rate of 9.1%.[93]

However, growth in real wages has historically lagged labor productivity growth. According to ILO estimates, Chinese workers' average output increased at a compound annual rate of 9.6% between 2000 and 2012, while employees' average real compensation increased at an annual

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[86] *Labor Dispute Law*, Article 5.

[87] *Labor Dispute Law*, Article 19.

[88] James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 453.

[89] *Labor Dispute Law*, Articles 5 and 48.

[90] ILO, *ILO Declaration on Fundamental Principles and Rights at Work* (adopted by the International Labor Conference at its 86th Session on June 18, 1998, annex revised on June 15, 2010). *See also* Hillary Josephs, "Measuring Progress under China's Labor Law: Goals, Processes, Outcomes," *Comparative Labor Law & Policy Journal* 30(2) (2008): 391.

[91] O. Hyun Kwon et al., "Evolution of the Interindustry Wage Structure in China since the 1980's," *Pacific Economic Review* 20(1) (2015): 20-21.

[92] ILO, *Wages, Productivity and Labour Share in China*, Research Brief (April 2016), 1-2.

[93] *Ibid*., 1.

growth rate of 8.2% over the same period.[94] Over the period 2000-2011, the ILO also estimates a decline in the labor income share (ratio of compensation of employees over gross value added).[95] Thus, real wages have not kept pace with worker contributions to output, and Chinese workers' share in China's expanding economy has effectively declined. The ILO points to weak labor institutions and weakening workers' bargaining power as important factors contributing to this trend.[96]

As noted above, the minimum wage in China is set at the local level using a "living wage" approach that focuses on subsistence wage levels, rather than a "wage floor" approach that focuses on labor productivity.[97] As a result, minimum wage growth lags real wage growth, to the point where virtually all workers, local and migrant, men and women, skilled and unskilled, earn above the minimum wage.[98] Accordingly, the minimum wage is not a significant factor in determining whether workers receive a fair wage that reflects contributions to output.[99]

Wage arrears have been a perennial problem in China, particularly in the construction industry.[100] Excess industrial capacity and slower economic growth have exacerbated this problem in recent years. As industrial enterprises shut down, compensation to employees has increasingly gone unpaid.[101] Labor strikes, not expressly permitted under Chinese law but often tolerated by government authorities, have increased in recent years, driven in large part by wage payment and retrenchment compensation issues.[102] Wage arrears are a particular problem for

[94] *Ibid*., 5.

[95] *Ibid*.

[96] *Ibid*. ("The reasons for the decline have been debated, but typically include technological changes, globalization, financialization, and weak labour market institutions – all of which contribute to a weakening of workers' bargaining power. Other explanations note the rapid structural transformation (from the agricultural to the non-agricultural sectors) where the capital share is often higher, or the restructuring of state-owned enterprises and increased monopoly power within industry.")

[97] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 327-328.

[98] ILO, *Wages, Productivity and Labour Share in China*, Research Brief (April 2016), 3-4. *See also* World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 324.

[99] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 327.

[100] *The Economist*, "Can't Pay, Won't Pay," October 29, 2011. *See also China Daily*, "Government Helps 3.7m Workers Get Unpaid Wages," January 26, 2017.

[101] Economist Intelligence Unit, *China Economy: China Hand: Labour Resources* (September 16, 2015).

[102] U.S. Department of State, *2016 Human Rights Report: China* (2016), 68. ("Authorities rarely released statistics for labor disputes, but in November 2015 the official Xinhua News Agency reported a growing number of wage arrears cases totaling 11,007 in the first three quarters of 2015, an increase of 34% over the same period in 2014. Unofficial records from the Hong Kong-based labor rights NGO China Labor Bulletin (CLB) showed that at least 1,050 strikes and collective protests by workers occurred between December 2014 and February 2015, 90[%]

migrant workers, most of whom work without a formal, written labor contract.[103] According to MOHRSS, there were 11,007 migrant worker protests over wage arrears in the first three quarters of 2015, an increase of 34% over the same period in 2014.[104]

2. *Labor Law Dispute Resolution*

The Chinese government has implemented legislation such as the *Labor Contract Law* that provides employees with a cause of action to challenge particular aspects of an employee's labor contract in a Chinese court.[105] As legislation has expanded the scope of labor contracts, employees have increasingly challenged employers in Chinese courts.[106] Nonetheless, the *Labor Contract Law* and the *Labor Dispute Law* do not alter the fundamental relationship between the worker, the union, and the state.

As discussed above, individuals cannot join together to form independent trade unions or collectively bargain outside the institutional framework controlled by the Chinese government and the CCP. Instead, individual workers can only issue individual challenges on a case-by-case basis after the fact of an alleged violation of labor rules.[107] An individual worker's prosecution of a case under these laws can be time-consuming and costly.[108] Migrant workers, who often have few resources and who may not be geographically fixed, face particular challenges in pursuing claims under this system.[109] Official Chinese trade unions are required to provide legal aid to workers as long as workers use the prescribed legal channels to address their concerns. Yet, in many cases, particularly outside of China's wealthiest cities, unions lack the financial resources and legal capacity to provide adequate legal assistance.[110]

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relating to unpaid wages.") *See also* Economist Intelligence Unit, *China Economy: China Hand: Labour Resources* (September 16, 2015).

[103] Kam Wing Chan and Will Buckingham, "Is China Abolishing the Hukou System?" *China Quarterly* 195 (September 2008): 599.

[104] *China Labor Bulletin*, "China Saw a Dramatic Increase in Wage Arrears Protests in Run Up to New Year," February 3, 2016.

[105] For a detailed discussion, *see* Hualing Fu, "Bringing Politics Back In: Access to Justice and Labor Dispute Resolution in China." In *Justice: The China Experience*, (eds.) Flora Sapio et al. (Cambridge: Cambridge University Press, 2017), 356-378.

[106] Mimi Zou et al., "Regulating Collective Disputes in China: A Tale of Two Actors," *Journal of Comparative Law* 10(2) (2016): 279-281.

[107] Hualing Fu, "Bringing Politics Back In: Access to Justice and Labor Dispute Resolution in China," In *Justice: The China Experience*, (eds.) Flora Sapio et al. (Cambridge: Cambridge University Press, 2017), 356-378.

[108] *Ibid*.

[109] *Ibid*.

[110] *Ibid*.

Consequently, China's labor dispute resolution system has the effect of containing and controlling labor concerns rather than addressing fundamental issues that affect workers systemically and collectively.

3. Trade Unions and Collective Bargaining

Limited collective bargaining power constrains real wage growth and frustrates worker efforts to secure a fair wage. As discussed above, workers in China have limited collective bargaining power because they lack the freedom to associate and assemble and the right to strike, and because ACFTU, the only legally sanctioned trade union in China, remains an instrument of the Chinese government and the CCP. Managers of enterprises fill most ACFTU leadership positions, and in general, workers do not directly elect their union representatives.[111] A report by the ILO explains:

> ACFTU is not feared for its ability to call millions of workers into action but because it may activate support from the local government or the Party, in particular, as many trade union leaders double as Party secretaries or deputies in people's Congresses. Because a union leader's authority derives from the party-state which values social stability and not strong action against unwilling enterprises, and because company employees are not called into action to bargain for a better deal, employers usually find themselves in a comfortable position and able to give in selectively to union demands, while at the same time withholding substantial concessions. The whole top-down organisational process has become characterised by serious flaws which allow management to largely dominate and control trade unions.[112]

Accordingly, negotiations between labor and management in China have traditionally been described as "collective consultations," which are a "formality."[113] In actuality, either labor and management do not "carry out real bargaining" or "management does not even meet with the trade unions, and just sends them a collective contract for 'approval.'"[114] This context is at odds with the practice of collective bargaining as envisioned by international institutions such as the ILO, in which trade unions are "legitimate units of bargaining."[115] Formal indicia of trade union membership in China do not necessarily support a conclusion that free bargaining between

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[111] Mimi Zou et al., "Regulating Collective Disputes in China: A Tale of Two Actors," *Journal of Comparative Law* 10(2) (2016): 282-283.

[112] Rudolf Traub-Merz, *All China Federation of Trade Unions: Structure, Functions and the Challenge of Collective Bargaining*, Working Paper No. 13 (International Labor Office, Global Labour University, September 2011), 18.

[113] Chris King-Chi Chan and Elaine Sio-leng Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot' to 'Party State-Led Wage Bargaining,'" *China Quarterly* 217 (March 2014): 226.

[114] *Ibid*., 226. *See also* Mimi Zou et al., "Regulating Collective Disputes in China: A Tale of Two Actors," *Journal of Comparative Law* 10(2) (2016): 281-282.

[115] ILO, *International Labor Standards on Collective Bargaining* (2017); ILO, *International Labor Standards on Freedom of Association* (2017); Bernard Gernigon et al., *ILO Principles Concerning the Right to Strike* (ILO, 1998), 3. *See also* Chris King-Chi Chan and Elaine Sio-leng Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot' to 'Party State-Led Wage Bargaining,'" *China Quarterly* 217 (March 2014): 227.

management and labor is occurring.[116] Trade unions controlled by a formal management hierarchy from the top down, under the influence of the Chinese government and the CCP, enjoy little credibility with workers.[117]

The difficulties that workers face in vindicating their interests through the legal system or trade unions has increasingly led them to pursue their grievances through unauthorized strikes and protests, in which they demand to negotiate directly with management.[118] Even though official data is not available, most observers agree that the incidence of unauthorized labor strikes has been on the rise since the 1990s.[119] A notable series of illegal strikes in 2010 at manufacturing sites in southern China brought to the central government's attention the need to address workers' collective demands out of concern that the strikes might cause social unrest or lead to the development of independent and empowered unions.[120] For example, during a strike at a Honda plant in Guangdong province, workers demanded a direct role in union elections. In response to these demands, workers were given some role in electing union representatives. Still, workers were excluded as candidates for leadership positions, which continued to be filled by company managers and supervisors.[121]

The top-down, state-led approach to collective bargaining in China essentially produces government-managed outcomes. In some cases, unauthorized strikes take place outside the institutional framework that governs industrial relations, and the subsequent bargaining between workers and management has moderately improved wages and working conditions.[122] However, this approach is fundamentally different from a market-based, bottom-up, worker-led negotiating

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[116] By 2011, 3.6 million enterprises had signed 1.8 million collective contracts covering 223 million workers. *See* Mimi Zou et al., "Regulating Collective Disputes in China: A Tale of Two Actors," *Journal of Comparative Law* 10(2) (2016): 281.

[117] *Ibid*., 283-284.

[118] Chris King-Chi Chan and Elaine Sio-leng Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot' to 'Party State-Led Wage Bargaining,'" *China Quarterly* 217 (March 2014): 238.

[119] Chang-Hee Lee et al., "What Sort of Collective Bargaining is Emerging in China?" *British Journal of Industrial Relations* 54(1) (March 2016): 222. According to official statistics, there were 9,000 "mass incidents" in 1994 and 87,000 in 2005, the last year the government released figures. In 2008, the number of incidents was estimated to be 127,000 according to a leaked report. It is unclear how many of these incidents are labor-related. One scholar estimates that approximately 30,000 strikes and protests by workers occurred in 2009. Manfred Elfstrom and Sarosh Kuruvilla, "The Changing Nature of Labor Unrest in China," *ILR Review* 67(2) (April 2014): 454.

[120] Chris King-Chi Chan and Elaine Sio-leng Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot' to 'Party State-Led Wage Bargaining,'" *China Quarterly* 217 (March 2014): 228-229, 238-239.

[121] *Ibid*., 228-234.

[122] Chang-Hee Lee et al., "What Sort of Collective Bargaining is Emerging in China?," *British Journal of Industrial Relations* (March 2016): 232-233.

process in which workers' leverage reflects their right under the law to strike.[123] Recent government campaigns to restrict the operations and activities of labor rights non-governmental organizations (NGOs) suggest that the government's focus will remain on obtaining preferred outcomes, rather than on fundamental changes in the legal role and capacity of trade unions in China.[124]

4. *The Hukou System*

Under the *hukou* system administered by the Chinese government, every Chinese citizen since the 1950s has been classified at birth as either an "agricultural" (rural) or "non-agricultural" (urban) resident and registered with a local jurisdiction – a city, town, or village – that is considered his or her official and only place of "permanent residence." This local *hukou* typically passes from mother to child and entitles the holder to services including education, housing, healthcare, and social welfare provided by the local jurisdiction.[125] Transferring one's *hukou* classification from agricultural to non-agricultural status or changing the place of registration is a difficult bureaucratic process.[126]

A key purpose for establishing the *hukou* system under China's command economy was to prevent mass migration to cities, while ensuring sufficient supplies of labor for grain production in rural areas and for industrial projects under government control.[127] After 1978, rapid economic growth and urban expansion created a demand for labor that was met by migration from rural to urban areas and from central to coastal regions. Over time, the persistence of the *hukou* system has resulted in an acute imbalance: over half of China's population now lives in urban areas, but only one-third of the urban population holds an urban *hukou*.[128]

Access to low-cost migrant labor has contributed to China's emergence as a low-cost production center in the global economy. As one scholar has noted, the *hukou* system has created a "huge

[123] Chris King-Chi Chan and Elaine Sio-leng Hui, "The Development of Collective Bargaining in China: From 'Collective Bargaining by Riot' to 'Party State-Led Wage Bargaining,'" *China Quarterly* 217 (March 2014): 238. *See also* Bernard Gernigon et al., *ILO Principles Concerning the Right to Strike* (ILO, 1998), 9, 11-12.

[124] *Financial Times*, "China Police Arrest Activists in Campaign Against Labour Unrest," January 11, 2016.

[125] Kam Wing Chan, "The Chinese Hukou System at 50," *Eurasian Geography & Economics* 50(2) (2009): 201-202. *See also* Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 2.

[126] Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 3.

[127] Maarten Bosker et al., *Hukou and Highways: The Impact of China's Spatial Development Policies on Urbanization and Regional Inequality*, Policy Research Working Paper WPS7350 (World Bank Group, Development Research Group, June 2015), 7. *See also* Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 2.

[128] Kam Wing Chan, "The Household Registration System and Migrant Labor in China: Notes on a Debate," *Population and Development Review* 36(2) (June 2010): 359.

class of super-exploitable, yet highly mobile or flexible industrial workers for China's new economy, now closely integrated into global trade networks."[129] For example, in China's largest migrant labor city, Shenzhen, often referred to as the "world's factory," local government officials have acknowledged that the city could not have achieved its rapid economic growth without rural migrant labor.[130]

Several *hukou*-related factors continue to limit labor mobility. First, rural *hukou* holders have shown reluctance to transfer their *hukou* to an urban location because it requires them to relinquish their increasingly valuable rural land-use rights, which in many cases represents the only retirement security that rural residents and their families have.[131] Second, rural residents that migrate outside the geographical area of their *hukou* registration may not have access to public services, healthcare benefits, housing, the educational system and formal employment under a written labor contract.[132]

The Chinese government has recently taken steps to modify the *hukou* system. The State Council *Opinion on Further Promoting Hukou System Reforms* ("*Opinion on Hukou Reform*")[133] issued in 2014 calls for several changes, including: removing the distinction between agricultural and non-agricultural *hukou*, and instead registering citizens by their place of origin;[134] allowing migrants to apply for a local *hukou* after holding a mandatory residence permit in an urban area for a certain period of time;[135] and permitting rural land-use rights holders to retain at least some of the value of their land-use right after obtaining an urban *hukou*.[136]

Nevertheless, these changes represent a modification of the *hukou* system rather than its elimination, and many aspects of the *hukou* system continue to limit labor mobility in China.[137]

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[129] Kam Wing Chan, "The Chinese Hukou System at 50," *Eurasian Geography & Economics* 50(2) (2009): 206-207.

[130] *Ibid*., 208. *See also* Kam Wing Chan, "The Household Registration System and Migrant Labor in China: Notes on a Debate," *Population and Development Review* 36(2) (June 2010): 359-360.

[131] Kam Wing Chan, "The Chinese Hukou System at 50," *Eurasian Geography & Economics* 50(2) (2009): 205. *See also* Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 6.

[132] Ming Lu and Yiran Xia, *Migration in the People's Republic of China*, Working Paper No. 593 (ADBI, September 2016), 5-7. *See also* Jason Gagnon et al., "Are Migrants Discriminated Against in Chinese Labor Markets?" *IZA Journal of Labor and Development* 3(17) (2014): 9-12.

[133] *State Council Opinion on Further Promoting Hukou System Reforms* (State Council, Guo Fa [2014] No. 25, issued July 24, 2014).

[134] Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 3.

[135] *Opinion on Hukou Reform*, Article 10.

[136] *Opinion on Hukou Reform*, Article 12.

[137] *Ibid*., 6.

The State Council's recent proposals have not been enshrined in major laws, and are often implemented on only a partial or pilot basis. Notably, the *Opinion on Hukou Reform* provides that controls be stricter in large cities, particularly mega-cities such as Beijing, Shanghai, and Shenzhen, than in small and medium-sized cities.[138] This concept of basing *hukou* policy on city size was first put forward in the *Decision on Several Major Issues for Comprehensively Deepening Reform* ("*Third Plenum Decision*") adopted by the CCP Central Committee (CCPCC) and the State Council in 2013.[139] Restrictions in larger cities make it difficult, if not impossible, for the vast majority of migrants to obtain an urban *hukou* in the urban areas where the best economic opportunities are located. Those migrants and their dependents who still choose to live in the larger cities will continue to face uncertainty regarding access to social services, education and healthcare.[140] Conversely, in the small and medium-sized cities where the Chinese government is relaxing controls on labor flows, economic opportunities are fewer and social services more limited.

Fiscal budget constraints, discussed further in Factor 4.B. of this report, are key impediments to achieving meaningful *hukou* reform. Local governments bear inordinate responsibility for financing public services such as policing, schools, hospitals, and roads.[141] A relaxation of the *hukou* system could accentuate this imbalance by increasing demand for municipal services. In 2016, the Chinese government announced further *hukou*-related changes aimed at increasing the "carrying capacity" of social services in local government budgets.[142] As this is a very recent development, it is difficult to assess its efficacy at this stage.

C. Assessment of Factor

The Department observes variability in wages across regions, sectors, and enterprises in China, and the steady rise of real wages in China's economy. Nonetheless, a number of institutional constraints limit the extent to which market forces contribute to wage formation in China. While China has expanded legislation to protect workers' legal rights, these developments have not

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[138] Chapter II of the *Opinion on Hukou Reform* calls for exercising strict control over the population of megacities, which are defined as cities with populations greater than five million. "Strict control" involves establishing a number of *hukou* eligibility criteria, to be evaluated according to a points system. A more relaxed set of criteria is applied to large cities with one million to three million and three million to five million residents, respectively.

[139] *Decision on Several Major Issues for Comprehensively Deepening Reform*, Article 23 (adopted by CCPCC at the Third Plenary Session of the 18th National Congress of the CCP on November 12, 2013). ("We will introduce new population management methods, accelerate the reform of household registration system, completely lift restrictions on new residence registration in administrative townships and small cities, relax restrictions on new residence registration in medium-sized cities in an orderly manner, lay down appropriate conditions for new residence registration in large cities, and strictly control the population size of megacities.")

[140] Charlotte Goodburn, *The End of the Hukou System? Not Yet*, China Policy Institute Policy Paper (China Policy Institute, University of Nottingham, September 2014), 4-5.

[141] *See* Athar Hussain and Nicholas Stern, "Public Finances, the Role of the State, and Economic Transformation, 1978-2020," In *Public Finance in China: Reform and Growth for a Harmonious Society*, (eds.) Jiwei Lou and Shuilin Wang (Washington, DC: World Bank, 2008), 13-38.

[142] *Program to Promote 100 million of the Non-Registered Population to Settle in the City* (State Council, Guo Ban Fa [2016] No. 72, issued September 30, 2016).

reduced restrictions on collective bargaining. Workers do not have the legal right to strike or organize independently, and as such, have no meaningful freedom of association. All trade unions are affiliates of the government-controlled ACFTU and its branches at the local and enterprise level. The legal and institutional relationship with the government inhibits unions from acting as true advocates of workers' rights and as a meaningful counterweight to management. Collective action has been on the rise, but these incidents are generally outside of the institutional process, and the Chinese government only condones them when they do not threaten social stability.

In addition, restrictions on labor mobility through the *hukou* system continue to inhibit and guide labor flows within China and to distort the supply side of the labor market. The Department notes recent efforts by the Chinese government to modify the *hukou* system by relaxing eligibility, allowing some rural residents to retain the value of rural land-use rights, and addressing local government budgetary constraints that affect the provision of municipal services. Nonetheless, the *hukou* system continues to limit wages and mobility, particularly in the largest cities that afford the best economic opportunities. Millions of migrant workers across China, who play a central role in China's low-cost labor force, continue to lack access to basic amenities and worker protections.

Factor Three: The extent to which joint ventures or other investments by firms of other foreign countries are permitted in the foreign country.

Opening an economy to foreign investment tends to expose domestic industry to foreign competition, including the management, production and sales practices that foreign enterprises bring to the host economy together with their investments. It also tends to reduce the scope and extent of government control over the market, since foreign investors, as a general rule, demand a certain degree of autonomous control over their investments.

Under this factor, the Department analyzes the Chinese government's foreign investment regime to assess the extent to which foreign investors are able to access China's market and how government interventions serve as barriers to foreign investment. (In Factor 5, the Department will further analyze how the Chinese government's foreign investment regime distorts resource allocations and market outcomes.) Part A of this section reviews the legal and institutional framework governing foreign investment, including the laws related to establishing an FIE, the foreign investment catalogue, and the foreign investment approval processes. Part B describes trends in China's inbound FDI flows, and then proceeds to analyze some of the key constraints on foreign investment, including equity limits and local partner requirements; the investment approval and regulatory process; technology transfer and localization requirements; and anti-monopoly enforcement and national security reviews.

In 2017, the Chinese government continues to rely on a foreign investment catalogue to encourage foreign investment in some sectors of the economy, while restricting or prohibiting it in others. The Chinese government continues to be ranked by the OECD as one of the most restrictive FDI regimes in the world. Although China has opened its economy to foreign investment over the last few decades in many respects, China's foreign investment regime continues to shield Chinese enterprises from competition, particularly those the Chinese government is trying to cultivate as market leaders. The Chinese government recently introduced a "negative list" system to its foreign investment regime, but substantial barriers to foreign investment remain.

A. Legal and Institutional Framework

1. Laws Establishing FIEs

The three most common corporate forms of FIEs in China are contractual joint ventures (CJV), equity joint ventures (EJV), and wholly foreign-owned enterprises (WFOE). These three corporate forms are governed by three separate laws, namely the *Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures*, the *Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures*, and the *Law of the People's Republic of China* *on Wholly Foreign-Owned Enterprises*.[143] Each of these forms of investment have different requirements and restrictions under Chinese law.[144]

When the Chinese government first began to open the economy to foreign investment, foreign companies often found that a Chinese joint venture partner was necessary for a successful market entry strategy, and in some cases, market access for foreign investment has been conditioned on forming a joint venture with a Chinese partner. Over time, as restrictions loosened, the WFOE became the dominant form of foreign investment in China because it provides a foreign investor with more control than a joint venture.[145] However, the Chinese government continues to prohibit WFOEs in certain sectors, and as a result, joint ventures with a Chinese firm remain an important facet of the foreign investment environment in China today.

2. *Foreign Investment Catalogue*

All FIEs must comply with the *Catalogue of Industries for Guiding Foreign Investment* ("*Foreign Investment Catalogue*").[146] Since the *Foreign Investment Catalogue* was first issued in 1995, it has been one of the fundamental legal documents regulating foreign investment in China, and it is the starting point for analyzing the potential restrictions on foreign investment in any particular industry.[147] The *Foreign Investment Catalogue* divides industries into three basic categories for foreign investment purposes: (1) "encouraged," (2) "restricted," and (3) "prohibited." Those industries not explicitly listed in the *Foreign Investment Catalogue* are

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[143] *Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures* (adopted by NPC on April 13, 1988, amended October 31, 2000, further amended September 3, 2016 and November 7, 2016); *Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures* (adopted by NPC on July 8, 1979, amended April 4, 1990, further amended March 15, 2001 and September 3, 2016); *Law of the People's Republic of China on Wholly Foreign-Owned Enterprises* (adopted by NPC on April 12, 1986, amended October 31, 2000, further amended September 3, 2016). In January 2015, China released a draft *Foreign Investment Law* for public comment, which if adopted, would create one law that would govern each of these different forms of foreign investment. *Notice on Seeking Comments to the "Foreign Investment Law of the People's Republic of China" (Draft for Public Comment)* (MOFCOM, issued January 19, 2015).

[144] James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 103. One difference between a CJV and an EJV is that parties to a CJV may agree to the entity's management structure, whereas the management structure of an EJV must comply with relevant laws and regulations. *Ibid.*, 94.

[145] *Ibid*., 93. *See also* Ken Davies, *International Investment – China Investment Policy: An Update*, OECD Working Papers on International Investment 2013/01 (OECD, 2013), 52.

[146] *Catalogue of Industries for Guiding Foreign Investment (2017Amendment)* (NDRC and MOFCOM, Order No. 4, issued June 28, 2017).

[147] In addition to the *Foreign Investment Catalogue*, China also issues the *Catalogue of Advantageous Industries for Foreign Investment in the Central and Western Regions* (NDRC and MOFCOM, Order No. 33, issued February 17, 2017, effective March 20, 2017), which encourages foreign investment in China's less developed regions. The most recent revision to this catalogue in February 2017 was the fourth since the catalogue was first issued in 2000. It covers 22 provinces and municipalities. *See also* the *Provisions Guiding the Direction of Foreign Investment* (State Council, Order No. 346, issued February 1, 2002, effective April 1, 2002).

deemed to be "permitted."[148] Different categories of investment in the *Foreign Investment Catalogue* generally lead to different degrees of approval scrutiny or application requirements. For example, foreign investment in "restricted" industries is often subject to stricter government review and more burdensome application requirements. For some industries, the *Foreign Investment Catalogue* requires that investment take a particular form (such as a CJV or EJV), that the proportion of foreign equity investment in the enterprise be capped at a particular level, or that the Chinese party must have a controlling interest.

The *Foreign Investment Catalogue* was amended in 2002 and 2005 to reflect China's WTO commitments to open certain sectors to foreign investment. An additional revision in 2007 placed new restrictions on several industries, including chemicals, auto parts, rare earths and processing, biofuel production, and edible oil processing.[149] The *Foreign Investment Catalogue* was again revised in 2011, with only minor changes, which, *inter alia*, added wholly foreign-owned medical establishments and removed the retailing of OTC medicines from the "restricted" category.[150] The *Foreign Investment Catalogue* was amended again in 2015 with 38 sectors remaining in the "restricted" category and 36 sectors in the "prohibited" category.[151] While the 2015 *Foreign Investment Catalogue* liberalized investment in a few areas, including the manufacture of chemicals and chemical raw materials, it did not liberalize many of the sectors important to foreign investors, such as services, agriculture, extractive industries, and other manufacturing sectors.[152]

China released a revised *Foreign Investment Catalogue* in June 2017, which continues to contain an "encouraged" category and places "restricted" and "prohibited" investments under a "Negative List for Foreign Investment Access" ("Negative List"). Encouraged industries may benefit from special incentives, but can still be subject to certain restrictions on foreign investment if they are also included on the Negative List.[153] China has indicated that it intends to move to a comprehensive negative list approach, in which foreign investment in all sectors is

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[148] *Provisions Guiding the Direction of Foreign Investment*, Article 4 (State Council, Order No. 346, issued February 1, 2002, effective April 1, 2002).

[149] *Catalogue of Industries for Guiding Foreign Investment (2007 Amendment)* (NDRC and MOFCOM, Order No. 57, issued October 31, 2007, effective December 1, 2007).

[150] *Catalogue of Industries for Guiding Foreign Investment (2011 Amendment)* (NDRC and MOFCOM, Order No. 12, issued December 24, 2011, effective January 30, 2012).

[151] *Catalogue of Industries for Guiding Foreign Investment (2015 Amendment)* (NDRC and MOFCOM, Order No. 22, issued March 10, 2015, effective April 10, 2015). *See also* AmCham China, *China's Investment Environment: Overcoming Impediments to the US-China BIT* (October 2015), 10.

[152] *Catalogue of Industries for Guiding Foreign Investment (2015 Amendment)* (NDRC and MOFCOM, Order No. 22, issued March 10, 2015, effective April 10, 2015).

[153] *Catalogue of Industries for Guiding Foreign Investment (2017Amendment)* (NDRC and MOFCOM, Order No. 4, issued June 28, 2017). Encouraged industries subject to foreign equity restrictions are listed twice, once under the encouraged category and then again under the restricted category.

permitted unless it is expressly included on a negative list.[154] Nonetheless, China is still using an approach that is fundamentally similar to previous versions of the *Foreign Investment Catalogue*.

By promoting foreign investment in certain industries while limiting or altogether prohibiting foreign investment in others, the *Foreign Investment Catalogue* reflects the Chinese government's policy priorities by channeling foreign investment into industries of its choosing.[155] As discussed under Factor 5, the Chinese government's industrial policies include encouraging foreign investment in high-technology industries, promoting indigenous innovation, developing national champions, guiding the development of Chinese domestic industries up the value chain and protecting sensitive and strategic industries from foreign investment.[156] The Chinese government's industrial policies are set forth in a multitude of other planning documents, such as five-year plans, which lay out its economic and development objectives for a five-year period, as well as other administrative regulations, departmental rules, and regulatory documents.

3. *Foreign Investment Approval Process*

In contrast to many market economies where corporate registration for any company, foreign or domestic, consists of filing the articles of incorporation with the relevant authorities, foreign investors in China are required to seek approvals from, or register with, multiple Chinese government agencies before an FIE can be established. In addition, after an FIE has been established, further government approvals may be required for significant changes to the enterprise, such as changes to the corporate structure, as well as expansion plans, such as opening new facilities or expanding product lines.[157]

Historically, Chinese law has required a foreign investor to file an application to obtain a certificate of approval by MOFCOM or its local branch in order to establish an FIE. This process typically includes submitting the relevant contracts and articles of association of the proposed

[154] *Opinions on the Implementation of the Market Access Negative List System*, Section 1(1) (State Council, Guo Fa [2015] No. 55, issued October 19, 2015, effective from December 1, 2015 to December 31, 2017).

[155] Wenbo Gu, "A Comparative Study on Foreign Investment Legal System in China," *Frontiers of Law in China* 5(3) (September 2010): 458, 460-461. *See also* European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016), 19; Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 102, 105-106.

[156] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 8-9; Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 16-17, 103-104.

[157] James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), Chapter 4.F. *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 20-22.

FIE.[158] According to the regulations establishing FIEs, MOFCOM or its local branch will not grant approval to a foreign investment in certain circumstances, including, *inter alia*, if (i) an investment would injure China's sovereignty or the public interest or would endanger state security; (ii) a CJV arrangement would violate Chinese laws, regulations or industrial policies; (iii) an EJV or a WFOE would not meet the "requirements of the development of China's national economy"; or (iv) an EJV arrangement includes obvious unfairness and harms the rights and interests of the Chinese party to the EJV.[159] In contrast, domestic investors generally only need to submit a "record" filing with the relevant government authority, rather than seeking approval from MOFCOM or its local branch.[160]

In September 2016, the Chinese government amended the laws governing CJVs, EJVs, and WFOEs, such that foreign investors in industries that are not listed in the Negative List are generally no longer required to seek MOFCOM approval for establishment of an FIE and post-establishment expansions, and instead may simply "record file" with the relevant MOFCOM authorities.[161] As discussed in more detail below, a comprehensive negative list for foreign investment has yet to be released. As a result, foreign investment in industries in the "restricted" or "prohibited" categories remain subject to MOFCOM approval.[162]

Foreign investment projects in restricted industries are also required to seek approval from the National Development and Reform Commission (NDRC) or its local branch.[163] For larger investments, State Council approval may be required. In reviewing the investment, NDRC will

[158] *Provisions Guiding the Direction of Foreign Investment*, Article 12 (State Council, Order No. 346, issued February 1, 2002, effective April 1, 2002).

[159] *Implementing Rules for the Law of the People's Republic of China on Wholly Foreign-Owned Enterprises*, Article 5 (State Council, Order No. 301, issued December 12, 1990, amended April 12, 2001, further amended February 19, 2014); *Implementing Rules for the Law of the People's Republic of China on Chinese-Foreign Contractual Joint Ventures*, Article 9 (State Council, issued September 4, 1995, amended February 19, 2014, further amended March 1, 2017); and *Implementing Regulations for the Law of the People's Republic of China on Chinese-Foreign Equity Joint Ventures*, Article 4 (State Council, issued September 20, 1983, amended July 22, 2001, further amended January 8, 2011 and February 19, 2014). *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 17.

[160] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 30.

[161] *Decision to Amend Four Laws including the Wholly Foreign-Owned Enterprise Law of the People's Republic of China*, Section (1) (adopted by NPC on September 3, 2016).

[162] *Announcement on Implementing the State's Requirement on the Establishment and Modification of Foreign-Invested Enterprises that Do Not Involve Special Access Management Measures Regarding Recordation Administration In Lieu of Approval* (NDRC and MOFCOM, Order No. 22, issued October 8, 2016).

[163] *Catalogue of Investment Projects Subject to Ratification by the Government*, Section 11 (State Council, Guo Fa [2016] No. 72, issued December 12, 2016, effective December 20, 2016). *See also* James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 146.

consider, *inter alia*, whether it (i) conforms to relevant laws and regulations as well as the provisions of the *Foreign Investment Catalogue*; (ii) conforms with development plans, industrial policies and access standards; and (iii) does not have a significant negative impact on the public.[164]

Foreign investments may also be subject to review under the *Anti-Monopoly Law of the People's Republic of China* ("*AML*") if a "concentration" results in a foreign investor gaining control and the transaction exceeds certain monetary thresholds. In such cases, MOFCOM pre-approval is required for the investment to proceed.[165] In addition, a foreign investment may be subject to national security review if a foreign investor would obtain control of certain domestic enterprises. Similar to *AML* approval, national security approval is required prior to seeking MOFCOM investment approval.[166]

Once project approval from NDRC is secured and a certificate of approval from MOFCOM is received, a foreign investor files an application with the State Administration of Industry and Commerce (SAIC) or its local branch to obtain a business license.[167] An enterprise cannot operate or exist in China without a valid business license that defines its "business scope."[168] Business activities must operate within the business scope, which is often narrowly defined, in order for the enterprise to maintain and renew its business license.[169]

The Chinese government imposes additional licensing requirements on a wide array of business activities, including food and drug production, pesticide manufacturing, and mining.[170] FIEs must obtain an industry-specific license prior to engaging in these activities and, in some cases, before applying for investment approval.[171] The specific requirements and the timelines for this approval process may vary widely depending on the industry in question. For heavily regulated industries, the industry regulator review process may take more than a year.[172] As a result, it is

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164 *Administrative Measures for the Confirmation and Recordation of Foreign-Funded Projects*, Article 16 (NDRC, Order No. 12, issued May 17, 2014).

165 *Anti-Monopoly Law of the People's Republic of China*, Chapter 4 (adopted by NPC on August 30, 2007).

166 *AML*, Article 31. *See also* James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 981.

167 James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 146.

168 *Ibid*., 147.

169 *Ibid*.

170 U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 17.

171 *Ibid*., 17-18.

172 *Ibid*., 19.

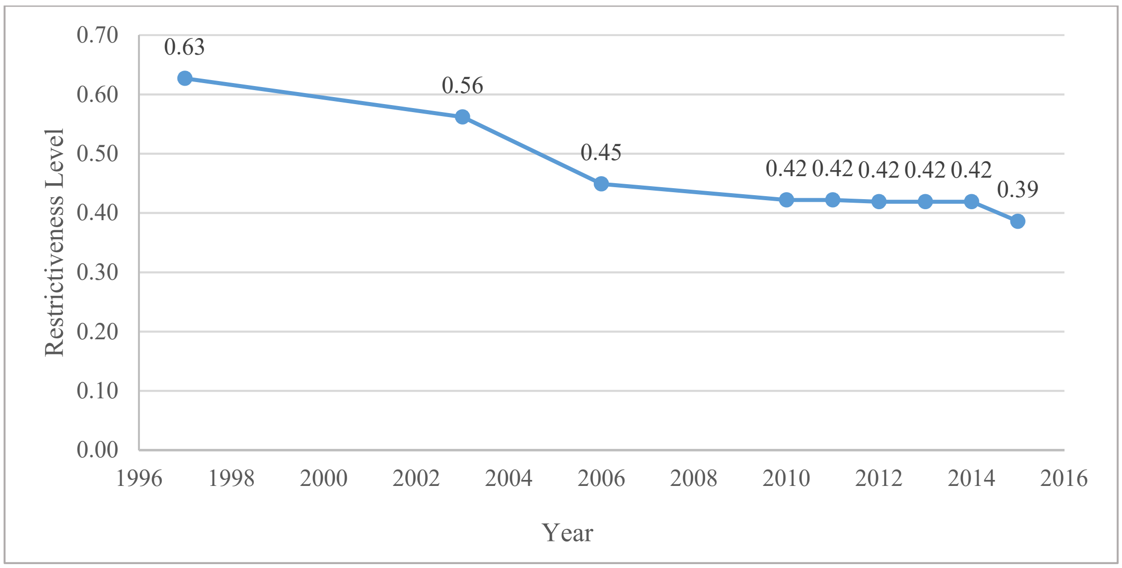
necessary for foreign investors to consult various specific regulations (both at the central and local government levels) and for the industry regulator to understand what specific procedures may be required for a particular investment.

B. Constraints on Foreign Investment

1. Foreign Investment Trends

The OECD, in its FDI Regulatory Restrictiveness Index, has continually ranked the Chinese government's foreign investment regime as one of the most restrictive in the world, even after some initial improvements following China's accession to the WTO (see **Figure 1**).[173] In 2016, the OECD FDI Regulatory Restrictiveness Index ranked China 59th out of 62 countries in 2016, just after Myanmar and five times as restrictive as the country average (see **Figure 2**).[174]

Figure 1: OECD FDI Regulatory Restrictiveness Index – China, 1997-2015
(0 = open, 1 = closed)



Source: OECD.

Notably, the OECD evaluates FDI restrictiveness solely based on a country's written measures governing FDI, and does not take into account enforcement, implementation, and government practices that are not codified in laws and regulations.[175] As a result, the OECD acknowledges

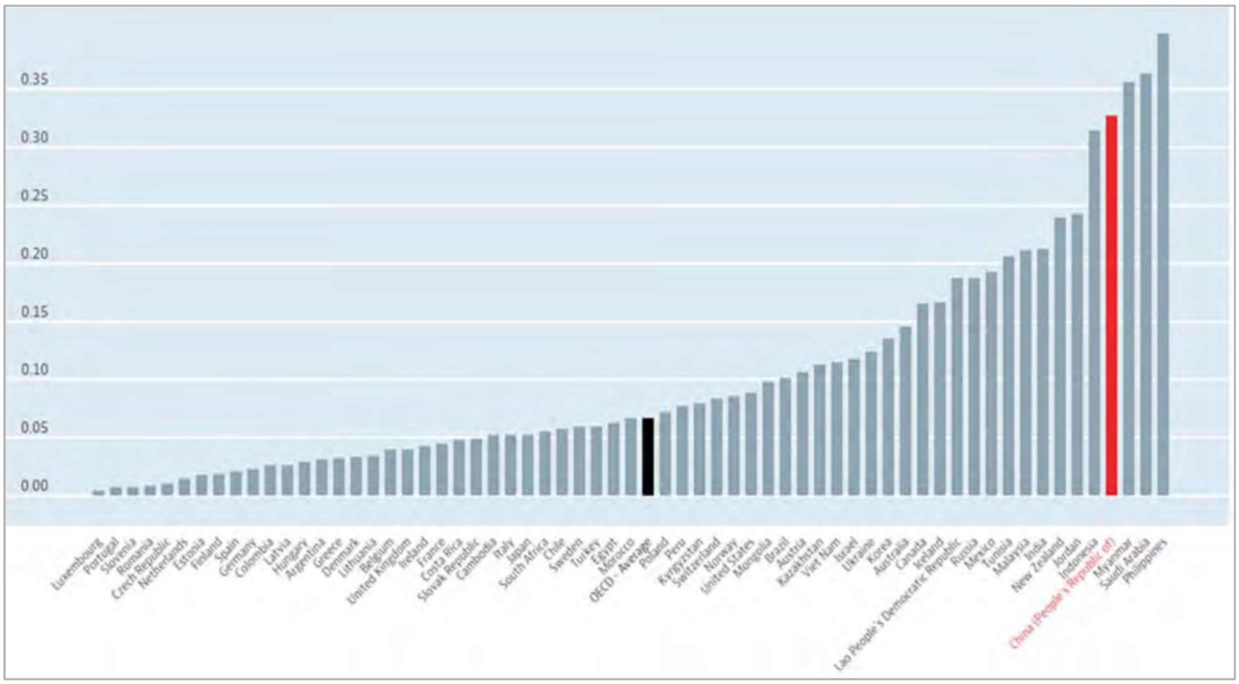
[173] OECD, *FDI Regulatory Restrictiveness Index – Rankings* (December 2016), available at http://www.oecd.org/investment/fdiindex.htm, accessed September 17, 2017.

[174] *Ibid*.

[175] The OECD FDI Regulatory Restrictiveness Index examines the following factors across a wide range of sectors: (i) the level of foreign equity ownership permitted; (ii) the screening and approval procedures applied to inward foreign direct investment; (iii) restrictions on key foreign personnel; and (iv) other restrictions such as on land

that by looking only at discrimination "on the books" and not at how the laws and regulations are implemented in practice, it is unable to evaluate the foreign investment environment in its entirety.[176] Foreign investors in China have long raised concerns about *de facto* restrictions on investment that are not contained in the government's written measures,[177] which will be discussed in more detail below.

Figure 2: OECD FDI Regulatory Restrictiveness Index – By country, 2016
(0 = open, 1 = closed)



Source: OECD.

Foreign investors have become increasingly concerned about the prospects for foreign investment in China in recent years, and FDI in China has begun to decline after many years of growth. In 2016, China attracted US$170.6 billion in FDI, representing a significant decrease from US$242.5 billion in 2015 and well below the average of $261.1 billion over the 2010-2015

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ownership, corporate organization. *See* Stephen Thomsen and Fernando Mistura, *Is Investment Protectionism on the Rise?* Global Forum on International Investment (OECD, March 2017), 1.

[176] Stephen Thomsen and Fernando Mistura, *Is Investment Protectionism on the Rise?* Global Forum on International Investment (OECD, March 2017), 1.

[177] *See* European Commission, *Impact Assessment Report on the EU-China Investment Relations*, Commission Staff Working Document SWD(2013) 185 final (May 23, 2013), 13-14. *See also* European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016) and Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 103.

period.[178] A three-year downward trend in China's inbound FDI that began in 2013 continued in 2016, marking a seven-year low in China's inbound FDI.[179] According to survey data, market access restrictions, concerns about government policies, and the perception that foreign businesses face a less welcome environment than before have contributed to this decline.[180]

Over the years, the United States and other WTO members, including the European Union (EU) and Japan, have consistently raised concerns about the Chinese government's foreign investment restrictions during meetings of the WTO Committee on Trade-Related Investment Measures (TRIMS). The United States and several other WTO members have also highlighted these issues during China's Trade Policy Reviews, including the most recent one, which occurred in July 2016.[181] Some of the top concerns voiced by foreign investors in China include: market access restrictions in the form of equity limits and local partner requirements; an opaque approval and licensing process; technology transfer and localization requirements; and anti-monopoly law enforcement and national security reviews.[182]

2. *Equity Limits and Local Partner Requirements*

Despite some liberalization since China's accession to the WTO, foreign investment in many sectors remains subject to a joint venture requirement or other equity restrictions. While the 2017 *Foreign Investment Catalogue* liberalized investment in some areas, it did not liberalize many of the sectors important to foreign investors, such as services, agriculture, extractive industries, and other manufacturing sectors.[183] Currently, 35 sectors remain in the "restricted" category of the *Foreign Investment Catalogue*, including the following sectors, which are subject to equity limits and/or local partner requirements (see **Table 1**).[184]

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[178] World Bank, *World Development Indicators/Foreign Direct Investment, Net Inflows (Balance of Payments, Current $US)*, (World Bank, available at http://databank.worldbank.org/data/reports.aspx?source=2&series=BX.KLT.DINV.CD.WD&country=CHN, accessed September 11, 2017.

[179] *Ibid*.

[180] AmCham China, *American Business in China White Paper* (2017), 12. U.S. Department of State Bureau of Economic and Business Affairs, *China: 2017 Investment Climate Statements* (2017).

[181] WTO, *Trade Policy Review Body Trade Policy Review: China, Minutes of the Meeting*, WT/TPR/M/342, (September 26, 2016).

[182] European Commission, *Impact Assessment Report on the EU-China Investment Relations*, Commission Staff Working Document SWD(2013) 185 final (May 23, 2013), 12-14. *See also* European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016); and Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 103-104, 141, 146, 149, 154, 157.

[183] *Ibid*.

[184] *See* the 2017 *Foreign Investment Catalogue* for a complete list of "restricted" and "prohibited" industries provided therein.

Table 1: Equity Restrictions and Local Partner Requirements in China's Foreign Investment Regime

Sector	Summary of Requirements
Selection and cultivation of new varieties of crops and production of seeds	Chinese party must be the controlling shareholder
Printing of publications	Chinese party must be the controlling shareholder
Manufacturing of whole automobiles	Chinese party's investment cannot be lower than 50%, and the same foreign investor may establish no more than two joint ventures in China for the same kind of automobiles
Value-added Telecommunications Services	Foreign investment cannot exceed 50%, excluding e-commerce
Basic telecommunications services	Chinese party must be the controlling shareholder
Banks	Foreign financial institution investment cannot exceed 20% or 25% depending on how the investment is structured
Insurance companies	For life insurance companies, foreign investment cannot exceed 50%
Medical institutions	Limited to CJV or EJV
Production of radio and television programs and movies	Limited to CJV

Source: Foreign Investment Catalogue (*2017 Amendment*).

The Chinese government's restrictions on foreign investment are often highly targeted and detail specific sub-sectors that are consistent with its industrial policy objectives, such as encouraging foreign investment in key components, equipment and technologies that the government deems to be critical to the development of China's domestic industry and its industrial capabilities. For example, the *Foreign Investment Catalogue* encourages foreign investment in civil aircraft and aircraft components, but restricts foreign investment in the final aircraft product market to joint ventures with a non-controlling interest.[185] These foreign investment policies serve to further the Chinese government's industrial policy objective of developing a "national champion" in the final aircraft market with the assistance of foreign technology and expertise.[186]

In some cases, the Chinese government first encourages and then restricts investment after the technology gap has narrowed. For example, since 2015, foreign investments in automobile manufacturing have been designated as "restricted" and require the Chinese partner to hold at least 50% of the equity in the joint venture,[187] in order to encourage the development of Chinese-

[185] *Ibid*.

[186] Keith Crane et al., *The Effectiveness of China's Industrial Policies in Commercial Aviation Manufacturing* (Rand Corporation, 2014).

[187] *See Catalogue of Industries for Guiding Foreign Investment (2015 Amendment)* (NDRC and MOFCOM, Order No. 22, issued March 10, 2015, effective April 10, 2015).

owned and branded vehicles. Prior to 2015, automobile manufacturing was a "permitted" industry for foreign investment, and prior to 2011, it was designated an "encouraged" industry in the *Foreign Investment Catalogue*.[188] Moreover, the Chinese government is now prioritizing the development of new energy vehicles (NEVs) and has encouraged investment in the manufacture of key components for NEVs, including components with specific technical requirements, such as battery separators with a thickness of 15-40μm and porosity of 40-60%.[189] At the same time, foreign investment in automobile manufacturing can avoid the restrictions described above if the foreign investor merges its automobile manufacturing investments in China into a joint venture that manufactures NEVs jointly with the Chinese partner.[190]

The *Foreign Investment Catalogue* is merely the starting point for determining what equity restrictions or local partnership requirements may exist. There are thousands of other regulations, rules, and regulatory documents related to foreign investment that are issued by central government authorities, as well as a myriad of local government regulations and restrictions that may contradict central government measures that may also need to be consulted.[191] For example, the 2015 *Foreign Investment Catalogue* shifted foreign investment in high-grade hotels, office buildings, and international exhibition centers from the restricted category to the permitted category, but did not remove significant domestic law restrictions that continue to exist for foreign investment in real estate.[192]

To the extent there is any inconsistency between the *Foreign Investment Catalogue* and any of the Chinese government's industrial policies, the industrial policies may prevail.[193] In addition to

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[188] *See Catalogue of Industries for Guiding Foreign Investment (2007 Amendment)* (NDRC and MOFCOM, Order No. 57, issued October 31, 2007, effective December 1, 2007); *Catalogue of Industries for Guiding Foreign Investment (2011 Amendment)* (NDRC and MOFCOM, Order No. 12, issued December 24, 2011, effective January 30, 2012); *Catalogue of Industries for Guiding Foreign Investment (2015 Amendment)* (NDRC and MOFCOM, Order No. 22, issued March 10, 2015, effective April 10, 2015).

[189] *Catalogue of Industries for Guiding Foreign Investment (2017Amendment)* (NDRC and MOFCOM, Order No. 4, issued June 28, 2017), "Catalogue of Encouraged Industries"- para. 209.

[190] *Ibid*., "Catalogue of Restricted Industries"- para. 7.

[191] *See* Covington & Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade (August 2014), 55. This study looks at 39 central government agencies that promulgated 137,328 measures affecting foreign investment that were in effect at the time of the survey. *Ibid.,* 5.

[192] *Thomson Reuters Practical Law*, "China Releases New Foreign Investment Catalogue," March 16, 2015.

[193] A provision in the notes section of the 2011 *Foreign Investment Catalogue* states that State Council special provisions or industrial policies shall prevail over the catalogue. This provision was removed from the 2015 *Foreign Investment Catalogue*. *See Catalogue of Industries for Guiding Foreign Investment (2011 Amendment)* (NDRC and MOFCOM, Order No. 12, issued December 24, 2011, effective January 30, 2012) and the *Catalogue of Industries for Guiding Foreign Investment (2015 Amendment)* (NDRC and MOFCOM, Order No. 22, issued March 10, 2015, effective April 10, 2015). *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 9.

outright investment restrictions, foreign investment faces other restraints, such as licensing limitations. For example, in addition to the equity limits in telecommunications sectors, FIEs are also prohibited from receiving licenses to engage in certain telecommunications services.[194] As a result, even if a foreign investor were able to establish an FIE in this industry in China, it would be unable to receive the license needed to conduct this business.

In January 2017, the State Council issued a notice calling for expanded market access for foreign investors in traditionally sensitive sectors such as financial services, securities and banking, insurance institutions, and telecommunications, through revisions to the *Foreign Investment Catalogue*.[195] However, in the 2017 *Foreign Investment Catalogue*, these sectors were listed in the "restricted" section with only minor changes,[196] and thus, it remains unclear whether and when new industries may be liberalized for foreign investment. Foreign investors remain skeptical that the Chinese government will implement a comprehensive and transparent liberalization of its foreign investment regime and continue to urge the Chinese government to adopt a comprehensive, single negative list for the administration of foreign investment, with only very limited, narrow, and transparent exceptions.

Recent surveys of foreign investors in China illustrate that foreign investors are not expecting the foreign investment regime to improve, despite the Chinese government's announced intentions to institute changes.[197] In the American Chamber of Commerce in China's (AmCham China) 2016 Business Climate Survey, over 60% of respondents have little or no confidence that the Chinese government is committed to opening China's markets further in the next three years, and 81% feel less welcome than before.[198] In addition, AmCham China's 2017 *American Business in China White Paper* states:

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[194] Covington & Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade (August 2014), 29.

[195] *Notice on Increasing Openness to Foreign Investment and Active Use of Foreign Investment*, Section 1 (State Council, Guo Fa [2017] No. 5, issued January 12, 2017).

[196] *Catalogue of Industries for Guiding Foreign Investment (2017 Amendment)* (NDRC and MOFCOM, Order No. 4, issued June 28, 2017).

[197] *See e.g.*, European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016), 36. ("More than two years after promises of market reforms and equal treatment were made at the Third Plenum, which European business had welcomed as a potential breakthrough, European companies are still treated unfairly. When compared to domestic Chinese companies, 57% of respondents report that FIEs tend to be subjected to unfair treatment. As the Decision was a reform package that the Chinese authorities chose to publicly announce of their own free will, the lack of follow through has been particularly disappointing.") *See also* AmCham China, *American Business in China White Paper*, (2017), Section II. ("One trend that is missing is reform of the Chinese economy. Long promised, meaningful reform has failed to materialize and is becoming increasingly difficult to enact.")

[198] AmCham China, *American Business in China White Paper*, (2017), 8-10. ("More than 60 percent of Business Climate Survey respondents have little or no confidence that the government is committed to opening China's markets further in the next three years. According to survey data, 31 percent of AmCham China member companies say that the investment environment is deteriorating, while only 24 percent believe that it is improving. This is the most pessimistic response we have received for this question since we began asking it in 2011. More than half of

> Despite recent rhetoric regarding opening and globalization, investment barriers in China remain high 15 years after China's accession to the World Trade Organization (WTO)… [T]he pace has been slow and uneven; following the 2008 world financial crisis, China even appears to be moving in the opposite direction in some regards.[199]

Similarly, according to a 2016 survey conducted by the European Chamber of Commerce, 70% of European companies surveyed feel less welcome in China than they did 10 years ago and only 22% of respondents are convinced of the government's commitment to foreign investment reform, representing a 10% decrease from the previous year.[200]

3. *Investment Approval and Regulatory Process*

Foreign investors have consistently raised concerns that the approval process is time-consuming, complicated, and expensive, often involving multiple government agencies.[201] As a result of overlapping and often conflicting rules and regulations, foreign investment in China can be excessively complicated, to the point where it deters investment as foreign investors must consult a wide range of documents and industry regulators to understand what restrictions may be applicable to their businesses. Given the multiple agencies that must review and approve foreign investment in China, the approval process presents many opportunities for government authorities to make decisions that favor domestic industry over foreign investors. Foreign investors have expressed concerns about the Chinese government increasingly using the investment review process as an instrument to shield selected Chinese domestic enterprises,

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members (55 percent) believe foreign companies are treated unfairly compared to local companies, and 81 percent feel less welcome than before.")

199 *Ibid*., 4.

200 European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016), 8. ("Although pronouncements made in the Decision committing to a market economy, and gradualist reform efforts such as the once-hailed pilot free trade zones initially piqued great interest among European companies, the absence of concrete developments has deepened their disillusionment in China's reform agenda, the extent of which can be seen from the following figures: 56% of respondents are of the view that doing business in China has become more difficult, a five-point increase from 2015; 57% report that foreign companies tend to receive unfavourable treatment compared to domestic Chinese companies; 57% of respondents believe that environmental regulations are strongly enforced against foreign companies, while only 14% think that they are strongly enforced against Chinese state-owned enterprises and only 12% think that this is the case with privately-owned Chinese companies; 58% of respondents state that the recent tightening of Internet controls and access restrictions has a negative impact on their business, a 17-point jump from 2015; 40% of respondents feel that foreign companies are being discriminated against through recently promulgated national-security-related legislation; 70% of respondents feel less welcome in China than they did 10 years ago.")

201 *See e.g.*, U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012); Covington & Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade (August 2014); James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 145.

including inefficient or monopolistic enterprises, from foreign competition.[202] Foreign investor concerns about unfair treatment in the approval process have typically focused on investment approval by MOFCOM, project approval by NDRC or its local branch, regulatory approval by the relevant industry regulator, and *AML* review by MOFCOM in the case of concentration transactions.[203] Foreign investors have mainly raised the following concerns about the foreign investment approval process in China.

First, foreign investors are often expressly subject to more onerous investment approval requirements than domestic investors. As noted above, inbound foreign investments often require the approval of several different government agencies. When approval is needed for domestic investments, the domestic process is "often less onerous than the process for foreign investment in the same industry."[204] Notably, many foreign investors believe that discrimination against foreign companies has been increasing in recent years and that the situation is likely to worsen in the future.[205]

Second, foreign investors often face broadly drafted regulations that provide government approval authorities the discretion to restrict or unreasonably delay approval. For example, if MOFCOM approval is required to establish a WFOE, MOFCOM will consider whether the investment meets the "requirements of the development of China's national economy."[206] Similarly, as noted above, in order for an EJV to receive project approval, NDRC will consider whether a foreign investment "is in line with development plans, industrial policies and access standards" and "has no material adverse effects on public interest."[207] Vaguely worded provisions such as these provide government authorities wide discretion to restrict investments in order to protect domestic competitors or otherwise act in furtherance of industrial policy objectives.

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[202] *See* European Commission, *Impact Assessment Report on the EU-China Investment Relations*, Commission Staff Working Document SWD(2013) 185 final (May 23, 2013), 90. *See also* Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 103-105.

[203] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 36-37.

[204] *Ibid.*, 33.

[205] *Ibid*., 39.

[206] *Ibid.*, 17.

[207] *Administrative Measures for the Confirmation and Recordation of Foreign-Funded Projects*, Articles 16(2) and 16(5) (NDRC, Order No. 12, issued May 17, 2014). *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 37.

Third, foreign companies have consistently reported that Chinese government officials have imposed *de facto* requirements beyond what is expressly set forth in Chinese laws and regulations.[208] AmCham China's 2017 *American Business in China White Paper* states:

> Despite the enormous economic benefits that China has reaped from FDI, there is an increasing perception of animosity toward foreign business that belies its contribution to China's development. As noted above, Chinese companies are expanding overseas into areas restricted to foreign companies in China. This imbalance is seen not just in market entry restrictions, but also in many unofficial practices that disadvantage FIEs already established in China.[209]

Foreign companies have reported that Chinese government authorities in charge of foreign investment approvals will use the approval process to advance its policy objectives, including restricting or unreasonably delaying market entry for foreign companies, requiring the foreign company to work with a Chinese partner, or extracting valuable, deal-specific commercial concessions as a price for market entry.[210] In addition, industry associations have noted that if a proposed FIE project includes terms that are perceived to be unfair to the Chinese party, or if the foreign party is from a country with a strained relationship with the Chinese government, government authorities are "likely to look on the proposal with disfavor."[211]

Although the Chinese government has recently introduced changes that would allow foreign investors to file with MOFCOM, rather than seek its approval, there are still several other Chinese government authorities from which approval may be needed. As result, multiple opportunities remain for the Chinese government to use the approval process to extract concessions from foreign investors. As noted above, most foreign investor concerns about the investment approval process have focused not only on the MOFCOM investment approval process, but have also included NDRC project approval and the *AML* approval processes.[212]

The lack of transparency in the approval process and the broad discretion granted to approval authorities create an environment in which it is possible for government authorities to impose requirements beyond what is written in the law.[213] This problem has been able to persist partly

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208 U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 36-37. *See also* Ken Davies, *International Investment – China Investment Policy: An Update*, OECD Working Papers on International Investment 2013/01 (OECD, 2013).

209 AmCham China, *American Business in China White Paper* (2017), 8-10.

210 U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 36-38.

211 James Zimmerman, *China Law Deskbook, A Legal Guide for Foreign-Invested Enterprises, 4th edition* (Chicago: American Bar Association, 2014), 148.

212 U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 36-38.

213 European Commission, *Impact Assessment Report on the EU-China Investment Relations*, Commission Staff Working Document SWD(2013) 185 final (May 23, 2013), 12-14. (Respondents to the EC survey "stressed that the

due to the lack of meaningful administrative or judicial review of Chinese regulatory actions, which enables government officials to take unilateral action without fear of legal challenge, as discussed in more detail in Factor 6.[214] While an appeals process exists in theory, the situation is exacerbated by that fact that foreign investors rarely invoke such processes given the low likelihood of success in prevailing on such claims and the potential for retaliation from Chinese government approval authorities that have considerable power to affect their business prospects in China.[215]

4. Technology Transfer and Localization Requirements

Foreign investors have raised longstanding concerns that they have been required to transfer advanced technologies to Chinese entities as a condition of entering the Chinese market.[216] Confidential accounts from foreign investors indicate that Chinese government officials, acting without the potential for legal challenge, sometimes require foreign enterprises to transfer technology, conduct research and development in China, or satisfy performance requirements relating to exportation or the use of local content as a condition for securing investment approvals.[217] One mechanism by which this practice occurs is the requirement that a foreign investor transfer technology to a joint venture that must be controlled by the Chinese party in order to gain market access. For example, some foreign automobile manufacturers have been informed that they will not be granted approval to manufacture electric vehicles in China unless they transfer core technology to a joint venture in which they can hold only a minority stake (even though the *Foreign Investment Catalogue* permits foreign investment up to 50%).[218]

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legal decision process was subject to political pressure, both from the local SOEs and from the administrative agencies at central, provincial and municipal level, which have a strong discretionary power to decide on foreign investments.") *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 36-38.

[214] *Ibid*. ("[I]nvestors feel that recourse to judicial remedies in China is not sufficient… 80% of the respondents who expressed an opinion on the Chinese legal system said that they did not have confidence in it to protect their rights as investors. They explained that the Chinese legal system lacked transparency and consistency, both in the decisions and in the judicial process itself.") *See also* Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 103.

[215] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 40; Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 103.

[216] Covington & Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade (August 2014), 31-32.

[217] Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 3-4.

[218] *Catalogue of Industries for Guiding Foreign Investment (2017 Amendment)*, Part I, "Catalogue of Restricted Industries for Foreign Investment," Article 7 (which states that for the manufacture of whole automobiles and special use cars, the proportion of shares of the Chinese party shall not be lower than 50%) (NDRC and MOFCOM, Order No. 4, issued June 28, 2017). *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 38.

In addition, foreign investors have also raised concerns about the Chinese government linking procurement preferences to technology localization measures designed to pressure foreign investors into transferring technology to Chinese parties.[219] For example, a potential foreign investor in a joint venture was told that "the Chinese government would purchase its products through public tenders."[220] However, foreign investment in this sector was subject to a requirement that foreign investors must hold a non-controlling interest. As a result, the foreign investor was forced to choose between transferring its intellectual property rights to a joint venture that it would not control or risk losing significant market share and revenue.[221] The Chinese government also provides incentives and regulatory preferences to foreign investors in certain high-tech industries if they locate R&D facilities or manufacturing facilities in China. For example, the Chinese government recently issued a measure that provides for expedited regulatory review for innovative new drugs where the applicant's manufacturing capacity has been moved to China,[222] which as noted above, would result in a foreign investor transferring its intellectual property rights to a joint venture that is controlled by a local partner.

Technology transfer concerns often arise in sectors and technologies that align with the Chinese government's industrial policy objectives. For example, there is a noticeable relationship between China's foreign investment restrictions and the priority industries that have been listed in the Chinese government's Made in China 2025 ("MiC2025") initiative, which is discussed in more detail in Factor 5.[223] The U.S. Chamber of Commerce in a report on MiC2025 notes that foreign investment restrictions impact half of the MiC2025 industries, and it concludes that "[t]hese restrictions either block opportunities for foreign companies to operate in the market, or, in some cases, create a de facto technology transfer requirement to the Chinese partner as a pre-condition for market access."[224] For certain MiC2025 industries in which foreign investment is encouraged, the U.S. Chamber has raised concerns that once China's economy has achieved self-sufficiency and closed the technology gap, it may impose additional requirements on foreign investors in these industries.[225]

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[219] Covington & Burling LLP, *Measures and Practices Restraining Foreign Investment in China*, prepared for the European Commission Directorate-General for Trade (August 2014), 6, 37-38.

[220] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 39-40.

[221] *Ibid*., 40.

[222] Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 10, 12, 132.

[223] U.S. Chamber of Commerce, *Made in China 2025: Global Ambitions Built on Local Protections* (2017), 26.

[224] *Ibid*.

[225] *Ibid*., 27.

5. *Anti-Monopoly Law Enforcement and National Security Reviews*

Foreign investors have expressed concerns that the *AML* may be used in some cases to protect the Chinese domestic market from foreign competition and encourage the development of national champions and indigenous innovation.[226] The *AML*'s stated purpose is to create a competition framework "which accord with the socialist market economy."[227] The *AML* by its terms requires MOFCOM, in conducting its review of concentration transactions, to take into consideration the effect on the development of the national economy, rather than limiting its review strictly to competitiveness concerns.[228] Such broad provisions along with increased enforcement activity in recent years have fueled concerns among foreign investors.[229] While both domestic companies and foreign companies have been targets of *AML* investigations, foreign companies have expressed concern that they appear to be the target of increased scrutiny by the Chinese government's enforcement agencies.[230] In addition, foreign investors have expressed concerns about "insufficient predictability, fairness and transparency" in the investigative processes, including Chinese government "pressure to cooperate in the face of unspecified allegations or face steep fines."[231]

The Chinese government's national security review mechanism also serves as a potential barrier to foreign investment. Certain transactions involving foreign investors may be subject to a national security review, however, the scope of the Chinese government's national security

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[226] U.S. China Business Council, *Competition Policy and Enforcement in China* (September 2014), 11. According to a 2014 U.S. China Business Council survey, 86% of U.S. companies surveyed were somewhat concerned about China's competition enforcement activities. *See also* AmCham China, *American Business in China White Paper* (2017), 36.

[227] *AML*, Article 4.

[228] *AML*, Article 27(5). *See also* U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 37.

[229] U.S. China Business Council, *Competition Policy and Enforcement in China* (September 2014), 7-8. Between 2008 and 2012, NDRC conducted approximately 20 price-related investigations. In 2013 alone, NDRC investigated more than 80 companies under the *AML* across a range of sectors, including pharmaceuticals, infant formula, liquor, and telecoms. *Ibid*.

[230] *Ibid*. *See also* Laurie Burkitt and Colum Murphy, "China Using Antimonopoly Law to Pressure Foreign Businesses," *Wall Street Journal*, August 4, 2014. ("Once targeted, industries and companies have little choice but to comply. Unlike in other markets, foreign companies can't expect much recourse from the courts, which are controlled by the Communist party. 'Despite all of the reform and progress to date, China is still a command economy driven by a political agenda that seeks to first and foremost legitimize the party in power,' said James Zimmerman, former chairman of the American Chamber of Commerce China and managing partner of law firm Sheppard Mullin Richter &Hampton LLP's Beijing office.")

[231] Office of the U.S. Trade Representative, *2016 Report to Congress on China's WTO Compliance* (January 2017), 171. *See also* AmCham China, *American Business in China White Paper* (2017), 42. ("While the NDRC maintains that it enforces anti-monopoly pricing laws without discrimination based on ownership against both domestic and foreign firms, the latter have been subject to disproportionately large fines. In 2016, approximately 94 percent of the NDRC's fines were imposed on foreign firms.")

review remains unclear.[232] The *National Security Law of the People's Republic of China* ("*National Security Law*") sets forth an expansive definition of national security, which considers economic security, political security, cultural security, and societal security,[233] and the national security system must "adhere to the leadership of the Communist Party of China."[234] The Chinese government's national security review regime protects interests that fall outside the widely accepted scope of essential national security concerns and international norms governing investment reviews.[235] In 2015, the State Council announced that government authorities should consider national security as a factor when enacting a new negative list system and use an expansive definition of national security, which includes "economic security."[236] In addition, the draft *Foreign Investment Law* contemplates a national security review for any foreign investment in China, regardless of whether it meets any threshold level of investment, and would allow for domestic industry to petition authorities to review a foreign investment for national security reasons.[237] Even if the Chinese government were to implement other liberalizing changes to its foreign investment regime, a sweeping national security review could undermine any progress and deter foreign investment.

According to recent surveys, foreign investors believe they have been targeted and discriminated against through national security-related legislation, such as the *National Security Law*, the *Counter-terrorism Law* and the *Cyber Security Law*. For example, according to one survey of

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[232] *AML*, Article 21. *See also Notice of the General Office of the State Council on Launching the Security Review System for Mergers and Acquisitions of Domestic Enterprises by Foreign Investors*, Section 1 (State Council, Order No. 6, issued February 3, 2011, effective March 3, 2011).

[233] *National Security Law of the People's Republic of China*, Articles 2 and 3 (adopted by NPC on February 22, 1993, amended August 27, 2009, further amended July 1, 2015).

[234] *National Security Law*, Article 4.

[235] According to the OECD *Guidelines for Recipient Countries Investment Policies Relating to National Security*, a national security review process should carefully circumscribe the scope of the review process, including by identifying precisely the transactions that are subject to review and the national security-based criteria on which determinations will be made. *See* OECD, *OECD Guidelines for Recipient Country Investment Policies Relating to National Security*, Investment Committee Report on Recipient Country Policies and SWFs (April 4, 2008). *See also* AmCham China, *China's Investment Environment: Overcoming Impediments to the US-China BIT* (October 2015), 12.

[236] *Opinions on the Implementation of the Market Access Negative List System*, Section III.9 (State Council, Guo Fa [2015] No. 55, issued October 19, 2015, effective from December 1, 2015 to December 31, 2017). The measure states: "While drawing up and implementing a negative list for market access, we should maintain a holistic view of national security and follow laws and regulations safeguarding national security as well as the national systems concerning security in various fields. With a focus on safeguarding economic security, we should maintain the national basic economic system and the socialist market economic order, improve the institutional mechanism to prevent and dissolve the economic security risks, guarantee key sectors and areas that are the lifeblood of the economy, key industries, major infrastructure and major construction projects, and ensure the security of other significant economic benefits."

[237] *Notice on Seeking Comments to the "Foreign Investment Law of the People's Republic of China" (Draft for Public Comment)* (MOFCOM, issued January 19, 2015).

European investors in China, 40% of respondents reported that foreign investors are being discriminated against through recently promulgated national-security-related legislation.[238]

C. Assessment of Factor

The Chinese government's foreign investment regime remains one of the most complex and restrictive in the world. Despite some government efforts to streamline investment procedures, China's foreign investment regime remains subordinate to industrial policy. The Chinese government is able to channel foreign investment into the producers, products, technologies, and industries it seeks to support, while limiting foreign investment in those sectors that it finds strategically important to develop. The Chinese government continues to impose significant barriers to foreign investment, including equity limits and local partner requirements, opaque approval and regulatory procedures, technology transfer and localization requirements, and anti-monopoly enforcement and national security reviews. Foreign investors remain skeptical that Chinese government pronouncements about liberalizing the foreign investment regime will lead to significant improvements in the foreign investment environment.

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[238] European Chamber of Commerce and Roland Berger Strategy Consultants, *European Business in China: Business Confidence Survey 2016* (2016), 38.

Factor Four: The extent of government ownership or control of the means of production.

Excessive government ownership or control of the means of production undermines the functioning of a market economy. If economic actors cannot make market-based decisions based on supply and demand, then prices and costs become distorted, and non-market conditions prevail. Part A of this section assesses the role of SIEs in China's economy. Part B assesses the extent to which government policies intervene in land markets through the ownership of land and the regulation of land-use rights.

A. State-Invested Enterprise (SIE) Sector

Part A analyzes the role of SIEs in China's economy. It begins by describing the Chinese government's legal mandate to "maintain a leading role for the state sector," which is codified in its constitutional documents as well as in economic legislation. It then examines key features of the SIE sector, including state-owned asset management; interrelationships between SIEs, the state, and the CCP; and sectoral policies designed to maintain SIEs in industries deemed strategic by the government and the CCP.

Part A then analyzes the prevalence of SIEs in China's economy. This analysis includes a statistical comparison of the SIE sector and the private sector; statistics on the persistence of SIEs in China's economy, across industries, and at the central and local levels; a comparison of SIEs in China and other economies; and a discussion of the definitional issues concerning official data on enterprises.

Finally, Part A also examines the bankruptcy system, the growth and concentration of SIEs through consolidations, and the emergence of state enterprise groups. The analysis concludes by reviewing recent government efforts to modify policies governing SIEs.

1. Legal and Institutional Framework

1.1. Legal Mandate to Preserve a Leading Role for the SIE sector

The Chinese government has a constitutional mandate, echoed in China's broader legal framework, to maintain and uphold the "socialist market economy," which includes "maintaining a leading role for the state sector" in the economy. The guiding principles for government ownership and control are set forth in the *PRC Constitution*[239] and the *Constitution of the Chinese Communist Party* ("*CCP Constitution*").[240]

[239] The *PRC Constitution* is not legally enforceable in Chinese courts. However, it is considered relevant as a document that expresses core views. *See* Keith J. Hand, "Resolving Constitutional Disputes in Contemporary China," *University of Pennsylvania East Asia Law Review* 7 (2011): 59-60.

[240] *Constitution of the Communist Party of China* (adopted by CCPCC on October 18, 1992, amended October 21, 2007, further amended November 14, 2012).

The *PRC Constitution* provides a clear mandate for government ownership and control over the economy:

- The preamble provides that "China will be in the primary stage of socialism for a long time to come."[241] Article 6 provides that "[i]n the primary stage of socialism, the State upholds the basic economic system in which public ownership is dominant and diverse forms of ownership develop side by side […]"[242]

- Article 7 provides that "[t]he state-owned economy, that is, the socialist economy with ownership by the whole people, is the leading force in the national economy. The state ensures the consolidation and growth of the state-owned economy."[243]

- Article 11 provides that "[t] he state *encourages, supports*, and *guides* the development of the non-public sectors of the economy […]" (emphasis added) In other words, the state reserves for itself an affirmative role in developing the private sector, as distinct from strictly granting lawful protections to the private sector.[244]

- Article 11 also provides that "[t]he state permits the private sector of the economy to exist and develop within the limits prescribed by law. The private sector of the economy is a complement to the socialist public economy." In other words, the nature and very existence of the private sector is explicitly limited and circumscribed in the *PRC Constitution* and is subordinate to the SIE sector.[245]

- The preamble, Article 11, and Article 15 provide that China is governed as a "*socialist* market economy," not strictly as a "market economy."[246] (emphasis added)

Furthermore, the *PRC Constitution* sets out a leading role for the CCP to ensure a certain outcome with respect to the overall structure and direction of the economy. In view of this leading role, the *CCP Constitution states*: "[T]he *Party must uphold and improve the basic economic system, with public ownership playing a dominant role* and different economic sectors developing side by side […][247] (emphasis added)

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[241] *PRC Constitution*, Paragraph 9.

[242] *Ibid.*, Article 6.

[243] *Ibid.*, Article 7.

[244] *Ibid.*, Article 11.

[245] *Ibid.*

[246] *Ibid.*, preamble and Articles 11 and 15.

[247] *CCP Constitution*, Preamble.

The core principles established by the *PRC Constitution* reflect that the government's role in China's economy is not solely that of a neutral market regulator but the predominant actor seeking to ensure certain structural economic outcomes. Wide-reaching economic legislation provides further evidence to this effect. For example:

- Article 1 of the *Property Law of the People's Republic of China* ("*Property Law*") makes clear that the law's purpose includes "safeguarding the basic economic system of the state," and "maintaining the socialist market order."[248] Article 3 of the *Property Law* states that:

  > In the primary stage of socialism, the state upholds the basic economic system under which the public (state) ownership shall play a dominant role and diversified forms of ownership may develop side by side. The state consolidates and develops the public (state) economy, and encourages, supports and guides the development of the nonpublic economy.[249]

- Article 1 of the *Company Law of the People's Republic of China* ("*Company Law*"), similar to Article 1 of the *Property Law*, states that the law is enacted for the purposes of, among other reasons, "maintaining the socialist economic order" and "promoting the development of the socialist market economy."[250]

- The *Law of the People's Republic of China on the State-Owned Assets of Enterprises*, which applies to all enterprises with any level of state investment, affirms the role of the state as the overseer, participant, and ultimate decision-maker in preserving the leading role of the state sector.[251]

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[248] *Property Law of the People's Republic of China*, Article 1 (adopted by NPC on March 16, 2007, Order No. 62, promulgated March 16, 2007).

[249] *Ibid*., Article 3.

[250] *Company Law of the People's Republic of China*, Articles 1 and 146 (adopted by NPC on December 29, 1993, amended December 25, 1999, further amended August 28, 2004 and October 27, 2005 and December 28, 2013).

[251] *Law of the People's Republic of China on the State-Owned Assets of Enterprises* (adopted by NPC on October 28, 2008, Oder No. 5, effective May 1, 2009), Article 5, provides: "The term "state-invested enterprise" as mentioned in this Law refers to a wholly state-owned enterprise or company with the state being the sole investor, or a company in which the state has a stake, whether controlling or non-controlling." Article 1 states that the law was formulated "for the purposes of safeguarding the basic economic system of China, *consolidating and developing the state-owned economy, strengthening the protection of state-owned assets, giving play to the leading role of the state-owned economy in the national economy*, and promoting the development of the socialist market economy." (emphasis added) Article 7 of the same law states that "[t]he *state shall take measures* to promote the centralization of state-owned capital to the important industries and key fields that have bearings on the national economic lifeline and state security, optimize the layout and structure of the state-owned economy, promote the reform and development of state-invested enterprises, improve the overall quality of the state-owned economy, and *strengthen the control force and influence of the state-owned economy*." (emphasis added)

- Article 1 of the *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises* provides:

> The present measures are enacted in order to establish a supervision and administration system of state-owned assets that meets the demand of the socialist market economy, to further activate the state-invested enterprises, to promote the strategic adjustment of the layout and structure of the state-owned economy, to *develop and strengthen the state-owned economy, and maintain and increase the value of state-owned assets*.[252] (emphasis added)

These laws and related measures affect the entire economy either directly, through the regulation of the SIE sector, or indirectly, by establishing the context for the private sector's relationship with the SIE sector. They set forth the government's legal authority to secure a leading a role for the SIE sector.

1.2. Institutions Exercising Government Ownership and Control

The State-owned Assets Supervision and Administration Commission (SASAC) was established in 2003. Classified as a government agency under the State Council, SASAC is the state's representative owner of state-owned assets as well as the supervisory organ of non-financial central SIEs, which as of 2017 comprise 102 enterprises and their subsidiaries.[253] In addition to the centrally controlled SASAC, there are also sub-national SASACs (Local SASAC), which perform the same role as SASAC for assets owned by sub-national government authorities.[254]

SASAC and Local SASACs play an active role in the management of SIEs, including investment decisions, personnel appointments, and share transactions.[255] SASAC's stated objective, as set forth in its founding document, is not to privatize state-owned assets, but to preserve and

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[252] *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises*, Article 1 (State Council, Order [2003] No. 26, issued May 27, 2003, amended January 8, 2011). The basic principles described in a 2006 State Council notice on the adjustment of state-owned capital and SIE reorganization include a requirement to "uphold the basic economic system under *which the public ownership plays a dominant role* and diverse forms of ownership develop side by side," "*firmly consolidate and develop public ownership economy*," and "enhance the state-owned economy's c*ontrolling power, influence, driving force, bring[ing] the leading role of the state-owned economy* into play." *Notice of the General Office of the State Council on Forwarding the Guiding Opinion of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises*, Section 1.1 (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006). (emphasis added)

[253] *List of Central State-owned Enterprises* (State Asset Supervision and Administration Commission website, available at http://www.sasac.gov.cn/n86114/n86137/index.html, accessed July 14, 2017).

[254] A 2013 study estimates that there are approximately 300 SASACs in China. Andrew Szamosszegi and Cole Kyle, *An Analysis of State-owned Enterprises and State Capitalism in China*, prepared for the U.S.-China Economic and Security Review Commission (Washington, DC: Capital Trade, Incorporated, October 26, 2011), 6.

[255] Barry Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget," *China Leadership Monitor* 18 (June 7, 2006): 3. *See also* Barry Naughton, "Top-Down Control: SASAC and the Persistence of State Ownership in China," Paper presented at the conference on "China and the World Economy," Leverhulme Centre for Research on Globalisation and Economic Policy (GEP), University of Nottingham, June 23, 2006, 6.

enhance their value.[256] Although SASAC has supported the privatization of some state-owned assets, primarily through public listings,[257] the government generally retains majority ownership.[258] By increasing the value of a minority of publicly listed shares, partial privatization effectively increases the value of enterprises that remain under government ownership and control.

There are also SIEs owned and supervised by other government authorities. For example, for the largest SOCBs in the financial sector, government ownership is exercised through Central Huijin Investment, a subsidiary of China's sovereign wealth fund, China Investment Corp., which in turn is supervised by MOF.[259]

1.3. State Control Mandated in Certain Sectors

The Chinese government has retained government ownership and control throughout China's economy. The *Notice of the General Office of the State Council on Forwarding the Guiding Opinions of the SASAC about Promoting the Adjustment of State-owned Capital and the Reorganization of State-owned Enterprises*,[260] issued by the State Council in 2006, defines the

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[256] The *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises*, which formally establish SASAC, provide at Article 14 that one of SASAC's six chief obligations is to "…*promote the preservation of and increase in the value of State-owned assets of enterprises, and prevent the loss of State-owned assets of enterprises*." *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises* (State Council, Order [2003] No. 26, issued May 27, 2003, amended January 8, 2011). *See also* Barry Naughton, "Claiming Profit for the State: SASAC and the Capital Management Budget," *China Leadership Monitor* 18 (June 7, 2006): 3. A 2006 State Council notice likewise provides that one of the basic principles for adjusting state-owned capital and reorganizing SOEs is to prevent the loss of state-owned assets, so as to guarantee that the value of state-owned assets is retained and increased. *Notice of the General Office of the State Council on Forwarding the Guiding Opinion of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises*, Section 1.1 (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006), (emphasis added).

[257] In its five-year retrospective, published in 2009, SASAC listed its principal achievement as helping central SOEs achieve public listings: Between 2003 and year-end 2007, SASAC approved a total of 52 subsidiary enterprises to issue their initial public share offering in- and outside the territory of China, with 12 newly listed companies in 2003, eight in 2004, seven in 2005, 13 in 2006, and 12 in 2007. Currently there are approximately 279 listed companies for which central SIEs act as the actual controlling shareholder. Over five years, through the issuance of shares, central SIEs have raised a large amount of capital. Capital raised totaled RMB 25.3 billion in 2003; RMB 64.2 billion in 2004; RMB 76.8 billion in 2005; RMB 133.9 billion in 2006; and RMB 317.8 billion in 2007. SASAC, *Central State-owned Enterprise Reform Work Five-Year Retrospective* (2008).

[258] A 2015 report states that the free float of SIE stocks typically accounts for less than 20% of total issuances. Jianguang Shen and Michael Luk, "Beware the New Direction of SOE Reform," (Mizuho Securities Asia Ltd. Economics Research, November 24, 2015), 2.

[259] Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 191-193, 218.

[260] *Notice of the General Office of the State Council on Forwarding the Guiding Opinion of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises* (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006).

objective of "[p]romoting the concentration of state-owned capital on major industries and key fields, enhancing the controlling power of state-owned economy, and bringing its leading role into play."[261] SASAC in 2006 also formulated a policy ("*SASAC Document*")[262] that divides economic sectors into three categories and related sub-categories, according to the perceived necessity for government control, namely: (1) strategic industries, which "affect national security and the lifeblood of the economy, in which the state must "maintain absolute controlling power"; (2) "basic and pillar industries" in which the state must "maintain relatively strong controlling power"; or (3) other industries in which the state must "maintain influence:"

(1) *Absolute controlling power*: This category comprises seven industries, namely: (i) defense, (ii) electricity grid and electricity production, (iii) petroleum and, (iv) telecommunications, (v) coal, (vi) civil aviation, and (vii) shipping. The *SASAC Document* states that these seven industries (as of 2006), comprising 40 SIEs under central SASAC control ("central SIEs"), accounted for 75% of the total value of central SIE assets, 82% of state-owned assets, and 79% of total central SIE profits. For central SIE s in these industries, the state should "increase the total amount of state-owned capital and optimize structures."[263]

(2) *Relatively strong controlling power*: This category comprises nine industries: (i) machinery equipment, (ii) automotive, (iii) information technology, (iv) construction, (v) steel, (vi) nonferrous metals, (vii) chemicals, (viii) mineral surveying design, and (ix) science and technology. The *SASAC Document* states that these nine industries (as of 2006) comprised 70 central SIEs, accounted for 17% of the total value of central SIE assets, 17% of state-owned assets, and 15% of total central SIE profits.[264]

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[261] *Notice of the General Office of the State Council on Forwarding the Guiding Opinion of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises*, Chapter 2, "Main Policies and Measures," Article 3 (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006). It lists some key sectors: "Major industries and key fields mainly include: industries concerning national security, major infrastructure and important mineral resources, industries that provide essential public goods and services, as well as the key enterprises in pillar industries and high-tech industries."

[262] *Xinhua News Agency*, "SASAC: State-owned Economy Should Maintain Absolute Controlling Power over Seven Industries," December 18, 2006.

[263] *Ibid*. Within this category of seven industries, the SASAC Document provides the following sub-categories: (a) The state should maintain sole investment or majority shareholdings for central SIEs in core infrastructure sectors including defense, oil and gas and other important natural resource development industries, as well as the electricity grid and telecoms. (b) The state should maintain majority shareholdings for the subsidiary enterprises of the sectors listed in sub-category (a), as well as for the central SIEs in civil aviation and shipping sectors. (c) The state should intensify reform and restructuring, introduce the non-public economy and foreign capital, and promote the diversification of investment entities and shareholding rights in downstream petrochemical operations and value-added services in the telecoms sector.

[264] *Ibid*. Within this category of nine industries, the SASAC Document provides the following sub-categories: (a) The state should maintain majority shareholdings or conditional relative shareholdings for central SIEs in the machinery equipment, automotive, IT, construction, steel, and nonferrous metals industries that will become important backbone enterprises and industry-leading enterprises. (b) The state should maintain shareholdings for scientific research and design-type central SIEs that bear important obligations including the conversion of industry-wide generic technology and of scientific research achievements. (c) The state should maintain fairly strong

(3) Influence: This category comprises, *inter alia*, (i) commercial logistics, (ii) investment, (iii) pharmaceuticals, (iv) construction materials, (v) agriculture, and (vi) geological surveying. The *SASAC Document* states that these industries (as of 2006), comprising over 50 central SIEs, and accounted for 8% of the total value of central SIE assets, 6% of state-owned assets, and 6% of total central SIE profits.[265]

As the foregoing demonstrates, the Chinese government accords great importance to government control in a wide range of sectors. In addition, for the first two categories of industries, in which the state must maintain an absolute or relatively strong controlling power, the *SASAC Document* also emphasizes the importance of establishing a group of "backbone enterprises" that are global leaders.[266]

To implement this policy, the Chinese government draws marked distinctions between sectors when devising policies and regulations. A key consequence of this policy has been the concentration of large SIEs in certain sectors and the formation of monopolistic or oligopolistic market structures.[267] This issue is discussed in more detail below.

2. *The Prevalence of SIEs in China's Economy*

2.1. Government Policy and SIEs

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controlling power for important backbone enterprises in all nine of the basic and pillar industries. In particular, the state should maintain majority shareholdings or conditional relative shareholdings for important backbone enterprises that have fairly strong influence and are driving forces within an industry, (d) Aside from the above, state-owned capital will be lowered as appropriate for the basic and pillar industries, albeit with a view toward strengthening the influence and driving force of the state-owned economy.

[265] *Ibid*.

[266] *Ibid*. The SASAC Document sets a general goal of having, by 2010, a group of important backbone enterprises with fairly strong influence and driving force for the development of an industry, which entails establishing a strong foundation for important backbone enterprises in the petrochemical, telecoms, electricity, shipping, and construction industries to develop and become *globally first-rate enterprises*, and for important backbone enterprises in the automotive, machinery, and IT industries to become globally first-rate enterprises. For those industries listed in Category (1), the state should also maintain sole investment or majority shareholdings for important backbone enterprises that will become *globally first-rate enterprises*.

[267] Barry Naughton, "The Transformation of the SIE sector: SASAC, the Market Economy, and the New National Champions," in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai, (New York: Cambridge UP, 2015), 52. ("A key feature of China's state firm strategy coming out of the 1990s was the creation of protected markets with limited competition. While these firms are sometimes criticized for their monopoly privileges, they are not, strictly speaking, monopolies. Instead, two or three incumbent central government firms compete in each market. The three oil firms have different specialties and concentrations but also compete as potentially integrated firms; three telecom companies now compete in providing mobile phone services [...] While the SASAC firms do not have absolute monopolies, they have substantial market power, and there are virtually insurmountable barriers to new firm entry in most cases [...] SASAC profitability therefore is significantly due to the protected markets in which these firms operate.")

The legal mandate to ensure a leading role for the SIE sector in China's economy is not simply a formality. Rather, as the World Bank has noted, it is a guiding principle and policy objective of the Chinese government that has a systemic impact on private firms in China's economy. Research reports published by various international institutions have recognized the distinct effect that Chinese government policy has had on SIE market dominance.

- World Bank. A 2013 report finds that "[a]lthough formal barriers to entry may be low in these industries, informal entry barriers convey the clear policy message—competition from private firms is not welcome."[268] The report also argues that many government departments favor SIE investments "instead of achieving the same ends through incentives, market forces, and private sector initiatives."[269]

- WTO. The Trade Policy Review for 2016 concludes:

  > China continues to maintain a basic economic system in which public ownership is kept as the mainstay of the economy while allowing diverse forms of ownership to develop side by side. As a result, the private sector is dominant in industries such as clothing, food, and assembly for export, while sectors of strategic importance (*e.g.* energy; utilities; and transport, financial, telecom, education, and health care services) remain only partially open to private investment. These sectors are often dominated by large SOEs.[270]

- OECD. According to a 2010 OECD report, the Chinese government policy of sectoral classification "marked a shift in policy away from encouraging private-sector involvement in all competitive sectors of the economy to one of private[z]ing smaller SOEs in non-strategic sectors while increasing government ownership in enterprises deemed to be strategic."[271]

2.2. The SIE Sector in China Compared with Other Economies

Several major economies have state-owned sectors, but China's state-owned sector is uniquely large as compared to other major economies. A 2013 report comparing "state-owned enterprises" in the BRIICS countries (Brazil, Russia, India, Indonesia, China and South Africa) determined that the assets of listed Chinese "state-owned enterprises" are equivalent to 145% of China's Gross National Income (GNI), while the corresponding figures for the other BRIICS countries are considerably lower, ranging from just 3% to 75%. The report also finds that the sales revenue of listed "state-owned enterprises" in China is equivalent to 26% of China's GNI, compared to a

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[268] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 26. *See also Ibid.*, 26-28, 106, 111.

[269] *Ibid*.

[270] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 95.

[271] OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2010), 114.

much lower proportion, ranging from 2% to 16%, in the other BRIICS countries.[272] In addition, according to the OECD, China was the only country among the OECD members and 11 non-OECD members included in its study in 2013 to have SIEs in all 30 sectors included in the study.[273]

In addition, SIE assets as a percentage of Gross Domestic Product (GDP) are multiples larger in China than in France, a market economy country with a relatively high degree of government ownership. MOF reported that non-financial "state-owned enterprise" assets in China totaled RMB 104 trillion in 2013, approximately 180% of China's total GDP for the same period.[274] By comparison, in France, non-financial SIE assets totaled €829 million, just under 40% of France's GDP that year.[275]

2.3. SIEs as Leading Enterprises in Key Sectors

Although government-controlled shareholding groups are not unique to China, SASAC is distinctive because the SIEs that it oversees are dominant in many sectors, particularly in critical sectors relating to infrastructure, transport, communications, energy, and capital-intensive manufacturing.[276]

Nearly every leading firm in a critical industry in China is under SASAC control. The vast majority of the 115 Chinese companies on the Global Fortune 500 are state-owned,[277] and of these 115, 48 are controlled by central SASAC.[278] The ten largest SIEs in 2015 reported

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[272] Przemyslaw Kowalski et al., *State-Owned Enterprises: Trade Effects and Policy Implications*, Trade Policy Papers 147 (OECD, 2013), 21.

[273] OECD, *The 2013 Update of the OECD's Database on Product Market Regulation: Policy Insights for OECD and Non-OECD Countries*, Economics Department Working Papers, No. 1200 (2015), 37. The OECD has published indicators of product market regulation that include a sub-indicator measuring the "scope of state-invested enterprises." This sub-indicator tracks whether SIEs are present in 30 different sectors that cover a large swath of the economy.

[274] MOF, *Ministry of Finance Discloses State-owned Enterprise Accumulated Property: for the First Time: 155,000 Firms with Total Assets of Over 100 Trillion* (August 1, 2014). (The report refers to state-owned and state-controlled enterprises, including centrally-managed enterprises, enterprises under central departments and affiliated subsidiaries, and state-owned and state-controlled enterprises of the 36 provinces (as well as autonomous regions, directly administered municipalities, and municipalities with independent planning status). State-owned financial institutions are not included.)

[275] Agence des participations de l'Etat, 2014-15, *The Government as Shareholder*, 2015.

[276] Jason Dean, Andrew Browne, and Shai Oster, "China's 'State Capitalism' Sparks a Global Backlash," *Wall Street Journal*, November 16, 2010.

[277] Celine Ge, "Alibaba, Tencent included in Fortune Global 500 for the First Time," *South China Morning Post*, July 21, 2017.

[278] SASAC Press Release (SASAC, available at http://www.sasac.gov.cn/n2588025/n2588119/c7419470/content.html, accessed on July 21, 2017).

revenues that were nearly four times as large as the revenue reported by the ten largest private companies in China.[279] Also according to *Fortune China*, in 2015, 19 out of China's 20 largest listed companies by revenue were SIEs.[280]

As noted above, China seeks to maintain control, to varying degrees, across a wide range of sectors. With respect to market concentration in individual sectors, examples of SIE dominance include:

- *Banking and Finance*. The "Big Five" commercial banks in China – Bank of China (BoC), Industrial and Commercial Bank of China (ICBC), China Construction Bank Corporation (CCBC), Agriculture Bank of China (ABC), and Bank of Communications (BCM) – all operate large branch networks on a nationwide basis. These are truly large banks, with combined assets of over RMB 78 trillion in 2015.[281] The Chinese government is also the largest shareholder of the top-four insurance companies, which together accounted for over half of China's life and non-life insurance markets in 2013.[282]

- *Energy*. In the oil and gas sector, three enterprises administered by SASAC – China National Offshore Oil Corp., China National Petroleum Corp. and Sinopec – accounted for 94% of domestic oil production and 99% of domestic gas production in 2015.[283] In the electricity sector, five power generation enterprises administered by SASAC account for just under half of installed capacity, and two power distribution enterprises administered by SASAC hold a quasi-monopoly over power distribution.[284]

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[279] *Fortune China*, "China's Top 500 List," July 8, 2015, and *Exclusive Debut: China's Top 500 Private Enterprises 2015 List*, [presentation] Chinese People's Political Consultative Conference, August 25, 2015.

[280] *Fortune China*, "China's Top 500 List," July 8, 2015.

[281] All information in paragraph taken from *China Banking Regulatory Commission 2015 Annual Report* (PRC, CBRC, 2015), 26.

[282] The firms China Life, Ping'an Life, and New China Life accounted for 53.7% of China's life insurance market in 2013. The firms PICC, Ping'an, and China Pacific accounted for 64.8% of China's non-life insurance market in 2013. Dagong Europe Credit Rating, *China's Insurance Market Overview: Characteristics, Trends, Challenges and Opportunities for Foreign Insurers* (June 24, 2014), 7-9.

[283] Lei Wang. [presentation] the Colorado School of Mines at the Oil & Gas Conference, Denver, Colorado, August 17, 2016.

[284] A 2011 report in the business publication Forbes states: "Of the more than 4,300 power generation companies in China that have capacity of 6,000 kilowatts and above, approximately 90 percent are state-owned, or companies with a majority of their shares controlled by the state. Among them, five corporations directly under the central government account for approximately 45 percent of China's installed capacity. *The big five are: China Huaneng Group; China Datang Corporation; China Guodian Corporation; China Huadian Corporation; and China Power Investment Corporation*. […] In order to transmit electricity around the country, there are 38 power transmission companies at the central government and provincial levels. […] The State Grid Corporation of China covers 25 provinces, municipalities and autonomous regions, while the China Southern Power Grid Co., Ltd. covers five. Provincial level power transmission companies, such as Inner Mongolia Power Company, operate locally and independently." Jack Perkowski, "Cracking China's Power Sector," *Forbes*, January 12, 2011. (emphasis added)

- *Telecommunications*. Two enterprises administered by SASAC – China Mobile and China Telecom – together with a third state-invested enterprise – China Unicom – account for practically the entire sector. In 2015 these three telecom firms agreed to sell and transfer assets worth a combined RMB 214 billion to an infrastructure-sharing joint venture, China Tower Corp.[285]

- *Aerospace*. The Commercial Aircraft Corporation of China, Ltd. (COMAC), managed by SASAC, is the only major firm dedicated to producing commercial jets.[286] In the airline sector, the majority of market share is accounted for by Air China Ltd., China Eastern Airlines Corp. and China Southern Airlines Co., all enterprises administered by SASAC.[287]

- *Automotive*. The market leaders in domestic vehicle sales are joint ventures between foreign automakers and the three SIEs: Shanghai Automotive Industry Corp., First Automotive Works, and Dongfeng Motor Corporation.[288] According to the National Bureau of Statistics of China (NBS), "state-owned enterprises" accounted for 47% of assets in the automotive sector in 2014.[289]

The market dominance of large SIEs is also indicated by their share of China's stock market. As of May 2017, the top ten firms listed on the Shanghai Stock Exchange account for approximately one-quarter of total market capitalization.[290] These firms include three SOCBs – Industrial and Commercial Bank of China, Bank of China, and Agricultural Bank of China – and two of the three oil companies administered by central SASAC – Petrochina and Sinopec.[291]

2.4. SIEs at the National and Sub-National Level

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[285] Bien Perez, "China's 'Big Three' Network Operators Inject 214 Billion Yuan Assets into Telecoms Tower Venture," *South China Morning Post*, October 15, 2015.

[286] Keith Crane et al., *The Effectiveness of China's Industrial Policies in Commercial Aviation Manufacturing* (Washington, DC: RAND Corp., 2014), 25. *See also About Us* (Commercial Aircraft Corporation of China, Ltd. website, available at http://english.comac.cc/aboutus/).

[287] *Bloomberg News*, "China's Carriers Set for Biggest Profit Since 2010 on Expansion," March 29, 2017.

[288] *China Daily*, "Top 10 Chinese Automotive Firms by Revenue in 2015," June 6, 2016.

[289] NBS, *China Statistical Yearbook – 2015* (Beijing: China Statistics Press, 2015), "13-2 Main Indicators of Industrial Enterprises above Designated Size by Industrial Sector (2014)" and "13-5 Main Indicators of State-owned and State-holding Industrial Enterprises by Industrial Sector (2014)." Calculations performed by the Department.

[290] "Shanghai Stock Exchange," available at http://www.sse.com.cn/market/stockdata/marketvalue/, accessed July 12, 2017.

[291] *Ibid*.

The Chinese government introduced SIE restructuring policies in the late 1990s, and the total number of SIEs and the workforce employed by SIEs declined significantly in the 1998-2007 period.[292] However, official statistics published by MOF in 2015 show that approximately 155,000 SIEs continue to be registered with the government at different levels, with 37.9 million employees and RMB 104.1 trillion in assets.[293]

In the late 1990s, the Chinese government implemented a policy to "grasp the large, let go of the small," which, in essence, called for the closure or sale of smaller SIEs – particularly in sectors of less strategic value – and the development of larger SIEs into industrial conglomerates – particularly in sectors of greater strategic value.[294] However, this policy did not result in the elimination of smaller SIEs. In terms of the number of enterprises, MOF statistics for "state-owned enterprises" (as defined by MOF) show that only 52,000 (33.5%) out of 155,000 are owned at the central level; the remaining 103,000 (66.5%) are owned at the sub-central level, divided among provincial (27.1%), municipal (10.3%), and county-level (29%) governments.[295] MOF statistics also indicate that "state-owned enterprises" at the sub-central level account for approximately half of total SIE assets and equity.[296]

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[292] OECD, *State Owned Enterprises in China: Reviewing the Evidence*, Working Group on Privatization and Corporate Governance of State Owned Assets (January 26, 2009), Section 4.2. According to statistics published by MOF and NBS, which define as SOEs strictly those under full government ownership, the total number of SOEs decreased from 262,000 in 1997 to 116,000 in 2006, and the number of workers employed by SOEs decreased from 71 million to 25 million over the same period. Moreover, the proportion of industrial SOEs declined relative to private and foreign-invested firms in the 1998-2006 period: in 1998, for every 100 SOEs, there were only 40.8 foreign-invested enterprises and 16.5 private-owned enterprises; by 2006, the proportions had increased to 243.9 foreign-invested enterprises and 600 private-owned enterprises. *See also* WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/199 (April 16, 2008), 92-93. ("Since the previous Review of China […] the number of SOEs fell from 929,152 (12.08% of all enterprises in China) in 2004, to 730,121 (8.46%) in 2006. SOEs held total assets of Y 29 trillion, and provided employment to 39 million people in 2006 (Y 18 trillion and 42.3 million people in 2003).")

[293] Jianguang Shen, "SOE Reform (I): Improving Corporate Governance," *Economics Weekly* (24) (Mizuho Securities Asia Ltd. Economics Research, May 29, 2015), 3; OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2017), 44.

[294] Chang-Tai Hsieh and and Zheng Michael Song, *Grasp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. w21006 (National Bureau of Economic Research, 2015), 7-15; Andrew Batson, *Fixing China's SIE sector*, Paulson Policy Memorandum (Paulson Institute, January 2014), 7. *See also* Tony Saich, *Governance and Politics of China*, Third Edition (New York: Palgrave MacMillan, 2011), 285.

[295] Jianguang Shen, "SOE Reform (I): Improving Corporate Governance," *Economics Weekly* (24) (Mizuho Securities Asia Ltd. Economics Research, May 29, 2015), 1. Calculations performed by the Department.

[296] A 2015 report by Mizuho Securities Asia Ltd., using MOF data, cites the followings figures for what it defines as "state-owned enterprises." (1) Assets: RMB 48.6 trillion at central level; RMB 9.8 trillion at municipal level; RMB 22.2 trillion at county level; and RMB 22.6 trillion at province level. (2) Equity: RMB 16.6 trillion at central level; RMB 7.5 trillion at province level; RMB 8.9 trillion at county level; RMB 4 trillion at municipal level. Jianguang Shen, "SOE Reform (I): Improving Corporate Governance," *Economics Weekly* (24) (Mizuho Securities Asia Ltd. Economics Research, May 29, 2015), 3. *See also* Andrew Batson, *Fixing China's SIE Sector*, Paulson Policy Memorandum (Paulson Institute, January 2014), 3.

2.5. China's Official Statistics on the SIE Sector Compared to the Private Sector

Using official statistics to determine the economic significance of the SIE sector in China is inherently difficult, and economists have reached varying conclusions about the size of the SIE sector relative to China's overall economy.[297] Nevertheless, NBS data for 2015 allow for a comparison of "state-owned and state-holding industrial enterprises"[298] and "private enterprises" in the industrial sector (as defined by NBS).[299] The data show that in 2015 on average state-owned and state-holding industrial enterprises were approximately 20 times as large as private enterprises when measured in terms of total assets, seven times as large in terms of revenue from principal business, five times as large in terms of total profits, and five times as large in terms of employees.[300] This significant size differential between state-owned and state-holding industrial enterprises over private enterprises has persisted over time. Using NBS data from 2005-2015, state-owned and state-holding industrial enterprises were, on average, 23 times as large as private enterprises in terms of total assets, 10 times as large in terms of revenue from principal business, 11 times as large in terms of total profits, and six times as large in terms of employees.[301] In addition, NBS statistics indicate that state-owned and state-holding industrial

[297] *See e.g.*, Andrew Batson, *The State of The State Sector.* [presentation] Gavekal/Dragonomics, March 2017; Paul Hubbard, *Reconciling China's Official Statistics on State and Control*, East Asian Bureau of Economic Research (Working Paper, Paper No. 120 (May 19, 2015); Derek Scissors, "China's SOE sector is bigger than some would have us think," East Asia Forum, (May 17, 2016); Nicholas Lardy, "Private not state firms are China's growth engine," East Asia Forum (November 30, 2014).

[298] *Note* that in the *China Statistical Yearbook – 2016* (concerning data for 2015), state-owned and state-holding industrial enterprises were all grouped under the heading "State-holding Industrial Enterprises" rather than "State-owned and State-holding Industrial Enterprises," which NBS used in previous years. *See Explanatory Notes on Main Statistical Indicators* after Table 13-15 for a detailed explanation: "State-holding enterprises cover the original state-owned enterprises and state-holding enterprises."

[299] NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), "Explanatory Notes on Main Statistical Indicators" (after section 13-15). *See* Section 2.6 for further information on the NBS definition of "state-holding enterprises" and "private enterprises." NBS alternatively uses the term "private enterprise" and "private-holding enterprise." For simplicity, the term "private enterprise" is used herein.

[300] Private enterprise in China in 2015 on average had RMB 105.7 million in total assets, RMB 54.8 million in liabilities, RMB 178.4 million in revenues, RMB 11.2 million in profit, and 160 employees. By contrast, in 2015 industrial state-holding enterprises in China had on average RMB 2.06 billion in total assets, RMB 1.27 billion in liabilities, RMB 1.25 billion in revenue, RMB 59.2 billion in profits, and 922 employees. All data in this paragraph is derived from NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), "13-6 Main Indicators of Private Enterprises by Industrial Sector (2015)" and "13-4 Main Indicators of State-holding Industrial Enterprises by Industrial Sector (2015)," and calculations performed by the Department.

[301] Data derived from NBS, *China Statistical Yearbook* for the years 2006-2016 (Beijing: China Statistics Press, 2006-2016), using tables titled "Main Indicators of Private Enterprises by Industrial Sector" and "Main Indicators of State-owned and State-holding Industrial Enterprises by Industrial Sector." *See* Footnote 299 for explanation of category title change from "State-owned and State-holding" to "State-holding."

enterprises tend to be larger in both capital- and labor-intensive industrial sectors.[302] As discussed in more detail below, these statistics may underestimate the size of the SIE sector.

Moreover, NBS statistics indicate that the number of state-owned and state-holding industrial enterprises in China fell by 30% from 2005 to 2015, but the total assets under the control of these enterprises grew by 240%, resulting in an almost four-fold increase in average assets per state-owned and state-holding industrial enterprise.[303] At the same time, NBS statistics suggest that over the past decade, the share of total assets of private enterprises has risen, as have revenue and profit.[304] Yet, as of December 2016, state-owned and state-holding industrial enterprises made up 44.8% of total assets, far in excess of the share of state-owned and state-holding industrial enterprises in total industrial enterprises (5.7%). This is also far in excess of the figure for total assets of private industrial enterprises (22.4%).[305]

In certain sectors, NBS statistics show that private enterprises account for a greater share of Fixed Asset Investment (FAI) than state-owned and state-holding industrial enterprises. For example, "private enterprises" account for more than 80% of FAI in textile, clothing and furniture manufacturing and also maintain a strong presence in retail and wholesaling in 2015.[306] Conversely, private enterprises account for only a small share of FAI in the healthcare, education, construction, and financial sectors. Rail, road, and air transportation all had state-holding enterprise shares in FAI in excess of 80% in 2015. In telecommunications, the state-owned and state-holding industrial enterprise share in FAI was 77%.[307] Overall, the NBS data estimates private enterprises accounted for around half of FAI in China [in 2015].[308]

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[302] For example, in petroleum extraction and automotive manufacturing, two capital-intensive industries, the total assets of state-owned and state-holding industrial enterprises are on average 63 and 29 times larger, respectively, than of private enterprises. In textiles and food, two labor-intensive industries, the total assets of state-owned and state-holding industrial enterprises are on average seven and four times larger, respectively, than of the average private enterprise. *See* NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), "13-6 Main Indicators of Private Enterprises by Industrial Sector (2015)" and "13-4 Main Indicators of State-holding Industrial Enterprises by Industrial Sector (2015)." Calculations performed by the Department.

[303] *Ibid*. Calculations performed by the Department.

[304] *Ibid*. Calculations performed by the Department.

[305] NBS, *Industry*, National Data (Monthly), available at http://data.stats.gov.cn/english/easyquery.htm?cn=A01, accessed June 1, 2017. As of December 2016, industrial firms in China totaled 379,142, of which 214,514 were defined as "private enterprises" and 21,579 as "state-owned industrial enterprises" or "state-holding industrial enterprises," with the sizeable remainder falling into other categories. Calculations performed by the Department.

[306] NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), Table 10-11 "Investment in Fixed Assets (Excluding Rural Households) By Sector, Jurisdiction of Management, Registration Status and Holding Type." Calculations performed by the Department.

[307] *Ibid*. Calculations performed by the Department.

[308] *Ibid*. Rail, road, and air transportation all had SIE shares in FAI in excess of 80% in 2015. Investment in telecommunications was 77% SIE and only 6% private, Table 10-11 "Investment in Fixed Assets (Excluding Rural Households)." Calculations performed by the Department.

Statistics on the size of SIEs relative to private enterprises are striking, especially when considering that the SIEs in China generally perform worse than private enterprises. A 2015 study by economists affiliated with the National Bureau of Economic Research finds that SIEs allocate capital less efficiently than private enterprises. Sampling 230 state business groups (of which 82 are managed by SASAC and 148 controlled by a local equivalent) and 91 private business groups between 2004 and 2013, the study attributes the differences in allocative efficiency largely to the degree of government influence over SIE business decisions.[309] MOF statistics indicate that the performance of "state-owned enterprises" improved in the years 1998-2007, during the period of large-scale restructuring of the SIE sector, but declined markedly after 2007.[310] In any case, size measurements do not fully account for the disproportionate share of factor inputs consumed by the SIE sector relative to its share of output. This is particularly true for capital. The IMF reports that the "SOE share in credit stock" was 55.6% in 2014.[311] Given that SIEs generally use capital less efficiently than the rest of the economy, their capital intensity of production is correspondingly higher.[312] It attributes this trend to the fact that SOEs have "soft budget constraints" and act "partly as a conduit for policy-driven investment."[313] A 2013 report by the World Bank notes the inherent tension between the poor performance of the SIE sector and its access to credit:

> The weighted average return on assets of SOEs is […] significantly lower than that of other firms […] On the other hand, the average debt to equity ratio of SOEs is substantially higher, exceeding 230[%] (Liu and Zhao 2009). If the financial system is liberalized, many highly leveraged SOEs would face difficulties in financing

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[309] *See* Alexander Ljungqvist et al., *State Capitalism vs. Private Enterprise*, Working Paper 20930 (National Bureau of Economic Research, February 2015), Abstract and 7-8.

[310] *See* Andrew Batson, *Fixing China's State Sector*, Paulson Policy Memorandum (Paulson Institute, January 2014), 7. SIE statistics cited by Batson include: overall return on assets stood at 0.2% in 1998, increased to 5.0% in 2007, and declined to 3.1% in 2012; overall return on equity stood at 0.4% in 1998, increased to 12.1% in 2007, and declined to 9.0% in 2011; overall profit margin stood at 0.3% in 1998, increased to 9.0% in 2007, and declined to 5.6% in 2012.

[311] *See* Kang et al., *People's Republic of China: Selected Issues,* IMF Country Report No. 16/271 (International Monetary Fund, July 2016), 9. *See* Table 1: Rebalancing Scorecard.

[312] *See e.g.*, Yasheng Huang, *State Capitalism in China*. [presentation] The Annual Proceedings of the Wealth and Well-Being of Nations, Beloit College, Beloit, Wisconsin, 2016, 27. ("Private firms are more efficient than SOEs and therefore they generate more value-added per unit of inputs—labor and/or capital—deployed"); Andrew Batson, *The State of The State Sector*. [presentation] Gavekal/Dragonomics, March 2017.

[313] *See* Wojciech Maliszewski et al., *Resolving China's Corporate Debt Problem*, Working Paper WP/16/203 (IMF, October 2016), 7. ("SOEs have been more leveraged and less profitable than private enterprises. SOEs have been the bulwark of government industrial policy, used to reach development and strategic goals. They have been the key policy instrument used by the central and local governments in the post-GFC response to mitigate growth slowdown […] Acting partly as a conduit for policy-driven investment, mostly in resources-intensive industries, they have reported higher and rising leverage compared to the private enterprises, and significantly weaker profitability [...] Inefficiency has been linked to soft budget constraints. The policy role of SOEs is enhanced by preferential access to financing. […] The privileged access has been underpinned by substantial land endowment (that can be used as collateral) and implicit government guarantees.")

> their investment or debt at low cost, resulting in deteriorating their financial situation and possibly leading to insolvency.[314]

The legal mandate to ensure a leading role for the SIE sector in China's economy has a systemic impact on private firms in China's economy, by discouraging new private sector entrants and reducing innovation and competition.[315]

2.6. Issues Concerning Official Data on Enterprises

As noted above, determining the economic significance of the SIE sector in China is inherently difficult, as China does not publish a single figure on the size of the entire SIE sector. In addition, economists have questioned the extent to which Chinese official statistics published by NBS can render a consistent and accurate picture of the state sector.[316] NBS reports some statistics based on China's formal enterprise registration system, and others using a concept of control as defined by NBS. However, neither of these reporting methods covers all of the complex mixed ownership structures that exists in China, and as a result, official statistics may underestimate the extent of government ownership and control in the economy.

First, NBS uses China's formal enterprise registration categories to report official statistics, but it is difficult to determine based on an enterprise's registration alone the extent of state involvement or control in that enterprise.[317] All enterprises in China must be registered under one of 18 categories pursuant to the *Provisions for the Classification of Enterprise Registration Types*. For domestically invested enterprises, there are eight possible enterprise registration

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[314] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 125.

[315] *Ibid.*, 25-28, 106, 111. ("State enterprises have close connections with the Chinese government. State enter-prises are more likely to enjoy preferential access to bank finance and other important inputs, privileged access to business opportunities, and even protection against com-petition (Li and others 2008). This discourages new private sector entrants and reduces competition and innovation. Some state enterprises operate outside their mandated area (many invest in real estate and the shadow banking system), because they can keep their earnings and invest them with limited external control or oversight. A new issue needing attention is the recent rapid expansion of some state enterprises owned by sub-central governments; their growth will likely further crowd out private sector activity, dampen competition, and conflict with efforts to build sound foundations for a market-based economy…") *Ibid*., 26.

[316] *See e.g.,* Loren Brandt, Johannes Van Biesebroeck, and Yifan Zhang, "Challenges of Working with the Chinese NBS Firm-Level Data," *China Economic Review* (May 2, 2014), 339–52; Chang-Tai Hsieh and and Zheng Michael Song, *Grasp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. w21006 (National Bureau of Economic Research, 2015), 7-15; Andrew Batson, *Fixing China's State Sector*, Paulson Policy Memorandum (Paulson Institute, January 2014), 7; Paul Hubbard, *Reconciling China's Official Statistics on State and Control*, East Asian Bureau of Economic Research (Working Paper, Paper No. 120 (May 19, 2015), Derek Scissors, "China's SOE sector is bigger than some would have us think," East Asia Forum, (May 17, 2016).

[317] Chang-Tai Hsieh and Zheng Michael Song, *Grasp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. 21006 (National Bureau of Economic Research, 2015), 7-15; Nicholas Lardy, *Markets Over Mao: The Rise of Private Business in China,* (Washington, DC: Peterson Institute for International Economics, 2014), 62-68; Curtis J. Milhaupt and Wentong Zheng, "Beyond Ownership: State Capitalism and the Chinese Firm," *The Georgetown Law Journal* 103:665 (2015): 671-676.

categories, including “state-owned enterprise.”[318] According to the NBS definition, “state-owned enterprise” for registration purposes is limited in scope to “non-corporate economic units where the entire assets are owned by the State.”[319] It does not include enterprises that are registered under any of the other categories but nevertheless may be subject to state involvement or control. For example, a publicly traded company that is registered as a “company limited by shares” may be controlled by the state, but it would not be included in NBS statistics as a “state-owned enterprise.”[320] Conversely, NBS registration statistics for “company limited by shares” and “private enterprise” do not indicate the extent to which these enterprises may in fact be subject to state involvement or control. In addition, an entity registered as a sino-foreign equity joint venture would be reflected in NBS registration statistics as a foreign-invested enterprise even if the joint venture were subject to significant state involvement or control. Therefore, a review of NBS statistics based on registration type alone can understate the extent of state involvement or control in the enterprise sector.

Second, as noted above, NBS also reports statistics using a concept of control based on six different categories,[321] which includes “state-holding enterprise” (which could alternatively be translated as “state-controlled enterprise”) and “privately-controlled enterprise.” “State-controlled enterprises” include not only “state-owned entities” as defined above but also include enterprises in which the state is the largest shareholder or exercises control over the enterprise by virtue of an agreement.[322] However, the concept of state-controlled enterprise used by NBS for

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318 The eight domestically-invested enterprise registration types are: 1) “state-owned enterprise”; (2) collective enterprise (3) share cooperative; (4) joint venture; (5) limited-liability company; (6) company limited by shares; (7) “private enterprises”; and (8) other enterprises.

319 NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), “Explanatory Notes on Main Statistical Indicators” (after section 1-8). (“State-owned Enterprises refer to non-corporation economic units where the entire assets are owned by the State and which have been registered in accordance with the *Regulation of the People’s Republic of China on the Management of Registration of Corporate Enterprises*. Not included from this category are solely State-funded corporations in the limited liability corporations.”)

320 Chang-Tai Hsieh and Zheng Michael Song, *Grasp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. 21006 (National Bureau of Economic Research, 2015), 9. (“[M]any state-owned firms, particularly after 1998, are registered as limited-liability or publicly traded companies, albeit with the controlling stake held by a state-controlled holding company. The Baoshan steel company and Shanghai’s SAIC Group’s stand-alone car company (SAIC)[…] are examples of publicly listed companies (and, thus, registered as share-holding companies) but with a controlling stake held by a holding company owned by the Chinese state (the Central government in the case of Baoshan and the local Shanghai government in the case of SAIC).”)

321 These categories are: (1) state controlled enterprise (which NBS translates as “state-owned or state-holding enterprise), (2) privately-controlled enterprise (which NBS translates as “private-holding,” (3) collective-controlled enterprise, (4) Hong Kong, Macao, Taiwan controlled enterprise, (5) foreign-controlled enterprise, and (6) others.

322 NBS, *China Statistical Yearbook – 2016* (Beijing: China Statistics Press, 2016), “Explanatory Notes on Main Statistical Indicators” (after section 13-15). (“State-holding enterprises cover the original state-owned enterprises and state-holding enterprises. They are classified according to the actual investment made by the contribor [*sic*] of state-owned part in the paid-in capital of the enterprises, or the degree of control or dominance of the contributor on the assets of the enterprises. The following cases are regarded as state holding: (1) Absolute state-holding in which the contribors [*sic*] of state-owned parts possess more than 50% of all the paid-in capital (stocks) of the enterprise; (2) Relative state holding in which the contribors [*sic*] of state-owned parts possess no more than 50% of the paid-in

statistical purposes still understates the extent of state involvement for at least two reasons. First, an enterprise in which the state holds a significant but non-controlling stake would be considered a private enterprise. Second, the concept of state-holding as defined by NBS does not capture all of the complex corporate structures that exist in China in which the state effectively controls the enterprise. For example, the NBS definition does not aggregate state involvement at different levels of the corporate structure or among different shareholders, such that an enterprise may be considered privately controlled even if the state has actual control over the enterprise.[323] Conversely, NBS statistics may overstate the extent of private control over industrial enterprises for the same reason.[324]

3. Bankruptcy, Consolidations and State Enterprise Groups

3.1. The Bankruptcy System

The incidence of bankruptcy cases in China is relatively limited given the size of China's economy and population, according to the IMF and other experts.[325] Statistics provided by the Supreme People's Court show that Chinese courts accepted 5,665 bankruptcy cases in 2016.[326] This figure pales in comparison to the United States, where the number of bankruptcy filings totaled 794,492 for the filing year ending March 31, 2017.[327] One reason for the disparity is that

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capital (stocks) of the enterprises, but more than that of any other contributors; or Agreed state holding in which the contribors [*sic*] of state-owned parts possess no more than other contributors but have actual control over the enterprises according to agreements; (3) In the case both contributors possess 50% and it is not clear which one is in absolute holding position, the enterprise is regarded as state-holding enterprise if one of the contributor has state-owned elements.")

[323] Paul Hubbard, *Reconciling China's Official Statistics on State and Control*, East Asian Bureau of Economic Research (Working Paper, Paper No. 120 (May 19, 2015), 10. ("The definition of 'state-owned and state controlled' is also non-cumulative – for example, company A might be 49 per cent state-owned and 51 per cent owned by a private shareholder, in which case it is classified as private controlled. Suppose they create a new company, company B in which company A holds a 51 per cent stake, with the remaining 49 per cent owned by wholly state-owned enterprise B. In this case, company C is not 'state controlled' because its controlling parent is not state-controlled. Nevertheless, the state would remain the ultimate beneficial owner of almost three quarters of company C.")

[324] *Ibid*. *See also* Derek Scissors, "China's SOE sector is bigger than some would have us think," East Asia Forum, (May 17, 2016).

[325] Wojciech Maliszewski et al., *Resolving China's Corporate Debt Problem*, Working Paper WP/16/203 (IMF, October 2016), 16. *See also* Markus Taube and Christian Schmidkonz, A*ssessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 236.

[326] *Bloomberg News*, "Chinese Leaders Back Bankruptcies for Unwanted Zombie Firms," March 13, 2017.

[327] United States Courts, *March 2017 Bankruptcy Filings Down 4.7 Percent* (April 19, 2017).

Chinese law does not provide for the bankruptcy of private individuals.[328] Nevertheless, of the bankruptcies filed in the United States, 23,591 were "business" bankruptcies, which is more than four times the number of bankruptcy cases accepted in China.[329]

In addition, the incidence of bankruptcy filings is low given the speed at which the country is transforming.[330] The low incidence of bankruptcy cases is not the result of a dearth of business exit in China. The IMF estimates that for each insolvency case accepted by China's courts, another 100 to 250 enterprises go out of business, many of them through deregistration and business license cancellation.[331] Studies suggest that such business exit disproportionately affects firms in the non-SIE sector that have less access to credit.[332] Business exit through means other than bankruptcy can have a detrimental impact on the financial health of a company's employees, management, shareholders, and creditors, in addition to discouraging future risk-taking among entrepreneurs in the economy as a whole.

As described below, a principal problem with China's bankruptcy system is the uneven manner in which the Chinese government has developed and administered bankruptcy regulations, as well as the discretion the Chinese government exercises in managing the business exit of enterprises under government ownership and control.

The adoption of a new *Enterprise Bankruptcy Law of the People's Republic of China* ("*EBL*")[333] in 2006 marked an important step forward. The *EBL* covers bankruptcy not only of SIEs, but also

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[328] Bankruptcy of private individuals is not expressly forbidden, but it is not covered in the EBL or any other bankruptcy legislation. *See also* CCP Central Committee United Front Work Department, *Recommendations on Establishing a Bankruptcy System for Individuals* (April 18, 2017).

[329] United States Courts, *March 2017 Bankruptcy Filings Down 4.7 Percent* (April 19, 2017).

[330] Markus Taube and Christian Schmidkonz, Ass*essment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 18.

[331] Wojciech Maliszewski et al., *Resolving China's Corporate Debt Problem*, Working Paper WP/16/203 (IMF, October 2016), 16. *See also* Changyin Han, "The Practice of Reorganization in China," *Arizona Journal of International & Comparative Law* 33(1) (2016): 277. The paper states that in the period 2006-2013, the annual number of "revoked enterprises" – *i.e.*, enterprises that exited the economy – ranged between 672,000 and 871,400; during the same period, the annual number of "bankruptcy cases" continually declined, from a high of 4,253 in 2006 to a low of 1,998 in 2013.

[332] Wojciech Maliszewski et al., *Resolving China's Corporate Debt Problem*, Working Paper WP/16/203 (IMF, October 2016), 7. For studies of firm survival in China, *See also* Jia Liu and Dong Pang, "Financial Factors and Company Investment Decisions in Transitional China," *Managerial and Decisions Economics* 30:2 (March 2009): 95; Chang-Tai Hsieh and Zheng Michael Song, Gr*asp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. w21006 (National Bureau of Economic Research, 2015), Table 1; David Audretsch et al., "Ownership, Productivity and Firm Survival in China," *Economia E Politica Industriale* 43(1) (2016): 67-83.

[333] *Enterprise Bankruptcy Law of the People's Republic of China* (adopted by NPC on August 27, 2006, Order No. 54, effective June 1, 2007).

of private enterprises, foreign enterprises, and Sino-foreign joint ventures.[334] The Chinese government also formally ended the system of "policy-led" bankruptcies, with all SIE bankruptcy cases henceforth to be conducted pursuant to the *EBL*.[335] In a departure from the "policy-led" bankruptcy model, the *EBL* rearranges the order in which claims are ranked, such that creditors are placed ahead of workers.[336]

While the *EBL* made certain improvements,[337] bankruptcy in China still faces several institutional issues. The foremost problem is the government's *ad hoc* approach to the business exit of SIEs. In spite of the poor performance of the SIE sector and the proliferation of "zombie" enterprises, bankruptcies of SIEs since the enactment of the *EBL* are few. Moreover, China's State Council has acknowledged the serious problem of economically unviable "zombie" enterprises.[338] International institutions have also taken note of this issue in assessments of China's economy.[339] According to one study, the existence of "zombie" enterprises in a province is correlated with the extent of SOCB operations in that province, one of several indications that banks under government influence act to support "zombie" enterprises.[340] By contrast, studies find that the private sector has faced harder budget constraints in the wake of the global financial crisis, as manifested in less secure lines of credit and higher factor input costs.[341]

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[334] Markus Taube and Christian Schmidkonz, *Assessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 18.

[335] A report filed by the National People's Congress on August 27, 2006 confirmed the impending elimination of policy-led bankruptcies in conjunction with the *EBL*, so as to eliminate the special treatment of SOEs. In February 2007, six months after the adoption of the *EBL*, MOF then issued a measure asking local financial authorities to submit reports by mid-year 2007 on outstanding cases to be resolved. *See* the *Notice on Pragmatically Strengthening the Administrative Work for the Policy-Led Closure and Bankruptcy of State-Owned Enterprises* (MOF, Cai Qi [2007] No. 30, issued February 25, 2007); NPC, *Enterprise Bankruptcy Law Amendment and the Enterprise Bankruptcy System* (August 28, 2006).

[336] *EBL*, Article 43, provides that liquidation and bankruptcy fees are ranked ahead of public interest debts. Article 42 defines "public interest debts" to include worker compensation and social welfare fees.

[337] The *EBL* contains provisions on the handling of restructuring plans and debt disposition. The law places the onus upon the debtor or the administrator to submit a restructuring plan to the court within six months of the date the court decides such a plan is needed, while also stipulating favorable conditions for restructuring solutions that would allow a company to emerge from insolvency. *EBL*, Chapter 8.

[338] IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 8.

[339] IMF, *2015 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 15/234 (IMF, August 2015), 17. OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017), 41.

[340] Yuyan Tan, Yiping Huang, Wing Thye Woo, "Zombie Firms and the Crowding-Out of Private Investment in China," *Asian Economic Papers* 15(3) (2016): 32-55.

[341] Douglas J. Elliott and Yu Qiao, *Reforming Shadow Banking in China* (The Brookings Institution, May 2015), 2, 6-7.

In exercising discretion over SIE business exit, Chinese government authorities, particularly at the local level, often act on imminent concerns relating to financial stability and unemployment.[342] A survey of four high-profile cases of SIE restructuring between 2014 and 2015 illustrates that indebted SIEs in heavy industries such as steel, shipbuilding, and coal frequently resort to worker layoffs and other restructuring measures, but rarely file for bankruptcy.[343] Defaults remain isolated incidents in spite of the high level of corporate debt in the SIE sector.[344] A 2016 study by a Chinese legal expert identifies the "negative attitude" of local governments as a key factor affecting the practice of enterprise reorganization in China. The study finds that local governments often act on concerns that bankruptcies will result in a decline in the number of publicly listed enterprises in their jurisdiction, or will increase the burden of resettling laid off workers. Consequently, local governments often intervene to preempt bankruptcy cases altogether, or alternatively, attempt to affect the outcome of bankruptcy proceedings by appointing government officials as trustees for insolvent enterprises.[345]

The lack of business exit and default among SIEs reflects the Chinese government's unwillingness to let SIEs fail, which in turn gives rise to an implicit government guarantee on credit provided to SIEs. Implicit government guarantees result in borrowing costs that are not commensurate with risks and returns, distorting the allocation of resources and promoting inefficiency in the SIE sector and the economy as a whole.[346] It also gives rise to a vicious cycle of continual borrowing and debt accumulation that distorts the financial sector in favor of SIEs.

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[342] Loss-making SOEs may still drive growth in a given jurisdiction and contribute to the local tax base (also indirectly by stimulating demand in corollary sectors and raising the value of land transactions). Maintaining SOEs is also a means to guard against large-scale layoffs; preserve the stability of the banking system; and avoid a drawn-out and uncertain bankruptcy process involving multiple stakeholders. Jianguang Shen, "Dealing with Zombie Companies and Overcapacity in China," *Economics Weekly* (47) (Mizuho Securities Asia Ltd. Economics Research, November 20, 2015), 3.

[343] *Ibid*., 5.

[344] In April 2015, Cloud Live Tech Group (002306 CN) announced it would default on a RMB 480 million bond, marking the first time a bond in the Chinese market failed to meet its principal payment. Previously, the only bond default was in March 2014, when Shanghai Chaori Solar Energy Science & Technology failed to meet its principal payment. Jianguang Shen, "First Case of Principal Default in the Bond Market," *Economics Weekly* (18) (Mizuho Securities Asia Ltd. Economics Research, April 10, 2015), 3. The October 2016 initiation of bankruptcy proceedings for Dongbei Special Steel, an SIE backed by the Liaoning provincial government, attracted widespread attention because of the rare nature of a Chinese state-owned enterprise declaring bankruptcy. The bankruptcy proceedings were only initiated after extensive efforts by the Chinese government authorities to rescue the firm through debt-to-equity swaps. Sidney Leng, "Major Chinese State Steel Maker Starts Bankruptcy Process after Failed Debt-to-Equity Attempt," *South China Morning Post*, October 13, 2016.

[345] Changyin Han, "The Practice of Reorganization in China," *Arizona Journal of International & Comparative Law* 33(1) (2016): 280-281.

[346] IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 33, 34, and 40.

Both the IMF and the World Bank have found implicit government guarantees to be a significant impediment to efficient business exit in China's economy.[347]

It is noteworthy that China's bankruptcy system does not adequately provide for the insolvency of financial institutions. The OECD has remarked that China's "[f]inancial institutions are still not covered by bankruptcy legislation and their insolvency process follows *ad hoc* rules."[348] Article 134 of the *EBL* appears to preclude financial institutions from self-filing for bankruptcy, leaving this option to the discretion of the regulatory authority.[349] Moreover, the law does not specify which or what type of "corresponding measures" the State Council should formulate when a financial institution is in bankruptcy. Similar to the OECD, the World Bank has found that "[f]inancial market infrastructure is improving but remains challenged: bankruptcy procedures are not widely understood […]"[350] According to a 2016 research paper by the Shanghai branch of the China Banking Regulatory Commission (CBRC), only four Chinese banks have undergone bankruptcy proceedings, of which three were initiated between 1997 and 1999 and one was initiated in 2005.[351] By comparison, the Federal Deposit Insurance

[347] *See* IMF, *2015 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 15/234 (August 2015), 16. ("Implicit guarantees are prevalent throughout the financial system, leading to mispricing of risk and misallocation of resources. Breaking this web will introduce greater uncertainty into the financial system and cannot be done overnight. At the same time, the process must start and will involve greater acceptance of defaults, credit events, and bankruptcies. This applies, in particular, to state-owned enterprises (SIEs), which benefit from preferential access to financing supported by a perceived state backing of their liabilities. Such perceptions create an uneven playing field that distorts the allocation of financing toward SIEs, crowds out the private sector, and lowers productivity growth." (emphasis added) S*ee also* World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 401. "The policies required to establish the renminbi as an international currency will have important implications for China and the world. […] State-owned enterprises would have to face hard budget constraints, that is, those that become insolvent would have to be allowed to go bankrupt, so that creditors would not be tempted to lend in the expectation that their loans enjoyed an implicit government guarantee." (emphasis added)

[348] OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017), 41.

[349] *EBL*, Article 134. ("If any commercial bank, securities firm, insurance company or other financial institutions falls under any of the circumstances set forth in Article 2 of this Law, the financial regulatory authority of the State Council apply for reorganization or bankruptcy liquidation of such financial institution with the People's Court. When adopting such measures as takeover and custody with the financial institutions that have incurred material operational risks, the financial regulatory authority of the State Council may apply to the People's Court for suspending the civil proceedings or execution proceedings where such financial institutions are the plaintiff or the parties against which execution is performed. Where the financial institutions implement bankruptcy, the State Council may formulate implementing measures according to the provisions of this Law and other relevant laws.")

[350] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 396.

[351] Shanghai Banking Regulatory Office Legal Affairs Department Task Group, "Research on the Allocation of Rights for Commercial Bank Bankruptcy Risk Disposal," *Jinrong Jianxue Yanjiu* 10 (2016): 80-81. Available at http://www.cbrc.gov.cn/chinese/files/2017/B2CAAC5EC34C4780B4D514F75D4848D0.pdf.

Corporation (FDIC) has recorded over 500 failed banks in the United States since October 2000.[352]

Discretion accorded to the government in the administration of bankruptcy proceedings provides the government with another instrument to influence business exit outcomes of both SIEs and privately-owned enterprises. First, the *EBL* affords courts the discretion to choose which bankruptcy cases to accept.[353] One Chinese legal expert notes that courts in China often lack an incentive to take on bankruptcy cases because "[t]he court's internal performance evaluation has not formed an encouraging mechanism for bankruptcy hearings."[354] In addition, the *EBL* contains no regulations governing insolvency of private individuals or sole proprietorships.[355] This gap effectively precludes bankruptcy proceedings for many small businesses, making it more difficult for them to deal with accumulated debts.[356]

For the cases accepted by the courts, the *EBL* also provides that the appointment of bankruptcy administrators be conducted at the court's discretion.[357] It appears that many bankruptcy trustees lack experience and the system may also not provide rational incentives in establishing trustee remuneration.[358]

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352 *Failed Bank List*, (Federal Deposit Insurance Corporation, available at https://www.fdic.gov/bank/individual/failed/banklist.html).

353 *EBL*, Article 10.

354 Changyin Han, "The Practice of Reorganization in China," *Arizona Journal of International & Comparative Law* 33(1) (2016): 282.

355 Markus Taube and Christian Schmidkonz, *Assessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 239.

356 A 2017 CCP document acknowledges this issue. *See* CCP Central Committee United Front Work Department, *Recommendations on Establishing a Bankruptcy System for Individuals* (April 18, 2017). (The document acknowledges that China does not have a bankruptcy system for individuals and that entrepreneurs are often asked to assume joint responsibility for the company's debt liability, and as a result, a large number of entrepreneurs shoulder heavy debts from which they are unable to separate themselves, which seriously impedes the process of self-correction between enterprises and the market. The document concludes that it has become increasingly urgent to implement a bankruptcy system for private individuals.)

357 *EBL*, Article 22. *See also* Filip Moerman, Marc Grey, and George A. Bongartz, *The New Chinese Bankruptcy Law, Restructuring Newsletter* (Cleary Gottlieb Steen & Hamilton LLP, Spring 2007), sequential page 2 [source not paginated]. ("Another important feature of the [*EBL*] is that once the court has accepted the bankruptcy filing, the court will appoint an administrator to take over the debtor's property and manage its affairs. While there is no provision for a debtor-in-possession, a debtor may request the court to permit it to continue to manage the debtor's property under the supervision of the administrator. The [*EBL*], however, does not specify whether management returns once the debtor has reorganized. The [*EBL*] does not itself specify who will be eligible to serve as administrator. It only provides that the Chinese Supreme Court will determine eligibility as well as compensation at a later point.")

358 Changyin Han, "The Practice of Reorganization in China," *Arizona Journal of International & Comparative Law* 33(1) (2016): 282.

According to the OECD's 2017 review of China's economy, "[a] major obstacle to getting rid of public zombie enterprises is the obstruction of the insolvency process by the insolvency manager for fear of state asset embezzlement."[359] The OECD further states:

> Asset disposal has made little progress between 2012 and 2015, with central SOEs controlled by SASAC shedding assets worth RMB 108 billion, equivalent to only 1.6% of the total. Stripping off assets is quite complicated as the suspicion of State asset embezzlement always looms large. The target of 345 zombie firms to be closed by SASAC in the coming three years appears rather modest given that it controls around 40 000 firms and that most zombies are SOEs. As SOEs expand internationally, destination countries place increased scrutiny on transactions involving SOEs to assess the potential anti-competitive effects in their markets.[360]

In addition to the institutional problems discussed above, the lack of efficiency of China's bankruptcy administration in China also effectively undermines the protection available to creditors. OECD statistics, using the World Bank *Doing Business* database, show that insolvency procedures in China lag behind major OECD economies.[361] A key impediment is inadequate staffing of local courts.[362] As the OECD has noted, one consequence of lengthy and uncertain insolvency procedures is that creditors are hesitant to participate in the reorganization of debtor enterprises, even if this approach would be conducive to recouping outstanding debts.[363]

At its Central Economic Work Conference in December 2015, the CCP decided to accelerate the business exit of "zombie" companies.[364] Beginning in 2016, the Chinese government took steps to implement this decision and facilitate more bankruptcy proceedings. In August 2016, the Supreme People's Court also set up a website for the first time to allow creditors to register bankruptcy applications and for courts to release information on pending bankruptcy cases. Statistics show a 54% year-on-year increase in accepted bankruptcy cases between 2015 and

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359 OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017), 41.

360 *Ibid.*, 46.

361 In a score that reflects the time, cost and outcome of insolvency proceedings involving domestic entities as well as the strength of the legal framework governing judicial liquidation and reorganization, China scores just above 50 out of 100, well behind other major economies such as Russia, France, the United Kingdom, the United States, South Korea, Germany, and Japan. OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017, 42.

362 The OECD stated in 2017: "The ongoing reform aiming at specialization of the industry by establishing bankruptcy divisions in intermediate courts in provincial capitals and No. 2 cities in provinces will likely increase the efficiency of case handling. Shenzhen has been a pilot and by July 2016 15 provinces had introduced this new system with nationwide coverage expected by end-year. A simplified procedure for micro- or small enterprises would also work in the same direction." OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017), 41-42.

363 *Ibid.*

364 *Xinhua Finance Agency*, "Eight Key Words Interpreting China's Central Economic Work Conference," December 22, 2015.

2016, but this growth spurt is not representative of long-term trends.[365] The number of accepted bankruptcy cases declined by more than half between 2005 and 2014, from over 4,000 to approximately 2,000.[366] As discussed in the next section, the increase in bankruptcy proceedings has coincided with an increase in the rate of consolidations among SIEs.

3.2. Consolidations of SIEs

Consolidation of state-owned assets through mergers and acquisitions (M&A) has facilitated the expansion of large SIEs and shaped the distribution of SIEs across different sectors. Government policies, as well as government intervention on a case-by-case basis, has guided this consolidation activity. In 1980, the State Council issued a decision to encourage horizontal mergers, which gave rise to the first generation of enterprise groups.[367] The Chinese government-led industry consolidation policies also played a major role in SIE restructuring in the 1990s.[368]

Over the past decade, the Chinese government has issued additional measures that solidify its SIE consolidation policy. The *SASAC Adjustment Opinion* of 2006 contemplates alliances among "powerful state-owned enterprises."[369] In August 2010, the State Council issued the *Opinions of the State Council on Promoting Enterprise Merger and Restructuring*,[370] which promotes consolidation of enterprises in six industries, most of which are dominated by SIEs, namely the automobile, steel, cement, aluminum, rare earths, and machinery manufacturing industries.[371] A principal objective for M&A set forth in this measure is to:

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[365] *Bloomberg News*, "Chinese Leaders Back Bankruptcies for Unwanted Zombie Firms," March 13, 2017; *Supreme People's Court Monitor*, "Ramping up China's Bankruptcy Courts, the Latest Data," May 18, 2016.

[366] *Bloomberg News*, "Chinese Leaders Back Bankruptcies for Unwanted Zombie Firms," March 13, 2017; *Supreme People's Court Monitor*, "Ramping Up China's Bankruptcy Courts, the Latest Data," May 18, 2016.

[367] Yong Zhang, *Large Chinese State-Owned Enterprises* (New York: Palgrave MacMillan, 2008), 42-43.

[368] *See* Chang-Tai Hsieh, and Zheng Michael Song, *Grasp the Large, Let Go of the Small: The Transformation of the SIE sector in China*, No. w21006 (National Bureau of Economic Research, 2015), 7. ("In the steel sector, for example, five large industrial groups were created in the late 1990s and early 2000s, and ownership of the state-owned steel manufacturers was transferred to these groups. Three of these groups are owned by the Chinese central government (the BaoSteel Group, the WuSteel Group, and the AnSteel Group) and two by provincial governments (the Hebei Steel Group and the Shandong Steel Group). In the automobile industry, state-owned automobile companies were consolidated into six state-owned conglomerates, the largest of which is the Shanghai Automobile Industrial Group (SAIC) owned by the municipal government of Shanghai.")

[369] *Notice of the General Office of the State Council on Forwarding the Guiding Opinion of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises*, Chapter 2, "Main Policies and Measures," Article 8 (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006).

[370] *Opinions of the State Council on Promoting Enterprise Merger and Restructuring* (State Council, Guo Fa [2010] No. 27, issued August 28, 2010).

[371] The *Opinions of the State Council on Promoting Enterprise Merger and Restructuring* was issued concurrent numerous other structural adjustment policies including, *inter alia*: *State Council Decision on Implementing the "Interim Provisions on Promoting the Structural Adjustment of Industry* (State Council, Guo Fa [2005] No. 40, issued December 2, 2005); *Nonferrous Metals Industry Adjustment and Revitalization Plan* (State Council,

> …[P]romote the union, trans-regional merger and restructuring, overseas M&A and investment cooperation among competitive enterprises by focusing on such industries as automobile, steel, cement, machinery manufacturing, electrolytic aluminum and rare earth, so as to improve industrial centralization, promote large-scale and intensive operation, accelerate the development of key enterprises with independent intellectual property rights and famous brands, cultivate a large number of large enterprise groups with international competitiveness, and promote the optimization and upgrading of industrial structure.[372]

The CCPCC and State Council's *Guiding Opinion on Deepening Reform of State-owned Enterprises* ("*SOE Reform Opinion*")[373] of 2015, discussed in more detail below, also calls for accelerated consolidation of enterprises through M&A. Pursuant to the *SOE Reform Opinion*, SASAC in February 2016 stated that it will promote consolidation through additional M&A transactions among central government SIEs on a pilot basis.[374]

Experts have noted the significant extent to which the Chinese government has influenced M&A transactions among large SIEs. In its 2008 *Trade Policy Review* of China, the WTO attributed the steady reduction in SIEs managed by SASAC "mainly" to M&A transactions rather than privatization or other forms of market exit.[375] There was an uptick in SIE M&A activity during the 18th Party Congress – one study identifies at least 16 major "mergers" of central SIEs between 2012 and 2016, of which six were transacted in 2015 and five in 2016 (see **Table 2** below).[376]

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published May 11, 2009); *Steel Industry Adjustment and Revitalization Plan* (State Council, Guo Fa [2009] No. 6, March 20, 2009).

[372] *Opinions of the State Council on Promoting Enterprise Merger and Restructuring*, Section 2.1 (State Council, Guo Fa [2010] No. 27, issued August 28, 2010).

[373] *Guiding Opinion on Deepening Reform of State-owned Enterprises* (CCP Central Committee and State Council, Guo Fa [2015] No. 22, issued August 24, 2015).

[374] Se Yan and Shuang Ding, *China – A Gradual Step Forward for SOE Reform* (Standard Chartered Global Research, February 26, 2016), 2.

[375] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/199 (April 16, 2008), 93.

[376] Wendy Leutert, *State-owned Enterprise Mergers: Will Less Be More?*, ECFR/197 (European Council on Foreign Relations, November 2016), 5. According to the financial publication Bloomberg News, in the 20 months leading up to September 2016, "the government has announced SIE deals involving 6.9 trillion yuan ($1 trillion) of assets in what's shaping up to be the biggest overhaul of state-owned companies since the 1990s." *Bloomberg News*, "Why China's $1 Trillion Merger Makeover Could Fail," September 7, 2016.

Table 2: Mergers of Central State-owned Enterprises in China, 2012-2016

Year	Industry	Central state-owned enterprise	Merged into/became
2012	Printing	China Printing Group Corporation	China Reform Holdings Corporation Ltd
2013	Electronics	Caihong Group Corporation	China Electronics Corporation
2013	Grain production and distribution	China Grain & Logistics Corporation	China National Cereals, Oils and Foodstuffs Corporation (COFCO)
2014	Machinery equipment	China National Erzhong Group Corporation	China National Machinery Industry Corporation (Sinomach)
2014	Food production and distribution	China Huafu Trade & Development Corporation	China National Cereals, Oils and Foodstuffs Corporation (COFCO)
2015	Rail equipment	- CNR Corporation - CSR Corporation	China Railway Rolling Stock Corporation (CRRC)
2015	Energy (Production)	- China Power Investment Corporation (CPI) - State Nuclear Power Technology Corporation (SNPTC)	State Power Investment Corporation
2015	Shipping	- China Ocean Shipping Group Corporation (COSCO) - China Shipping Group Company	China COSCO Shipping Corporation Ltd
2015	Metals	China Metallurgical Group Corporation	China Minmetals Corporation
2015	Energy (Logistics)	Zhuhai Zhenrong Company	Nam Kwong (Group) Company Ltd
2015	Energy (Logistics)	Sinotrans & CSC Holdings Company Ltd	China Merchants Group Company Ltd
2016	Textiles	Chinatex Corporation	China National Cereals, Oils and Foodstuffs Corporation (COFCO)
2016	Travel Services	China International Travel Services Group	China National Travel Service (HK) Group
2016	Metals	Wuhan Iron and Steel Corporation	Shanghai Baosteel Group Corporation
2016	Construction materials	- China National Building Materials Group Corporation (CNBM) - China National Materials Group Corporation Ltd (Sinoma)	China Construction Materials Group
2016	Cotton production and distribution	China National Cotton Reserves Corporation	Sinograin

Source: Adapted from Wendy Leutert, *State-owned Enterprise Mergers: Will Less Be More?* ECFR/197 (European Council on Foreign Relations, November 2016), 5.

Scholars have suggested that the government at times pressures enterprises to participate in M&A transactions. A 2013 legal study notes an "evolving dynamic" by which national, state-owned business groups purchase smaller SIEs at the province- and sub-province-level, subject to pressures exerted by the Chinese government.[377] As part of *Article IV Consultations* in 2016, the

[377] *See* Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65(4) (May 2013): 725-726. ("Initially, local governments sought investment from the national groups to rescue moribund local SOEs. As the national groups expanded, local governments began to view them as competitive threats to local businesses. Local protectionism increased, and a push was made to create "provincial champions." The relationship between national and local groups appears to be in flux again because of the global financial crisis, which prompted renewed central-local cooperation. The local governments now view the national champions as sources of support for small and midsize enterprises, which suffered when they lost the backing of foreign and private companies. For the national groups, which are under pressure from their governmental supervisors to grow, tie-ups with local groups are an avenue of expansion.")

IMF recommended that mechanisms for enterprise restructuring in China be "market-based, rather than relying on *forced mergers* between weak and strong firms" (emphasis added).[378] The broader regulatory framework governing M&A in China also illustrates how such transactions serve high-level policy objectives, such as promoting structural adjustment and shedding excess capacity. (See Factor 5.A. for further discussion.)

3.3. State Enterprise Groups

As part of its management of SIEs, the Chinese government has pursued an objective to create "national champions." These often take the form of large enterprise groups under government ownership and control ("state enterprise groups," or SEGs).[379] The State Council has stated that by developing large SEGs, China "can reap economies of scale, invest heavily in research and development, undertake overseas investment, and ultimately compete internationally as modern transnational corporations."[380] The use of control pyramids allows SEGs to meet these government policy directives by quickly growing in scale through increased reliance on private capital without diluting government control.[381]

Many of the central SIEs managed by SASAC constitute SEGs. When SASAC was established in 2003, it took charge of roughly 200 of the most important non-financial SIEs.[382] Subsequently, the number of SIEs managed by SASAC has declined, to 102 as of 2017.[383] These remaining SIEs are now among the largest enterprises in their sectors, both in China and worldwide.

Government policy has played an important role in fostering the emergence of large SEGs. SEGs are organized under the *Circular of the State Administration for Industry and Commerce on Printing and Issuing the Interim Regulations for Administration of Registration for Enterprise Groups* ("*Enterprise Group Rules*"),[384] which were issued by the State Administration of

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[378] IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 20.

[379] Wendy Leutert, "Challenges Ahead in China's Reform of State-owned Enterprises," *Asia Policy* 21 (January 2016), 85.

[380] Dylan Sutherland and Lutao Ning, "The Emergence and Evolution of Chinese Business Groups: Are Pyramidal Groups Forming?" in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 141.

[381] *Ibid*., 151.

[382] Sarah Y. Tong, "Corporate Governance of China's SOEs and CAEs," in *China into the Hu-Wen Era: Policy Initiatives and Challenges*, eds. John Wong and Hongyi Lai (Hackensack: World Scientific Publishing, 2006), 270.

[383] *List of Central State-owned Enterprises* (SASAC website, available at http://www.sasac.gov.cn/n86114/n86137/index.html, accessed July 14, 2017).

[384] *Circular of the State Administration for Industry and Commerce on Printing and Issuing the Interim Regulations for Administration of Registration for Enterprise Groups* (SAIC, Gong Shang Qi Zi [1998] No. 59, issued April 6,

Industry and Commerce in 1998 concurrent with government policies to restructure the SIE sector. Under the *Enterprise Group Rules*, business groups shall have at least two layers: a parent company (the first layer) and at least five controlled subsidiaries (the second layer), with required registered capital of RMB 50 million for the parent company and exceeding RMB 100 million for the parent company and controlled subsidiaries combined.[385] Proper registration requires an "Articles of Grouping" that specifies the business group's boundaries and internal governance rules.[386] According to one legal review study, such standard Articles of Grouping would contain directives for the business to undertake important functions requested by the Chinese government, such as implementing national industrial policies, advising the government in the development of such policies, and implementing national standards.[387] Moreover, business groups qualify for unique benefits such as the eligibility to establish financial subsidiaries and research institutes.[388]

SEGs have far-reaching influence over the means of production in China's economy. For example, China Guodian Corporation (CGDC) is one of the top-five enterprises in China's power generation sector.[389] With over 100,000 employees, it owns 16 regional and provincial branch companies, 13 large subsidiaries, two research and development institutes, and 200 power companies spread over 31 provinces.[390] Its subsidiaries include five publicly listed companies. Like many other SEGs, CGDC has operations outside of its core business. For example, CGDC is the majority shareholder for city commercial banks in the Ningxia and Hebei provinces; founded an insurance company; and has investments in securities, trust, and asset management businesses.[391]

The Chinese government is effectively able to exert control over the broader economy with less capital than would otherwise be required for complete government ownership through these

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1998). *See also* Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review*, Volume 65(4) (May 2013): 715.

[385] *Circular of the State Administration for Industry and Commerce on Printing and Issuing the Interim Regulations for Administration of Registration for Enterprise Groups*, Article 5 (SAIC, Gong Shang Qi Zi [1998] No. 59, issued April 6, 1998).

[386] *Ibid*., Article 6.

[387] Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65(4) (May 2013): 730.

[388] *Ibid*., 717-718.

[389] Todd J. Edwards, "China's Power Sector Restructuring and Electricity Price Reforms," *Asia Papers* 6(2) (Brussels Institute of Contemporary China Studies, January 18, 2012): 17-20.

[390] *See* CGDC website, available at www.cgdc.com.cn/, accessed September 13, 2017.

[391] Nicholas Lardy, *Markets Over Mao: The Rise of Private Business in China,* (Washington, DC: Peterson Institute for International Economics, 2014), 51.

"control pyramids,"[392] in which SASAC controls a group of enterprises, each of which in turn controls its own subsidiaries.[393] While control pyramids exist in other economies,[394] they are especially prevalent in China's economy, where the control pyramids managed by SASAC operate in many of the major industries.[395] As discussed in more detail below, given the relationship between the CCP, the state and state-owned assets in China, the result is that these corporate structures allow the Chinese government and the CCP to exert control over large segments of China's economy, influencing economy-wide resource allocation, rates of innovation, and economic growth.[396]

Control pyramids permit the Chinese government to diversify SIE ownership and to profit from public listings of SIEs, without relinquishing meaningful control over SIE decision-making. The Chinese government maintains a controlling stake in listed firms, while minority shareholders have only limited influence.[397] In addition to control pyramids, contractual and equity linkages among SIEs serve as a means for the Chinese government to influence not only the decisions of individual SIEs, but also the manner in which various SIEs interact in China's economy.[398]

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[392] Dylan Sutherland and Lutao Ning, "The Emergence and Evolution of Chinese Business Groups: Are Pyramidal Groups Forming?" in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 103-106. For example, a first-tier enterprise is 49% financed by outside shareholders and 51% by a single controlling shareholder. In lower tiers, a similar relationship holds, so as we move down the tiers of the control pyramid, at each new tier new firms will be increasingly financed by outside shareholders, while control still lies at the apex firm. So, in the second tier, 74% of the firms are financed by outside shareholders and in the third this rises to 85.25%. If lower ownership shares are required to lock in control, which could be as low as 10%, external shareholders can rapidly be responsible for financing the business group's expansion. For a generally discussion of pyramid groups, *see* Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65(4) (May 2013), 717.

[393] Dylan Sutherland and Lutao Ning, "The Emergence and Evolution of Chinese Business Groups: Are Pyramidal Groups Forming?" in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 103-106.

[394] Rafael La Porta et al., "Corporate Ownership around the World," *Journal of Finance* 54(2) (1999): 497.

[395] Dylan Sutherland and Lutao Ning, "The Emergence and Evolution of Chinese Business Groups: Are Pyramidal Groups Forming?" in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 104.

[396] Randall Morck, Daniel Wolfenzon, and Bernard Yeung, "Corporate Governance, Economic Entrenchment, and Growth," *Journal of Economic Literature* 43 (2005): 655-720.

[397] Dylan Sutherland and Lutao Ning, "The Emergence and Evolution of Chinese Business Groups: Are Pyramidal Groups Forming?" in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 139-140. (Pyramidal ownership "provide[s] an ingenious solution for group insiders wishing to socialize the risk of their business group expansion plans.")

[398] *See* Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65(4) (May 2013): 723-724. ("While groups in the same industry do sometimes compete domestically, SASAC has encouraged the national groups to collaborate in overseas projects to increase their global competitiveness. These linkages, often among groups in complementary industries, are designed to facilitate technological development and a host of other objectives, such as information sharing,

4. Government and CCP Influence over the Behavior of SIEs

The Department previously concluded that the constitutional, legal and *de facto* source of authority for governance in China lies with the CCP.[399] There are "eight nominally independent small parties ultimately controlled by the CCP," such that "no substantial political opposition groups exist" in China.[400] As such, the relatively unique characteristics of the Chinese system of governance require an examination of the CCP's extensive influence on SIE corporate governance.

4.1. CCP Influence over SIEs

The CCP exercises significant influence over the SIE sector. One form of influence is through the Organization Department under the CCP Secretariat, which appoints individuals to leading positions in the CCP, the government, and the military, as well as in SIEs and other institutions.[401] Scholars have emphasized the institutional continuity between the Organization Department's work and the *nomenklatura* system that originated in the Soviet Union. Under this system, the CCP maintains a list of individuals whom it may appoint, dismiss, or hold in reserve for important leadership positions, in accordance with an intricate ranking system.[402] An economist notes that, while there are regulations that specify appointment powers for SASAC:

> …in practice, this is an extremely sensitive and complex issue. The Communist Party of China in fact exercises nearly complete control over personnel decisions throughout the SIE sector. The system, copied from the Soviet Union but still fully in use in China today, requires Communist Party committees to make

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marketing, and pooling of capital for capital-intensive projects. […] [T]hese linkages typically take two forms: equity joint ventures and contractual alliances. In most economies, these forms of collaboration would raise obvious antitrust concerns. China enacted an Antitrust Law in 2008 that, as a formal matter, would appear to subject these alliances (along with mergers and other combinations between SOEs) to antitrust scrutiny. In practice, however, the national enterprises under SASAC supervision have thus far been virtually exempt from antitrust enforcement.")

[399] Shauna Biby, Christopher Cassel, and Timothy Hruby, *The relevance of the Chinese Communist Party for the limited purpose of determining whether particular enterprises should be considered to be "public bodies" within the context of a countervailing duty investigation*, Memorandum of Proceedings (U.S. Department of Commerce, 2012), 3.

[400] *World Factbook: China* (U.S. Central Intelligence Agency, available at http://bit.ly/1ivGnuD, last updated on May 7, 2017, accessed on May 24, 2017).

[401] Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: HarperCollins, 2010), 49-50 (stating that "the CCP has remained unyielding on a number of fronts. Its control over personnel appointments has been inviolate.").

[402] *See* Zheng Yongnian, *The Chinese Communist Party as Organizational Emperor: Culture, Reproduction, and Transformation* (London: Routledge, 2010), 103-104. ("The CCP's most powerful instrument in structuring its domination over the state is a system called the 'Party management of cadres' (*dangguan ganbu*), or more commonly known in the West as the *nomenklatura* system. The *nomenklatura* system 'consists of lists of leading positions, over which Party units exercise the power to make appointments and dismissals; lists of reserves or candidates for these positions; and institutions and processes for making the appropriate personnel changes.'")

> appointments to a name list, or *nomenklatura* of professional and managerial positions. It is not an exaggeration to say that the political power of the Communist Party is based on its control of job appointments.[403]

The CCP Organization Department can function to discipline and control leaders in both government and business.[404] In so doing, it can blur the line between the state and the private sector, and influence executives in SIEs.[405]

Pursuant to the *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises*, SASAC as the managing entity of state-owned assets has the power to appoint SIE managers, board members and Supervisory Board members.[406] In fact, this power is either shared with or superseded by the CCP.[407] Within the *nomenklatura* system, there is a formal division of appointment power between SASAC and the CCP, particularly insofar as the Organization Department has the power to appoint the executives of 53 central SIEs.[408] In turn,

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403 Barry Naughton, "Top-Down Control: SASAC and the Persistence of State Ownership in China," Paper presented at the conference on "China and the World Economy," Leverhulme Centre for Research on Globalisation and Economic Policy (GEP), University of Nottingham, June 23, 2006, 4.

404 Tony Saich, *Governance and Politics of China* (New York: Palgrave MacMillan, 2011), 123. ("[T]he Central Organization Department and its affiliates play a crucial role in maintaining discipline and adherence to the CCP through their control over member's personal files, their evaluation of performance and recommendation for promotion. Basically, the Department oversees the CCP's nomenklatura appointments; these cover all senior ministry appointments, senior judicial appointees, heads of major state-owned enterprises, top university presidents, the editor of key party publications and other media, provincial leaders and directors of think tanks.")

405 *See* Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 24. ("The huge state corporations have adopted the financial techniques of their international competitors and raised billions of dollars in capital, growing to an economic scale never before seen in all of Chinese history. But these companies are not autonomous corporations; they can hardly be said to be corporations at all. Their senior management and, indeed, the fate of the corporation itself, are completely dependent on their political patrons."). *See also* Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: Harper, 2010, 68. ("[W]ith the need to be profitable and compete globally, top executives of state enterprises these days have relative freedom to run their businesses inconceivable a decade ago. But throughout the reform of the sector, the CCP has retained its influence by maintaining power over all senior appointments. Through personnel, they can in turn direct corporate policy.")

406 *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises*, Article 13 (State Council 2003 Order No. 26, issued May 27, 2003, amended January 8, 2011).

407 Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: HarperCollins, 2010), 49-50. ("[T]he CCP has remained unyielding on a number of fronts. Its control over personnel appointments has been inviolate.")

408 *See* Liwen Lin and Curtis Milhaupt, "We are the (National) Champions: Understanding the Mechanisms of State Capitalism in China," *Stanford Law Review* 65(4) (May 2013): 737-738. ("Party and corporate leadership appointments take place in a highly institutionalized sharing arrangement between the CCP and SASAC. In fifty-three central enterprises, the occupants of top positions, including board chairmen, CEOs, and party secretaries, are appointed and evaluated by the Organization Department of the CCP's Central Committee. This is a legacy of the appointment practice prior to the establishment of SASAC. Some of these positions hold ministerial rank equivalent to provincial governors and members of the State Council; others hold vice-ministerial rank…While the

CCP influence over SASAC is reinforced by a Party Committee within SASAC.[409] Furthermore, the Local SASACs have express instructions to defer to the CCP in all specific personnel decisions.[410] In general, though, SASAC and Organization Department authorities at the local level jointly appoint the senior executives of local SIEs.[411] For example, the Shanghai SASAC supervises the personnel management of the automotive manufacturer SAIC, and as such, formally appoints SAIC's top executives. Yet, nominees are first recommended by the Shanghai municipal CCP and inspected by the Shanghai CCP Organization Department.[412] SAIC's CEO, President, and Chairman of the trade union are current CCP officials.[413]

One manifestation of the CCP's appointment power is the manner in which high-profile individuals are "shuffled" through postings in business and government. "Shuffling" has two distinct characteristics that underscore how SIE leadership is subject to government direction. First, SIE management can cycle between SIEs and government bodies. For example, the chairman of China National Offshore Oil Corporation was appointed Governor of Hainan Province; the head of China Construction Bank was transferred from the State Administration of Foreign Exchange; and the head of Sinopec came from a senior political post in northeast China.[414] Second, top executives at different SIEs in the same sector may be required to switch positions. Examples of this "executive reshuffling" can be seen in the telecommunications,

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appointments power formally resides with SASAC, appointments are made with input from various party organs and ministries supervising relevant business operations, and are subject to approval by the State Council.")

409 Barry Naughton, "Top-Down Control: SASAC and the Persistence of State Ownership in China," Paper presented at the conference on "China and the World Economy," Leverhulme Centre for Research on Globalisation and Economic Policy (GEP), University of Nottingham, June 23, 2006, 5.

410 *State Council General Office Notice on Reissuing the State Council State-owned Asset Supervision and Administration Commission Guiding Opinion on Establishing Municipal (Local) Level People's Government State-owned Asset Supervision and Administration Organizations*, Article 3 (State Council, Guo Ban Fa [2004] No. 84, issued November 26, 2004). *See also* Article 7. (The notice states that the establishment of municipal (local) level People's Government state-owned asset supervision and administration entities will be administered by Party Committees of provinces, autonomous regions, and municipalities directly under the central government, in accordance with the provisions of relevant central government documents.)

411 Liu, Fend and Zhang, Linlin, "Executive Turnover in China's state-owned enterprises: Government-oriented or market-oriented?" *China Journal of Accounting Research* (2017), 4. *See also* Margaret Pearson, "State-Owned Business and Party-State Regulation in China's Modern Political Economy," in *State Capitalism, Institutional Adaptation, and the Chinese Miracle*, eds. Barry Naughton and Kellee S. Tsai (New York: Cambridge University Press, 2015), 40-41.

412 Yeo, Yukyung and Pearson, Margaret, "Regulating Decentralized State Industries: China's Auto Industry," *The China Review* (8) 2 (2008): 248.

413 SAIC website, available at http://www.saicmotor.com/english/company_profile/board_of_directors/index.shtml, accessed August 8, 2017.

414 *China's Emerging Financial Markets Challenges and Global Impact*, eds. Min Zhu, Jinqing Cai, and Martha Avery (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2009), 149.

airlines, and oil and gas sectors.[415] As one scholar describes: "[M]ore disorienting is the frequent interchange of senior figures in the *nomenklatura* between even competing firms in the same industry, a kind of musical chairs played not just at the very highest level, but at the operational level as well."[416] *The Economist* notes that these reshufflings serve as a reminder to the managers of the SIE sector that the government is ultimately in charge, noting that "[e]ven the most successful top executives of China's SOEs are cadres first and company men second. They care more about pleasing their party bosses than about the global market."[417]

Additionally, vice-CEO positions are to be appointed through the central SASAC's Party Committee.[418] Senior positions in other enterprises are supposed to be appointed by the SASAC's personnel bureau, though in reality these appointments are also not free from CCP influence.[419] Similarly, SASACs at the municipal level have been instructed to defer to the CCP in all specific personnel decisions.[420]

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[415] *See* Erica Downs and Michael Meidan, "Business and Politics in China: The Oil Executive Reshuffle of 2011," *China Security* 19 (2011): 3. *See also* Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: HarperCollins, 2010), 84-89. ("During the first week of April 2011, the [CCP] reshuffled top executives of China's three major national oil companies (NOCs): China National Offshore Oil Corporation (CNOOC), China National Petroleum Corporation (CNPC) and China Petrochemical Corporation (Sinopec) […] The oil executive reshuffle was a blatant reminder of the CCP's control over China's flagship firms. Unlike the CEOs of companies like ExxonMobil and Shell, the leaders of China's NOCs are not selected by their boards of directors, outgoing CEOs and other senior managers. Instead, they are nominated by the Organization Department, the secretive human resources division of the CCP, and ultimately approved by the Politburo.") (emphasis added)

[416] Nicholas Calcina Howson, "China's Restructured Commercial Banks: Nomenklatura Accountability Serving Corporate Governance Reform?" in *China's Emerging Financial Markets Challenges and Global Impact*, eds. Min Zhu, Jinqing Cai, and Martha Avery (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2009), 144.

[417] *The Economist*, "State Capitalism is Not All the Same," January 2012. (The article states further that "…nobody would apply the term 'paper tiger' to the Organization Department. Created by Chairman Mao in 1924, it has become the world's mightiest human-resources department. It appoints all the senior figures in China Inc. In 2004 it reshuffled the heads of the three biggest telecoms companies. In 2009 it rotated the bosses of the three biggest airlines. In 2010, it did the same to the chiefs of the three biggest oil companies, each of which is a Fortune 500 company.")

[418] Barry Naughton, "Top-Down Control: SASAC and the Persistence of State Ownership in China," Paper presented at the conference on "China and the World Economy," Leverhulme Centre for Research on Globalisation and Economic Policy (GEP), University of Nottingham, June 23, 2006, 5.

[419] *Ibid*.

[420] *Ibid*., 5-6, citing *Guiding Opinions on Setting up State Asset Supervision and Management Organs at the Level of the Municipal (prefectural) Peoples Government* (stating that municipal SASACs shall uphold the principle that the CCP manages cadres (*i.e.*, managers), perfect the cadre management system, and guarantee that the local party committee strengthens its management of the responsible personnel at important key point SOEs in the locality).

The CCP's appointment power appears to influence SIE operations. As one source explains, the CCP "can intervene for any reason, changing CEOs, investing in new projects or ordering mergers," regardless of the laws that are in place.[421]

A 2017 OECD report highlights the corporate governance problems created by this appointment system:

> "[a] major link between business and politics is the appointment system and the intertwined career paths in the public administration and the SOE system, where progress has so far been modest…Sometimes SOE managers appear to fare worse than their private peers in profit maximisation or raising the market value of the firm but those may not be their primary goals, which include public policy objectives.[422]

Party influence is reinforced by the existence of Party Committees that exercise a stronger influence over enterprise decisions. According to the *Company Law*, an organization of the CCP may be set up in all enterprises, regardless of whether it is a state, private, domestic or foreign-invested enterprise, to carry out activities of the Chinese Communist Party.[423] Party committees in SIEs, are subsequently subject to party discipline and control.[424] The *CCP Constitution* states that in SIEs, the CCP committee (referred to as the CCP "primary party organization"):

> guarantees and oversees the implementation of the principles and policies of the Party and the state in its own enterprise and backs the meeting of shareholders, board of directors, board of supervisors and manager (factory director) in the exercise of their functions and powers according to law… and participates in making final decisions on major questions in the enterprise.[425]

While there is a lack of transparency regarding the precise role Party Committees play in enterprise decision-making, studies have found their influence to be substantial, particularly in SIEs. A 2010 OECD report notes that Party committees in SIEs "often play an active role in

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[421] Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 24.

[422] OECD, *OECD Economic Surveys: China,* (Paris: OECD Publishing, 2017), 44.

[423] *Company Law*, Article 19. (The article states that the Chinese Communist Party may, according to the Constitution of the Chinese Communist Party, establish its branches in companies to carry out activities of the Chinese Communist Party and that the company shall provide necessary conditions to facilitate the activities of the CCP.)

[424] Nicholas Calcina Howson, "China's Restructured Commercial Banks: Nomenklatura Accountability Serving Corporate Governance Reform?" in *China's Emerging Financial Markets Challenges and Global Impact*, eds. Min Zhu, Jinqing Cai, and Martha Avery (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2009), 142. ("The CCP Committee in any bank or other SOE is in turn subject to control by the CCP system (as contrasted with the state and military), with appointments to enterprise-level Party committees governed by Party personnel appointments.")

[425] *CCP Constitution*, Article 32.

human resources and the strategic decision making of the enterprise."[426] Other survey evidence confirms the active role of party committees in many SIEs.[427]

The formal parallel structure within SIEs, wherein corporate and CCP leaders operate side-by-side affects the independence of corporate board decisions. As one recent examination states:

> In particular, the widespread joint appointment of board chairman and party secretary undermines outside investors' confidence in boards of directors. Specifically, it implies that the board's independent decision-making authority may be subject to influence by the CCP committee, suggests the possibility of political priorities trumping profit maximization, and underscores the state's predominant authority to shareholders already wary about protection of their interests.[428]

The role of Party Committees also extends to private enterprises. Cheng Li, a leading scholar on the CCP based at the Brookings Institution, notes that the linkages between the private sector and the CCP became tighter as a consequence of the "Three Represents" policy, which combines an official acceptance of private entrepreneurs with active efforts to recruit them into the CCP.[429] According to China's official Xinhua News Agency, 51.8% of all non-state firms had in-house CCP cells in 2015.[430] At least one observer has noted that there has been a concerted effort to establish Party committees in private enterprises, with occasional cash incentives for those CCP

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[426] OECD, *OECD Economic Surveys: China 2010* (Paris: OECD Publishing, 2010), 116.

[427] Victor Nee and Sonja Opper, "On Politicized Capitalism," in *On Capitalism*, eds. Victor Nee and Richard Swedberg (Stanford: Stanford UP, 2007), 120. ("An in-depth study of state involvement of listed corporations finds persisting party interference in almost all domains of the firms' activity, with party committees exercising an even stronger influence in the firm than government bureaus. Local party committees exert the most control in personnel decisions, especially the selection of managers of departments, branches, and subsidiaries, and the selection and dismissal of vice chief executive officers. In essence, party involvement concentrates on personnel issues, which have been a central focus of the *nomenklatura* system for decades of socialist planning. The fact that local party units tend to have a high level of involvement in decisions assigned de jure to the enterprise manager suggests that they may use the manager's office as their venue for interventionist activities. Party influence with the firm may be even stronger if the CEO is actively involved in the CCP and holds a party office. Particularly in large- and medium-sized firms, management positions are often filled by politically active members of the CCP.")

[428] Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21 (January 2016), 95.

[429] *See* Cheng Li, "China's Communist Party State: The Structure and Dynamics of Power," in *Politics in China: An Introduction*, ed. William A. Joseph (Oxford: Oxford University Press, 2010), 205. ("[F]or the last decade or so, the CCP has actively sought to recruit members from groups that only came into existence with the market reforms, the so-called new social strata, which includes, among others, private entrepreneurs ('Red Capitalists'), technical personnel and managers in private firms and foreign-funded enterprises […]") *See also* 209. ("The rise of private entrepreneurs in terms of political influence can be traced to July 2001, when then-CCP General Secretary Jiang Zemin gave an important speech on the anniversary of the CCP's founding. […] Jiang's so-called "Theory of the Three Represents" was an ideological justification for the priority given to the private sector in China's economic development and for allowing entrepreneurs to be members of the [CCP].")

[430] *Xinhua News Agency*, "Authorized Announcement: 2015 Annual Chinese Communist Party Statistics Report," June 30, 2016.

members who achieve this.[431] The presence of Party Committees can constrain overall decision-making of private firms.[432] According to one study, "membership in the CCP is often regarded as a minimum requirement for a career as professional managers – particularly in SOEs, and *in private firms that exceed a certain size and influence*." (emphasis added)[433] According to recent reports, the CCP is also writing itself into the articles of association of large enterprises.[434]

4.2. SIEs as Instruments of State Industrial and Macro-Stabilization Policies

SIEs are recipients of policy preferences, but in turn must carry out a wide range of policy objectives.[435] As noted above, SIEs have a legal mandate to preserve a leading role for the SIE sector in China's economy, and as such, respond to social, economic, and political objectives set by the state. As a manager of one of China's largest SIEs has acknowledged:

> As a unique kind of economic organization, SOEs are different from the CCP or administrative departments, in that they have to create material wealth and compete in the market place. They are also

[431] Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: HarperCollins, 2010), 32. ("When the allure of the elite network is not enough, the CCP tosses money into the mix. To attract private entrepreneurs into the club, the CCP offers cash incentives for business leaders and workers who sign up new members.") *See also* Jun Du and Sourafel Girma, *Red Capitalists: Political Connections and the Growth and Survival of Start-up Companies in China*, University of Nottingham Research Paper Series – China and the World Economy, Research Paper 2007/40 (2007), 4-5.

[432] Regina M. Abrami, William C. Kirby, and F. Warren McFarlan, "Why China Can't Innovate," *Harvard Business Review* (March 2014). Based on discussions with private business owners, Richard McGregor notes that the stated purpose of the CCP Committee in a private enterprise can range from a formality, to the formation of a study group, to providing "ethical" and "spiritual" guidance. However, McGregor notes that "left unstated by all the entrepreneurs was the fundamental reason for the CCP's interest in the private sector. The CCP's presence […] was more than just a monitoring device. It was a kind of political insurance policy […] to be activated in a crisis." Richard McGregor, *The Party: The Secret World of China's Communist Rulers* (New York: HarperCollins, 2010), 216-217.

[433] Victor Nee and Sonja Opper, "On Politicized Capitalism," in *On Capitalism,* eds. Victor Nee and Richard Swedberg (Stanford: Stanford University Press, 2007), 109.

[434] *See* Jennifer Hughes, "China's Communist Party Writes Itself into Company Law," *Financial Times*, August 15, 2017. ("More than 30 Hong Kong-listed state-owned enterprises, representing more than $1tn in market capitalisation, have this year added lines to their central documents that place the CCP, rather than the Chinese state, at the heart of each group. New phrases injected into the articles of association in recent months include describing the CCP as playing a core role in 'an organised, institutionalised and concrete way' and 'providing direction [and] managing the overall situation'. […] Companies acknowledging the role of the CCP range from state oil group Sinopec and ICBC, the world's largest bank by assets, to steel and energy groups as well as leading brokers including Haitong Securities. The articles of association for China Railway Group, one of the country's biggest construction groups, now state that 'when the board of directors decides on material issues, it shall first listen to the opinions of the CCP committee of the company'.")

[435] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 26. (State enterprise management and government officials usually support each other - management often accepts informal guidance from government officials and, in return, "state enterprises are more likely to enjoy preferential access to bank finance and other important inputs, privileged access to business opportunities, and even protection against competition.")

> different from enterprises under other forms of ownership, for they assume not only basic economic responsibilities, but also important political and social responsibilities. SOEs are considered a potent mechanism for the government to implement national policies while being the reliable instrument for the country to cope with major economic risks.[436]

Beyond their role of carrying out industrial policy objectives, SIEs in recent years have also been used to implement the government's macro-stabilization policies, by driving investment and maintaining economic growth.[437] This macro-stabilization role has required substantial low-return investments that have increased the debt burden and financial strain on SIEs.[438]

Although the CCP outlined in its *Third Plenum Decision* measures to implement its objective of comprehensively deepening reforms, primarily SIE reforms, the CCP has increasingly made clear that it has prioritized short-term stability and growth via economic stimulus, at the expense of fundamental reform and change. The government pursuing the route of stimulating the economy beyond its underlying growth potential necessarily is at odds with the Chinese government and the CCP's stated objectives of reforming the SIE sector to allow the market to play a more decisive role.[439]

The "leading role" for the SIE sector in China is reflected in the disproportionate allocation of resources that SIEs receive relative to other types of enterprises. Many sources, including the IMF and the OECD, have concluded that China's SIEs receive preferential access to financing from state-owned commercial banks.[440] SIEs also receive preferential access to important inputs

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[436] Zhou Xinmin, *Core Capability of Leaders, Exploration and Practice of China's State-Owned Enterprises* (East West Discovery Press, 2007), 7.

[437] Batson, Andrew, "Villains or Victims? The Role of SOEs in China's Economy," *China Economic Quarterly*, June 2016, 7.

[438] *Ibid*.

[439] Naughton, Barry, "Supply-Side Structural Reform: Policy-Makers Look for a Way Out," *China Leadership Monitor*, March 2016, 2.

[440] *See, e.g.*, IMF, *People's Republic of China Sustainability Report 2011* (November 23, 2011), 10 ("With interest rates being held below market levels, loan demand has long been high and banks have been forced to ration credit. In these circumstances, banks have preferred to lend to SOEs that benefit from implicit state guarantees."); The Economist Intelligence Unit, *Country Finance: China* (July 1, 2010), 55 ("The five large state-owned commercial banks continue to dominate the lending market, with a combined market share of over 50%. Despite official orders to transform themselves into truly commercial banks, they continue to lend much of their portfolios to the state-owned enterprises (SOEs)."); OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2010), *see also* 54, 56. ("Even so, as discussed in Chapter 3, commercial banks are not yet generally pricing loan risk efficiently and lending remains biased towards SOE. This highlights another important difficulty with using quantity-based tools to implement monetary policy. Because SOEs still have preferential access to bank finance, a reduction in credit growth, for example, typically falls disproportionately on private-sector firms which, as a group, have been the most productive in China (Chapter 4).") and ("As discussed in detail in Conway et al. (2010), the macro-based evidence of a significant negative relationship between changes in interest rates and capital formation in China is not particularly compelling. The most common and obvious explanation is that state-owned commercial banks are obliged to lend to SOEs that enjoy soft budget constraints, often have their debts forgiven and are therefore insensitive to changes in the price of credit.")

(*e.g.*, land and raw materials) and enjoy other competitive advantages unavailable to private firms.[441]

SIEs also enjoy indirect preferences by constraining private and foreign enterprises that might otherwise present significant competition to SIEs in state-favored industry sectors. A World Bank report confirms that China's economic policies discriminate in favor of larger, state-owned firms, resulting in "over abundant resource flows to (often less efficient SOEs)" and encouraging "Chinese firms to expand simply as a means of gaining policy support." Indeed, China issues official lists which grant SIEs an exclusive or privileged role in certain sectors.[442] This effectively holds back small- and medium-sized enterprises from developing.[443]

4.3. Proposals to "Reform" SIEs

During the 18th Party Congress (2012-2017), the CCP issued policies with the aim of modifying various aspects of government ownership in the economy. The Chinese government has proposed several policies under what it terms "reform" of SIEs.[444] Key guidance for these policies is set forth in the *Third Plenum Decision*.[445] The *Third Plenum Decision* calls for the market to play a "decisive" role in resource allocation.[446] Among the most prominent policies put forward is to "[v]igorously develop…a mixed economy," through, among other means, "allow[ing] more state-owned enterprises (SOEs) and enterprises of other types of ownership to

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[441] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 25.

[442] *Ibid*., 113.

[443] *Ibid*., 109. *See also* Carl Walter and Fraser J.T. Howie, *Red Capitalism: The Fragile Financial Foundation of China's Extraordinary Rise* (Singapore: John Wiley & Sons (Asia) Pte. Ltd., 2011), 8-10. ("… the foreign and non-SIE sectors will be supported only as long as they are critical as a source of jobs (and hence, the all-important household savings), technology and foreign exchange…[today's non-state commercial sector] is there to be used tactically by the CCP and is not allowed to play a dominant role.")

[444] Proposed policies include, *inter alia*, diversifying the ownership of SIEs, the creation of asset management companies, a formal separation between "commercial" and "public welfare" SIEs, improved hiring and compensation mechanisms for corporate executives, greater public disclosure of company information, increased consolidation through mergers and acquisitions, and further securitization of SOE shares. Some of these initiatives are discussed in more detail below. *See* Wendy Leutert, "Challenges Ahead in China's Reform of State-Owned Enterprises," *Asia Policy* 21 (January 2016): 83-99; Wendy Leutert, *State-owned Enterprise Mergers: Will Less Be More?*, ECFR/197 (European Council on Foreign Relations, November 2016), 3-4; Se Yan and Shuang Ding, *China – A Gradual Step Forward for SOE Reform* (Standard Chartered Global Research, February 26, 2016); Se Yan and Shuang Ding, *China – A Cautious Step Forward for SOE Reform* (Standard Chartered Global Research, October 8, 2015).

[445] *CCP Central Committee Decision on Several Major Issues for Comprehensively Deepening Reform* (adopted by CCPCC at the Third Plenary Session of the 18th National Congress of the CCPon November 12, 2013).

[446] *Third Plenum Decision.*

develop into mixed enterprises."[447] The *Third Plenum Decision* calls for mixed-ownership to be introduced even at the level of centrally owned enterprises, which are still wholly and directly owned by the state.[448]

4.3.1. Mixed Ownership Proposals

Pursuant to the CCP's *Third Plenum Decision*, the CCPCC and State Council in 2015 jointly issued the *Guiding Opinion on Deepening Reform of State-owned Enterprises* ("*SOE Reform Opinion*"). It includes more detailed proposals with respect to mixed ownership, including: the reduction in the percentage of state-owned shares (Article 7); in select cases, the conversion of state-owned shares into preferred shares, and establishment of "a national special management share system in a few special fields" (similar to the "golden share" that gives the state veto power in crucial sectors) (Article 7); the distribution of company shares to employees and management (Article 19); and the distribution of state-owned shares to private investors through capital injection, share acquisition, debt-for-equity swaps, and other means (Article 17).[449] The document affords some discretion to sub-central government authorities in implementing these policies.[450]

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[447] *Third Plenum Decision*, Article 6. Pursuant to the *Third Plenum Decision*, the CCP Central Committee and State Council in 2015 jointly issued the *Guiding Opinion on Deepening Reform of State-owned Enterprises* ("*SOE Reform Opinion*"). *Guiding Opinion on Deepening Reform of State-owned Enterprises*, Articles 7, 17, and 19 (CCP Central Committee and State Council, Guo Fa [2015] No. 22, issued August 24, 2015). The Chinese government established corresponding pilot programs in certain sectors and enterprises in 2016. *See also* Se Yan and Shuang Ding, *China – A Gradual Step Forward for SOE Reform* (Standard Chartered Global Research, February 26, 2016), 2. ("To advance 'mixed ownership' reform, SASAC announced in February 2016 that it will advance mixed ownership in the electricity, petroleum, natural gas, railroad, civil aviation, telecommunications and military sectors, introducing multiple diversified investors. SASAC will also experiment with employee shareholding systems for mixed-ownership enterprises.")

[448] *Ibid*.

[449] *Guiding Opinion on Deepening Reform of State-owned Enterprises*, Article 7, 17, and 19 (CCP Central Committee and State Council, Guo Fa [2015] No. 22, issued August 24, 2015). To advance "mixed ownership" reform, SASAC announced in February 2016 that it will advance mixed ownership in the electricity, petroleum, natural gas, railroad, civil aviation, telecommunications and military sectors, introducing multiple diversified investors. SASAC will also experiment with employee shareholding systems for mixed-ownership enterprises. Se Yan and Shuang Ding, *China – A Gradual Step Forward for SOE Reform* (Standard Chartered Global Research, February 26, 2016), 2.

[450] *SOE Reform Opinion*, Article 4, provides that the institution that performs the duties of capital contributor [*i.e.*, SASACs at different levels of government] is responsible for formulating plans to define the functional definition and classification scheme of the enterprises it funds, to be approved by the government authority at its level [*i.e.*, central, province, or sub-province level]. In each region in China, in turn, local authorities of the Chinese government may delineate and dynamically adjust the state-owned enterprise functional types, taking into account actual circumstances. Province-level plans illustrate the degree of variation in province-level. According to government website reports, from December 2013 to November 2014, province-level SASACs in 19 provinces issued roadmaps for state-owned assets and state-owned enterprise reform. Of these documents, some were "opinions on deepening state-owned and state-owned asset reform," whereas others were "official plans." Only around one-half of the plans specify timetables and objectives with respect to reform of the mixed ownership system, and specific targets are not uniform. *See* Xiamen Municipality, *19 Province-Level SASACs State-Owned Asset Reform Roadmaps Concentrate Capital in Strategic and Emerging Industries* (November 12, 2014); Shandong

Analysts have pointed out that mixed-ownership reform is not likely to lead to fundamental changes in the operations or role of SIEs in China's economy unless the CCP is willing to cede control.[451] Mixed ownership may allow for the transfer of productive capital to state-owned firms, but it has not introduced market mechanisms into firms still controlled by the government.[452]

The *Third Plenum Decision* prefaces the mixed ownership proposal by stating that China "must unswervingly consolidate and develop the public economy, persist in the dominant position of public ownership, *give full play to the leading role of the state-owned sector, and continuously increase its vitality, controlling force and influence*."[453] (emphasis added) The *Third Plenum Decision* also emphasizes that an economy with mixed ownership "improv[es] the amplification function of state-owned capital."[454] State Council guidelines issued in 2015 to promote mixed ownership reaffirm that state capital should have "the absolute controlling position."[455]

In addition, the *SOE Reform Opinion* does not appear to mean that SIEs will be privatized. Indeed, as Article 18 of the *SOE Reform Opinion* makes clear, "mixed ownership" also refers to an expansion of government ownership through encouraging state-owned capital to acquire equity in non-public enterprises through various means, including those enterprises in "high-tech industries" and "strategic industries" characterized by "great development potential and strong growth."[456]

Moreover, diversifying SIE ownership structures is not a new feature of China's economic policy. Enterprises with diverse ownership structures already exist, particularly among the subsidiaries of SIEs managed by SASAC and Local SASACs.[457] Within these entities, the extent

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Province, *16 Provinces Including Jiangsu, Shanghai, Guangdong, and Shandong Unveil Province-Level State-Owned Asset and State-Owned Enterprise Reform Plans* (September 2014).

[451] Curtis J. Milhaupt and Wentong Zheng, *Why Mixed-Ownership Reforms Cannot Fix China's State Sector*, Paulson Policy Memorandum (January 2016), 19-20.

[452] Marshall W. Meyer and Changqi Wu, *Making Ownership Matter: Prospects for China's Mixed Ownership Economy*, Paulson Policy Brief (September 2014), 2.

[453] *Third Plenum Decision*, Chapter 2, Preamble. (emphasis added)

[454] *Ibid.*, Chapter 2, Paragraph 6.

[455] *Xinhua News Agency*, "China Urges SOE Modernization Through Mixed Ownership Reform," September 24, 2015.

[456] *SOE Reform Opinion*, Article 18.

[457] Furthermore, as implemented, mixed-ownership reforms have often entailed shares being sold to other state-invested enterprises or government-backed funds. For example, in 2015, the provincial state-invested enterprise Jiangxi Salt sold a 47% stake to four outside investors, all four of which were SIEs. David Keohane, "SOE You Think You Can Reform? Mixed-ownership Edition," *Financial Times*, September 28, 2015.

of government ownership can be difficult to ascertain owing to the manner in which corporate owners in China are classified.[458]

Finally, during the period when the specifics of "mixed ownership" policies were being formulated, the CCP's senior leadership made a decision to tie compensation of enterprise managers to that of government officials of the same bureaucratic rank. This decision marks a clear step backward in the corporatization and marketization of SIEs.[459] Thus, while the Chinese government has emphasized "separating ownership from control" through asset management companies and other means, the government continues to influence the incentives of corporate managers.[460]

4.3.2. State-Invested Enterprise Classification Reform

In addition, under the rubric of "reforming" SIEs, the Chinese government is pursuing a policy to divide SIEs into either "commercial" or "public interest" enterprises.[461] "Commercial" SIEs will be opened to various forms of ownership (with the state variably exercising majority, conditional, or minority shareholdings), operate in "fully competitive" industries, and be evaluated according to competitiveness and profitability.[462] "Public interest" SIEs, on the other hand, will remain under sole ownership of the state, operate predominately in non-competitive industries, and be evaluated according to their ability to deliver quality goods and services reliably and cost-effectively.[463]

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[458] For example, owners classified as "legal persons" may be state entities. *See* further discussion on enterprise classification below. Marshall W. Meyer and Changqi Wu, *Making Ownership Matter: Prospects for China's Mixed Ownership Economy*, Paulson Policy Brief (September 2014), 2.

[459] Barry Naughton, "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage," *China Leadership Monitor* 50 (April 2016): 8.

[460] *See* Donald Clarke, "Central Committee and State Council Issue Document on State-owned Enterprise Reform," *Chinese Law Professor Blog*, September 21, 2015. ("[O]wnership and control necessarily are now, have always been, and always will be, separated in SOEs. If SOEs are not performing properly, it is not because ownership and control are insufficiently separate. It is because management does not have the right set of incentives that align their interests with those of the state owner.")

[461] *SOE Reform Opinion*, Article 4.

[462] *SOE Reform Opinion*, Article 5. *See also* Se Yan and Shuang Ding, *Global Research, China – A Cautious Step Forward for SOE Reform* (Standard Chartered Global Research, October 8, 2015), 6-7. ("The guidelines also call for profit-oriented SOEs to introduce corporate and shareholding systems and make full use of public listings. Market-oriented companies should have an open equity structure, and each company should outline its own strategy.")

[463] *SOE Reform Opinion*, Article 6. Subsequently, in December 2015, SASAC, MOF and NDRC issued the *Guiding Opinion on the Functional Definition and Classification of State-owned Enterprises* (*SOE Classification Opinion*). Consistent with the *SOE Reform Opinion*, which provides that "commercial" SIEs and "public interest" SIEs are independent market entities, and therefore their business operation mechanisms must meet the requirements of the market economy. *Guiding Opinion on the Functional Definition and Classification of State-owned Enterprises*, Section 1, Paragraph 4 (SASAC, MOF, NDRC, issued December 30, 2015). SASAC and Ministry of Finance released a corresponding *Implementation Plan for Optimizing the Function Classification and Evaluation of Central State-owned Enterprises* (*SOE Classification Plan*) for central-level SIEs in August 2016. *See also Notice on Issuing*

In December 2015, SASAC, MOF, and NDRC issued the *Guiding Opinions on the Functional Definition and Classification of State-owned Enterprises* ("*2015 SOE Classification Opinion*"), which accords "commercial" and "public welfare" SIEs a degree of independence consistent with a "market economy." However, immediately following this provision it states that "commercial SOEs and SOEs in public welfare nature shall conscientiously serve national strategies and take the initiative to fulfill social responsibilities."[464] In other words, both types of SIEs, even commercial SIEs nominally designated for competitive, market-driven sectors, are required to fulfill national objectives set by the government. There is not yet a clear indication that the "commercial" versus "public welfare" classification system is a basis for full divestiture of state share-holdings. Rather, the *2015 SOE Classification Opinion* aims to make state-invested enterprises in non-strategic commercial sectors "market players that are full of vigor and vitality."[465]

B. Land and Land-Use Rights

Part B of this section examines land and land-use rights. It begins by detailing China's system of public land ownership and the various restrictions the Chinese government places on tenure and scope of land-use rights. It then considers the manner in which the government compensates parties whose rural land-use rights have been revoked. Part B concludes with a discussion of the major barriers to efficient allocation of land resources, including the segmentation of rural and urban land markets; government allocation of land resources and state industrial policy;

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the Implementation Plan for Optimizing the Function Classification and Evaluation of Central State-owned Enterprises (SASAC, MOF, Guo Zi Fa Zong He [2016] No. 252, issued August 24, 2016).

[464] *Notice on Issuing the Implementation Plan for Optimizing the Function Classification and Evaluation of Central State-owned Enterprises*, Section 1, Paragraph 4. (SASAC, MOF, Guo Zi Fa Zong He [2016] No. 252, issued August 24, 2016). Documents published by Local SASACs further demonstrate the link between so-called "SOE reform" policies and government efforts to maintain control over sectors it deems strategic. A report published on a municipal government website in November 2014 states that 19 provinces issued "roadmaps for state-owned assets and state-owned enterprise reform" between 2013 and 2014. Of these, nearly all set targets for retaining some level of state-owned capital in "strategic and emerging industries," *i.e.*, industries selected by the government for priority support under state-sponsored science and technology programs. Xiamen Municipality, *19 Province-Level SASACs State-Owned Asset Reform Roadmaps Concentrate Capital in Strategic and Emerging Industries* (November 12, 2014).

[465] *Notice on Issuing the Implementation Plan for Optimizing the Function Classification and Evaluation of Central State-owned Enterprises*, Section 2.1 (SASAC, MOF, Guo Zi Fa Zong He [2016] No. 252, issued August 24, 2016). *See also* Barry Naughton, "Two Trains Running: Supply-Side Reform, SOE Reform and the Authoritative Personage," *China Leadership Monitor* 50 (April 2016): 7-8. ("What has emerged instead is a mandate for the creation of multiple investment funds with developmental objectives. That is, these funds are expected to foster the creation of big, competitive firms, develop emerging industries, to intervene in markets precisely in order to shape specific developments. If it is true, as the Third Plenum document states, that government is to withdraw from microeconomic interventions in the economy, these investment funds suggest that the government withdrawal would be accomplished simply by delegating the government's objectives to these investment funds, which would be partially market-oriented operators. On the ground, though, it doesn't represent much improvement at all, and in the reform context, it is a step backward.")

misaligned incentives of local government actors; and the inadequate documentation of land-use rights in rural areas.

The Department finds that, owing in large part to the Chinese government's regulatory framework for land ownership and land use, land prices are distorted and land resources are not efficiently allocated. Fiscal imbalances incentivize local governments to maximize revenues from land transactions, which further skews the allocation of land resources. Although the government has taken some steps to improve land markets, such as developing secondary transfer markets and better modes of land compensation, these developments do not fully address the existing distortions in the land market.

1. *Legal and Institutional Framework*

1.1. Public Ownership and the Separation of Ownership and Use Rights

Private land ownership is prohibited in China. All land is owned by some level of government, the distinction being between rural land owned by the local government or "collective" at the township or village level (referred to as "collectively owned"), and urban land owned by the national government (referred to as "state-owned").[466] Public land ownership is consistent with the objective, set forth in the *PRC Constitution*, of "uphold[ing] the basic economic system under which the public (state) ownership shall play a dominant role" in the economy "[i]n the primary stage of socialism."[467] Chinese laws governing land administration further codify this system of public land ownership. The *Land Administration Law of the People's Republic of China* ("*LAL*") provides for a system of "socialist public ownership."[468] The *Property Law* classifies land in China as either "collectively owned" or "state-owned."[469]

Prior to 1978, individuals and non-state entities in China did not possess land-use rights.[470] After 1978, the Chinese government separated land ownership from the right to use land, in an attempt to introduce productivity incentives.[471] The *LAL*, adopted in 1986, codifies the ownership of

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466 *PRC Constitution*, Articles 9 and 10. *See also* Chengri Ding and Yan Song, *Emerging Land & Housing Markets in China* (Cambridge: Lincoln Institute of Land Policy, 2005), 14.

467 *Property Law*, Article 3.

468 *Land Administration Law of the People's Republic of China*, Article 2 (adopted by NPC on June 25, 1986, Order No. 8, effective January 1, 1999).

469 *Property Law*, Articles 45-48 (promulgated March 16, 2007). *See also* OECD, *OECD Investment Policy Reviews: China 2008: Encouraging Responsible Business Conduct* (Paris: OECD Publishing, 2008), 23-25.

470 The principal legislation during this period was the *Land Reform Law of the People's Republic of China* ("*Land Reform Law*"), promulgated in June 1950 in the context of large-scale land expropriation and redistribution by the CCP. *See* Tony Saich, *Governance and Politics of China, Third Edition* (New York: Palgrave MacMillan, 2011), 42.

471 For state-owned land in urban areas, the separation of ownership from use rights was first instituted in the early 1980s in special economic zones (SEZs) to attract foreign investment. In rural areas, the "household responsibility system" of 1978 introduced the contracting of collectively owned land to individual households for private farming

land-use rights and, in certain circumstances, their transfer. The *PRC Constitution* was correspondingly amended in 1988 to allow for the transfer of land-use rights.[472] In response to the rapid development of urban land markets in the 1990s, the Chinese government formalized urban land-use rights through new laws and regulations; notably, the *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas* ("*State-owned Land Regulations*") and the *Law of the People's Republic of China on Administration of Urban Real Estate* ("*UREL*").[473] The *Rural Land Contracting Law of the People's Republic of China* ("*RLCL*"),[474] adopted in 2002, permits certain forms of rural land-use rights transfers.[475] The *Property Law*, adopted in 2007, codifies general provisions for land contracting rights, construction land-use rights, residential land-use rights, and easement rights, with respect to both urban and rural land.[476]

Although the Chinese government has established a legal framework for land-use rights, significant restrictions remain with respect to the scope, tenure, and security of such rights. These restrictions are discussed in more detail below.

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in conjunction with a policy that allowed farmers to sell above-quota agricultural output at decontrolled prices. By 1983, use rights for virtually all arable land had been allocated to rural households in this manner. Chengri Ding and Yan Song, *Emerging Land & Housing Markets in China* (Cambridge: Lincoln Institute of Land Policy, 2005), 14; World Bank and State Council DRC, World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 76299 (March 23, 2013), 129. *See also* Barry Naughton, C*hina's Economy: Transitions and Growth* (Cambridge: MIT Press, 2007), 241. ("Instead of allocating work points for inputs (for labor days, reputation, or effort), some collectives began allocating work points for output, linking the remuneration of a given work group or household to the output of a specific plot of land. Some went even further and simply contracted pieces of collective land to individual households to cultivate. […] By 1981-1982 a nationally defined program of contracting land to households, known as 'household contracting' or the 'household responsibility system' emerged as the clearly preferred organizational system […] By the end of 1982 more than 90% of China's agricultural households had returned to some form of household farming.")

472 Chengri Ding and Yan Song, *Emerging Land & Housing Markets in China* (Cambridge: Lincoln Institute of Land Policy, 2005), 14, 39.

473 *Interim Regulations of the People's Republic of China Concerning the Assignment and Transfer of the Right to the Use of the State-owned Land in Urban Areas* (State Council, Order [1990] No. 55, issued May 19, 1990). *See also Law of the People's Republic of China on Administration of Urban Real Estate* (adopted by NPC on July 5, 1994, amended August 30, 2007, further amended August 27, 2009).

474 *Rural Land Contracting Law of the People's Republic of China* (adopted by NPC on August 29, 2002, Order [2002] No. 73, effective March 1, 2003, amended August 27, 2009).

475 *See*, *China's Political System*, ed. Sebastian Heilmann (CITY: Rowman & Littlefield Publishers, 2017), 256. ("Following the 2002 and 2003 changes in party and state leadership, a change in policy with respect to rural development was introduced. The focus of the political agenda of the Hu Jintao and Wen Jiabao leadership was to improve rural livelihoods. In March 2003 new legal regulations on land-leasing contracts and land-use rights entered into effect. Under the new regulations, China's rural population is allowed to sell future land-use rights on a voluntary and legal basis, and farmers are to receive adequate compensation for transfers of land-use rights.")

476 *Property Law*, Chapters 11-14.

1.2. Scope of Land-Use Rights

1.2.1. Rural Land

The Chinese government imposes onerous restrictions on the scope of land-use rights in rural areas. These restrictions are evident in several respects. Foremost, individual holders of rural land-use rights – also referred to as "contracting rights" – cannot convert collectively owned rural land into state-owned urban land. Collectively owned land may only be "leas[ed] out to land users with due compensation" once that land has been "requisitioned and turned into state-owned land."[477]

Second, there are restrictions on rural land-use for non-farming purposes. The law distinguishes between (1) rural agricultural land and (2) rural construction land for commercial and non-commercial purposes,[478] and places limits on the transfer of agricultural land to construction land.[479] The *LAL* provides that contracting of collectively owned land is for farming purposes only, and individuals contracting the land "ha[ve] the obligation to protect the land and rationally use it in conformity with the purposes of use provided for in the [land-use rights] contract."[480] The *RLCL* provides that the contracted rural land shall not be used for non-agricultural construction without lawful approval.[481] The government will administer "administrative sanctions" to those who unlawfully use their contracted land for construction not related to farming.[482]

Third, within the category of rural construction land, there are limits on how such land may be used for housing (*i.e.*, residential land). The *LAL* provides that each rural village household "shall only have one house site, the area of which may not exceed the limits fixed by provinces, autonomous regions and municipalities directly under the Central Government."[483] The law further requires "examination and verification by the township (town) people's government and

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477 *UREL*, Article 9.

478 *LAL*, Article 4.

479 *Property Law*, Article 43; LAL, Article 4.

480 *LAL*, Articles 14 and 15.

481 *RLCL*, Articles 8 and 60. *See also* World Bank and State Council DRC, "Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization," *Natural Resources Forum* 39(2) (2014), 41. ("In line with plans and regulations of land use, collective organizations can use land for collective nonagricultural industrial and commercial activities, but under the current law, they cannot lease collective construction land to non-collective entities for commercial or industrial development. Furthermore, the rights to rural homestead land are limited: with strong emphasis on collective membership, farmers only have the right to occupy and use land, but not the right to profit from it.")

482 *RLCL*, Articles 8 and 60.

483 *LAL*, Article 62.

approval by the county people's government."[484] If farmers choose to sell or rent out their residences, the law mandates that their application to construct another residence will not be approved.[485] This provision makes it difficult for rural residents to lawfully earn non-farm revenue from residential property. At the same time, because rural residential land is not subject to the stringent use restrictions that exist for farmland, it is especially prone to conversion into state-owned urban land by local governments.[486]

Fourth, the Chinese government generally does not allow rural land-use rights to serve as collateral for credit. The *Property Law* expressly forbids the mortgaging of use rights for collectively owned land, including arable land, residential land, land set aside for farmers to cultivate for their private use, and hilly land allotted for private use, unless it is otherwise prescribed by law.[487] Recent pilot programs have been introduced to relax this prohibition, but have yet to result in a meaningful change to nationwide practices.[488] According to a 2015 OECD report, the inability of farmers to use rural land use rights as collateral constrains their access to financing. Rural commercial banks and credit cooperatives have expanded financing for agricultural projects, but the OECD finds that lending by these institutions is "currently biased toward larger, usually state-owned, enterprises that have significant collateral and guarantees."[489]

Furthermore, the Chinese government has established a complex legal framework governing the transfer of use rights for farming purposes. The *RLCL* provides that contracting rights for farmland may be sub-contracted, leased, exchanged, or swapped to third parties (including for monetary compensation) by individual contracting rights holders, a practice collectively referred

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[484] *Ibid*.

[485] *Ibid*.

[486] Neither the *LAL* nor the *Property Law* contain express provisions regarding the conversion of rural residential land for other uses.

[487] *Property Law*, Article 184.

[488] In March 2016, PBOC, CBRC, China Insurance Regulation Commission (CIRC), and other central government authorities launched a pilot program in over 200 counties across China that grants loan collateral to rural land-use rights holders. It applies to both holders of household contracting rights as well as to holders of operating rights in the secondary market. It is premature to assess whether the new pilot program can improve financing for farmers. The land-use rights that banks would obtain if farmers fail to repay the loans may not be valuable in practice, considering the numerous restrictions placed on selling land-use rights and the relatively low value of farmland in general. Moreover, due to underdeveloped land titling and registration systems (discussed in more detail below), it is questionable to what extent farmers are able to meet the basic requirements established by the Chinese government, which include, *inter alia*, documentation that proves ownership of contracting or operating rights, and the absence of any disputes over contracting or operating rights. *See e.g.*, The Economist Intelligence Unit, *Trial Scheme to Allow Farmers to Mortgage Their Land* (March 29, 2016). *See also Notice of the People's Bank of China, the China Banking Regulatory Commission, the China Insurance Regulatory Commission and Other Departments on Issuing the Interim Measures for the Pilot Program of the Loans Secured against the Management Right of Contracted Rural Land* (PBOC, CBRC, CIRC, Yin Fa [2016] No. 79, issued March 15, 2016).

[489] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 17-18.

to as "circulation." "Circulation"[490] is subject to the condition that the third party to whom the land is transferred must not alter the nature of the ownership of the contracted land nor its use for agriculture and must have the operational capability to engage in agricultural activity.[491] Third parties may acquire contracting rights through one of three means: negotiation, tender, or auction. The third parties may further "circulate" their rights through transfer, leasing, shareholding, mortgaging, and other means.[492]

Studies show that across China, agricultural land-use transfer policies remain at an experimental stage. A 2015 OECD study identifies five main types of land transfer arrangements that have been applied to varying degrees in different localities: (1) exchange of land-use rights; (2) leasing of operation rights; (3) outright transfer of contract rights; (4) land joint-stock cooperatives; and (5) land circulation trusts.[493] The Chinese government has also established Land Transfer Centers (LTCs) in rural regions to facilitate transactions, particularly the bundling and transfer of small land holdings to larger commercial farming operations.[494] Another program to facilitate land transactions, initiated in Sichuan province, involves the creation of a unified platform for conducting land-bidding transactions aimed at improving price discovery for land.[495] A 2016 policy change, moreover, allows foreign companies to rent or lease farmland.[496]

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[490] *RLCL*, Chapter II, Section 5.

[491] *Ibid.*, Article 33.

[492] *Ibid.*, Article 49.

[493] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 13-14. ("i. Exchange of land-use rights – Within the same collective, two farmers may want to exchange operation rights for their respective land. This may aid consolidation for farmers who have a number of non-contiguous plots. ii. Leasing of operation rights – In such an arrangement, farmers rent out the right to cultivate their land to another entity within or outside the rural collective (however, under equal conditions, members from the collective are given priority). Despite renting out the operation rights, the farmers retain the contract right to the farmland. iii. Outright transfer of contract rights – Conditional on the lessor having built a stable livelihood outside the agricultural sector, the outright transfer of contract rights is allowed. At this point, the contract between the household transferring out the land and the village is terminated. iv. Land joint-stock cooperatives – Farmers may jointly pool their operation rights to engage in cooperative agricultural production. They are then given a share of the joint-stock cooperative and are generally paid a dividend proportionate to their share. […] v. *Land circulation trusts* – Farmers entrust their operation rights to a trust company, which is responsible for finding tenants, land development, procuring funds and organising construction activities […]. Some of these functions, such as land development and recruitment of tenants, are undertaken by an operating company contracted by the trust. The first such trust was CITIC Trust Co., Ltd. which was established in 2013 in Yongqiao district, Suzhou, Anhui province." (emphasis added))

[494] Yanling Peng et al., *How Farmland Mortgages Could Stimulate Rural Entrepreneurship in China* (Paulson Institute, February 14, 2017), 8.

[495] Land was transferred to larger, more efficient farming operations, and there was a shift in production toward more profitable crops. The Chengdu experiment is considered one of the most successful agricultural land reform programs in China. Klaus Deininger et al., *Impact of Property Rights Reform to Support China's Rural-Urban Integration*, Policy Research Working Paper WPS7388 (World Bank, August 11, 2015), 6, 14.

[496] This policy change followed a government announcement about its intent to relocate 100 million farmers, about 12% of the rural population, into smaller cities. *See Opinions of the General Office of the CCP and the General*

Analyses published by the World Bank and OECD find that the Chinese government has achieved only limited success in developing secondary markets for farmland in China.[497] Rented land as a share of total farmland increased from 3% to 24% between 1996 and 2013, but remains lower than in many OECD countries.[498] Large farming enterprises only make up a small share of the secondary market.[499] Pilot programs designed to increase the scope of land-use rights transfers have varied widely by province, with gains in land consolidation concentrated in North and Northeast China.[500] The OECD has identified a number of problems that constrain land rental markets in China's agriculture sector, including: poorly defined contract rights; a perceived lack of contract enforcement by independent courts; corruption among local officials; and the difficulty of valuing operating rights due to a lack of transparency and a uniform valuation method. Surveys indicate significant mismatches in price expectations between those wishing to rent in and those wishing to rent out.[501]

1.2.2. Urban Land

The Chinese government also imposes significant restrictions on the scope of land-use rights in urban areas. The *LAL* provides that any entity or individual seeking land for construction must apply for approval from the government, the formal owner of state-owned land.[502] As with rural land, the government draws a legal distinction between different categories of urban land, which is divided into industrial, commercial, and residential land.[503] Within this system, there are restrictions on transferring land from one category to another, and some regulations are not uniform across categories (*e.g.*, with respect to the tenure of use rights.)[504]

Office of the State Council on Improving the Measures for Separating Rural Land Ownership from Contracting Management Right (CCPCC and State Council, Order, issued October 30, 2016). *See also* Saibal Dasgupta, "China Embraces Corporate Farming," *VAO News*, November 2, 2016; Lucy Hornby, "China Land Reform Opens Door to Corporate Farming," *Financial Times*, November 3, 2016.

497 World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization* (2014), 10-11. *See also* Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 6.

498 OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2015), 107 (*see* Figure 2.5).

499 The Chinese government has taken actions to increase private investment in large-scale farming, but the effects of the reforms have also varied widely by province – a recent study found that only 20% of land in China is cultivated by farms larger than 5 acres and only 4% of land is now operated by corporate farms. Xianqing Ji, et al., "Are China's Farms Growing?" *China & World Economy* 24(1) (2016): 59.

500 OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2015), 107.

501 Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 14.

502 *LAL*, Article 21.

503 *Property Law*, Chapters 11-14.

504 *Ibid*.

The Chinese government classifies land-use rights for state-owned urban land as either "granted" or "allocated," depending on how the government confers the use rights.[505] When use rights are "granted," they are effectively leased by the government in return for a payment.[506] In addition to paying the government for the right to use the land, the party receiving the urban land-use right is required to use the land in accordance with the terms and use purposes set forth in a contract signed with the relevant municipal- or county-level government department in charge of land administration.[507]

The government has discretion to "grant" use rights via one of three means – negotiation, tender, or auction – each of which constitutes a different form of use rights transaction.[508] An Asian Development Bank Institute (ADBI) study for the period 2003-2008 finds that "small, expensive land parcels were generally leased by auction, whereas large, inexpensive lots were leased by listing." For land leased by listing, the total area was much larger, and the average transaction price much lower, than for land leased by auction. The report further notes that "local governments use agreement and tender for most industrial land leasing transactions, whereas auctions are used for commercial and residential land leasing to ensure that the highest tenderer acquires the land and that there is no price cap."[509] An economist emphasizes the informal nature of many land-use rights transactions in China:

> The method of transfer is occasionally open auction, but far more often such transfers are arranged in private negotiations between the local government official and the company desiring a lease. The situation is fraught with conflicts of interest, and the result is often corruption, sometimes on a grand scale.[510]

As an alternative to "granting" use rights, government authorities above the county level may "allocate" use rights to an entity or individual.[511] In this arrangement, the party receiving the land-use right does not pay the government. The *UREL* defines the "allocation" of land-use rights as either the conveyance of land to a land-user subsequent to that land-user's payment of compensation, resettlement, and other fees to rural collectives (*i.e.*, when agricultural land is

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[505] *Ibid*., Article 137.

[506] *State-owned Land Regulations*, Articles 8-14; LAL, Article 4. Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People's Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 5.

[507] *Ibid*.

[508] *Ibid*.

[509] *Ibid*.

[510] Dwight Perkins, "China's Land System: Past, Present, and Future" in *Property Rights and Land Policies*, eds. Gregory K. Ingram and Yu-Hung Hong (Cambridge, Ma: Lincoln Institute of Land Policy, 2009), 88-89.

[511] *UREL*, Article 22.

converted for urban use), or simply as land-use rights conveyed for no fee at all.[512] In contrast to the limited tenure of "granted" land-use rights, "allocated" land-use rights are indefinite.[513]

Since the late 1990s, Chinese law has limited the "allocation" of land to certain specified uses.[514] Construction on "allocated" land is generally not permitted unless it is for purposes of a government or military installation, urban basic infrastructure and public services, energy, transport, and irrigation projects, or other uses set forth in law.[515] Nonetheless, the existence of a category that allows for the conveyance of state-owned land at no cost creates the potential for abuse by local government authorities.

1.3. Tenure of Land-Use Rights

The Chinese government generally does not grant land-use rights for an indefinite period. For collectively owned rural land, the Chinese government has extended the tenure of contracting rights in small increments over time. A 1998 amendment to the *LAL* for the first time codified a 30-year tenure period.[516] The CCP put forward recommendations in 2008 and 2013 to grant indefinite tenure to rural contracting rights holders.[517] To date, however, the *LAL* has not been further amended to codify these recommendations.[518] A 2013 World Bank report identifies indefinite use rights as an important item for reforming China's economy in rural areas, and

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[512] *Ibid*., Article 23.

[513] *Ibid.*, Article 22.

[514] *See* Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People's Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 5. ("In 1999, the revised *LAL* established new regulations. With the exception of the four types of construction land (military use; municipal infrastructure; energy and power industries; and schools, hospitals, and other public facilities) that can be transferred through allotment, construction units are permitted to use state-owned land only by means of a paid transfer (Article 54 of Chapter V).") *See also Land Allocation Catalogue* (MLR, Order [2001] No. 9, issued October 22, 2001). The Catalogue provides that "allocated" land will be strictly limited to 19 categories, which primarily comprise military and governmental purposes, public infrastructure and utilities, and other public interest, social and cultural purposes. Moreover, allocated land-use rights may not be used by an FIE, even if the FIE is a joint venture that is majority owned by a domestic firm.

[515] *Ibid*., Article 23; *LAL*, Article 54.

[516] Samuel Ho and George Lin, "Emerging Land Markets in Rural and Urban China: Policies and Practices," *The China Quarterly* 175 (2003): 689-690; *LAL*, Article 14 (August 29, 1998).

[517] *See Decision of the Central Committee of the Communist Party of China on Several Big Issues on Promoting the Reform and Development of Rural Areas* (CCPCC, Zhong Fa [2008] No. 16, issued October 15, 2008) for recommendation to grant indefinite land-use contracting rights. The *Third Plenum Decision* of 2013 reiterates this recommendation.

[518] The *LAL* was last amended in 2004.

states that "[i]t is important that the Communist Party's [2008 policy decision] regarding this issue be enshrined in law soon."[519]

Chinese law grants longer tenure periods for state-owned urban land. The *UREL* provides that when the government chooses to "allocate" land-use rights, there are no tenure limits.[520] In the more common scenario, however, urban land-use rights are "granted" in which case tenure periods are limited:

- 70 years for residential land-use;
- 50 years for industrial production land-use;
- 50 years for educational, healthcare and scientific and technological research land-use;
- 40 years for commercial land-use; and
- 50 years for all other land-use purposes.[521]

Chinese law is not entirely clear with respect to whether and how land-use rights may be extended. The *Property Law* states that once the 30-year tenure period on rural land contracting rights expires, the contracting rights holder can continue to contract in accordance with relevant national regulations.[522] Yet, the law does not specify which national regulations or administrative procedures apply.

With respect to urban land-use rights, the *State-owned Land Regulations* provide that when the land-use rights tenure expires, the land-use rights holder may apply for an extension, subject to signature of a new contract with the relevant government authority. If not extended, the rights revert to the state, and any buildings on the land or improvements made to the land then become property of the state.[523] The *LAL* likewise provides that government departments in charge of land administration are authorized to take back land-use rights for state-owned urban land if the land-user has not applied for an extension or the application for an extension has not been approved.[524]

The *Property Law*, in turn, draws an important distinction regarding renewal of use rights for different categories of urban land. Rights for *residential* construction land may be "automatically renewed" upon expiration, whereas *non-residential* construction land extensions will be processed according to provisions of the law. The statute, however, neither specifies what

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[519] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 76299 (March 23, 2013), 129.

[520] *UREL*, Article 23.

[521] *State-owned Land Regulations*, Article 12.

[522] *Property Law*, Article 126.

[523] *State-owned Land Regulations*, Articles 8-11 and 39-41.

[524] *LAL*, Article 58.

"automatically" means nor what provisions of the law apply with respect to non-automatic renewals.[525]

1.4. Compensation for Expropriated Land-Use Rights in Rural Areas

In principle, rural land-use rights holders in China receive compensation when their use rights are revoked. In both a legal and practical sense, however, the level of compensation is inadequate. The *LAL* provides for a per capita resettlement subsidy and arable land compensation payment for individuals whose agricultural land has been requisitioned; yet, this payment is calculated based on the value of farm crops, rather than on the higher value of the land once it has been converted into urban land.[526] A 2015 academic study finds numerous other deficiencies in the legal framework governing monetary compensation for rural land. For example, compensation is generally paid as a one-time lump-sum payment, rather than in increments over time,[527] and compensation for demolished rural housing is insufficient.[528]

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[525] *Property Law*, Article 149. *See also* Donald Clarke, "Full Private Land Ownership Returns to China's Cities," *Chinese Law Prof Blog*, April 15, 2017. ("In 2007, the authorities granted a teaser: the Property Law was promulgated, and it stated that residential LURs would, at the end of their term, be renewed 'automatically.' But it didn't say what 'automatically' meant. As Professor Wang Liming, a member of the drafting team, later admitted, this lack of clarity was no accident; the drafters had deliberately opted for ambiguity.") In March 2017, Chinese Premier Li Keqiang stated that residential construction land-use rights "can be renewed, and no application or pre-set conditions needs to be filed or met." These and other government policy statements elaborate on the meaning of a provision codified in the Property Law, but they do not meaningfully clarify the rules governing tenure of urban land-use rights more generally. Ministry of Foreign Affairs, *Transcript of Premier Li Keqiang's Meeting with the Press at the Fifth Session of the 12th National People's Congress* (March 16, 2017); Donald Clarke, "The Paradox at the Heart of China's Property Regime," *Foreign Policy*, January 19, 2017.

[526] Article 47 of the *LAL* provides: (1) the resettlement subsidy amount will be based on the value of the three-year average annual crop yield of the requisitioned land, at a minimum of four to six times that value and a maximum of 15 times that value; (2) the arable land compensation payment is set at six to ten times the value of the three-year average annual crop yield of the requisitioned land.

[527] Zhu Qian, "Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou," *Land Use Policy* 46 (2015): 252-253. ("[T]he land acquisition compensation is one-time lump sum compensation. The living expenses for land-lost villagers are of ongoing and long-term nature that requires a sustained income to support. Moreover, these expenses often increase significantly over the following years. The compensation rate initially set by local authorities may seem sufficient to rural villagers and subsequently secure villagers' acquiescence. After a few years, when living expenses increase, the feeling of disfranchisement after land acquisition would become strong among villagers.")

[528] *Ibid*., 252-253. ("[The *LAL*] specifies rural land acquisition compensation but does not regulate rural housing demolition compensation, which is the burden of local municipalities. […] It is not uncommon for housing demolition executors to disobey municipal regulations and implement their own policies and incentives for quick rural villager relocation. During the process, township administration often gives acquiescence to rural village's own, unofficial or illegal, policy and thus amplifies rural collective's power in housing demolition and compensation. Alternatives to municipal policies are often used to overcome housing demolition and villager relocation barriers in practice. The compensation difference in housing demolition and villager relocation can be huge. The highest incentive for timely demolition and relocation was 70,000 RMB yuan in a village in Yuhang District, Hangzhou and the lowest was only 5,000 RMB yuan in another village in the same district.")

A fundamental problem is that collectively owned rural land, as a category of land ownership, is ambiguous. An ADBI study notes that, in fact, a "three-class system of collective ownership exists in [China's] rural regions," comprising "natural villages," "administrative villages," and "towns."[529] The *LAL* provides that monetary compensation for requisitioned land be paid out through collectives rather than directly to individuals.[530] This arrangement facilitates corruption and embezzlement at the local level, reducing the likelihood that individuals will receive the compensation they are due.[531]

Several studies indicate that, in practice, compensation provided for expropriated land-use rights in China is inadequate.

- A 2011 survey by the Landesa Rural Development Institute, covering 1,791 farmers across 17 provinces, finds that one in every four farmers does not receive any compensation at all. For those who do, the mean value received is only a fraction of the commercial value of the land.[532] The survey also finds that farmers are often pressured by collectives to lease their small plots of land to outside companies, and that such companies may put the land to illegal non-farming uses or acquire leases that exceed the land-use rights contracting period of the farmer.[533]

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[529] *See* Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People's Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 1-2. ("A three-class system of collective ownership exists in the PRC's rural regions and includes (i) natural villages—peasant collective ownership of farms in villages; (ii) administrative villages—peasant collective ownership of more than two rural collective economic organizations in villages; and (iii) towns—peasant collective ownership in townships. This three-class system makes property rights over rural collective-owned land difficult to discern. The term "collective" is not clearly defined, nor is the relationship between the collective and the farmers. This leads to ambiguous property rights and makes it difficult for rural land to enter the market.")

[530] *LAL*, Articles 25-30.

[531] Zhu Qian, "Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou," *Land Use Policy* 46 (2015): 252-253.

[532] Landesa Rural Development Institute, *Summary of 2011 17-Province Survey's Findings* (April 26, 2012), 2. ("The survey finds that affected farmers received some compensation in 77.5% of all cases, were promised but did not receive compensation in 9.8% of cases, and were neither promised, nor received compensation in 12.7% of cases. […] The mean compensation paid to affected farmers was 18,739 yuan per mu (app. $17,850 per acre), a fraction of the mean price authorities themselves received for the land (778,000 yuan per mu or $740,000 per acre, mostly in cases of commercial projects).")

[533] *Ibid*., 4. ("About a third (32.6%) of the surveyed villages reported some extent of farmland leasing to outside bosses or companies. […] The median amount of farmland that these bosses or companies hold right now is about 100 mu, and the mean amount is 560 mu. In 69.5% of all cases this is assembled as one large, continuous tract of land, a strong indication of pressure being applied to farmers who typically hold very small parcels. […] The lease terms tend to be long. Some are so long that they are illegal as they run past the farmer's own contract for the land. […] The farmland leased out is used for a variety of purposes, some illegal, such as: 10.2% for apartment buildings or tourism, and 20.7% used at least partially for factories or commercial development. […] Violation of farmers' consent is widespread. Surveyed farmers indicated that in 11.4% of these cases, local officials said that the land transfer was an order from the government above, and farmers had no choice but to comply. In another 14.0% of the cases, local officials came to persuade or pressure the affected farmers, and farmers eventually agreed. Besides, in another 41.7% of cases, officials and bosses came together to "negotiate" a deal with farmers.")

- A 2015 World Bank study finds that "[w]hile farmers receive compensation for their agricultural land based on the value of land for agricultural production, land acquired in this way can be transferred by local governments at prices a hundred times or more what was paid in compensation."[534]

- A 2012 World Bank study finds that "the current practice of expropriating the entire difference between the agricultural value of the land and its urban market value is equivalent to a 100% capital gains tax."[535] A separate World Bank report also states that "[i]n reality, large amounts of collective construction land have also entered the urban market illegally, particularly in China's eastern coastal areas and large cities."[536]

In certain instances, rural land-use rights holders have received various forms of compensation, including non-monetary compensation.[537] However, these compensation methods have yet to be instituted on a systemic, nationwide basis. Indeed, land expropriation and compensation is one of the primary sources of social discontent in China. Protests over land expropriation and compensation have become regular occurrences, with 60,000 protests in 2013 alone.[538]

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[534] Klaus Deininger et al., *Impact of Property Rights Reform to Support China's Rural-Urban Integration*, Policy Research Working Paper WPS7388 (World Bank, August 11, 2015), 4. *See also* Dwight Perkins, "China's Land System: Past, Present, and Future," in *Property Rights and Land Policies*, eds. Gregory K. Ingram and Yu-Hung Hong (Cambridge, Ma: Lincoln Institute of Land Policy, 2009), 88. ("The potential for abuse is enormous. It is not just that local officials often do not pay attention to the national laws and procedures, but that in many cases the transfer of the land involves a corrupt arrangement between the local official, who receives a payment, and the purchasing unit, which gets the land at a favorable price. In some cases, local governments collude with developers to simply expand the boundaries of what is considered urban and thereby convert land from collective to government ownership, thus confiscating rural land without compensation. […] The method of transfer is occasionally open auction, but far more often such transfers are arranged in private negotiations between the local government official and the company desiring a lease. The situation is fraught with conflicts of interest, and the result is often corruption, sometimes on a grand scale.")

[535] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 76299 (March 23, 2013), 32.

[536] World Bank and State Council DRC, "Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization," *Natural Resources Forum* 39(2) (2014), 41.

[537] Novel compensation methods include, *inter alia*, providing social security assistance and employment alternatives as part of a compensation package; granting localities permission to retain a portion of requisitioned land for non-farming commercial and residential use; and the establishment of shareholding cooperatives, under which the local government either acquires land owned by township and village enterprises ("TVEs") and allows those TVEs to retain their use rights, or TVEs retain their rural collective land ownership and lease their land or invest it as stock in joint ventures for capital returns and interests. Zhu Qian, "Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou," *Land Use Policy* 46 (2015): 254-255.

[538] Sarah Hsu, "China Is Finally Improving Property Rights Protections," *Forbes*, November 30, 2016. *See also* Wei Xiao, *The Compensation for Land Expropriation in Rural China Under the Constitution in People's Republic of China* (Hong Kong: The University of Hong Kong, 2014), 1.

According to an OECD estimate, 65% of social conflicts in China's rural areas involve disputes over land.[539]

In Chongqing and Chengdu municipalities, the Chinese government has recently piloted a *dipiao*, or land voucher, program involving rural residential land. Rural residents can offer residential land for conversion into farmland, which entitles them to a *dipiao* eligible for sale on a property exchange. A land developer wishing to build on what currently is a tract of farmland, but who at the same time must show no net reduction in farmland will result from the project, has the option to buy a *dipiao* at the exchange to offset the reduction.[540] The land developer negotiates prices directly with the individual selling the *dipiao*, as opposed to indirect negotiation with a representative from a rural collective. In theory, the price the developer pays for the land-use rights should reflect the construction-use value of the land, rather than the lower farmland-use value. The farmer is promised 85% of the proceeds with the remainder going to the local government.[541]

The *dipiao* program indicates a new policy approach, but it does not markedly improve the status of land-use rights in China. First, the program has not been adopted on a nationwide basis. Second, to the extent it has been implemented, it has given rise to corrupt practices, as some farmers have claimed that they have been forced out of their homes or did not receive compensation for the sale of their *dipiao* from the property exchange.[542] Studies also show that the reclaimed farmland is not always as fertile as the agricultural land lost to development.[543]

2. *Barriers to the Efficient Allocation of Land Resources*

2.1. Segmentation of the Land Market between Rural and Urban Areas

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[539] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 15.

[540] Samson Yuen, "China's New Rural Land Reform? Assessment and Prospects," *China Perspectives* 2014/1 (2014): 63-64. *See also* Jianguang Shen, "Benefits of Offering Urban Hukou to Migrant Workers," *Economics Weekly* (56) (Mizuho Securities Asia Ltd., January 29, 2016), 6. ("In recent years, another new utility of rural residential land is to swap it with urban construction land. The Ministry of Land and Resources allows local governments in selected areas to buy residential land from farmers and turn it into arable land. Then, these local governments could have new quota (in addition to allocated quota) to turn arable land around the cities into new urban construction land.")

[541] Samson Yuen, "China's New Rural Land Reform? Assessment and Prospects," *China Perspectives* 2014/1 (2014): 63-64.

[542] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 15.

[543] The Economist Intelligence Unit, *China Economy: Thinking Big: Modernizing Agriculture* (May 24, 2013).

Owing largely to the legal and institutional framework discussed above, China does not have a nationally unified land market. Land administration is bifurcated between collectively owned rural land and state-owned urban land. Within each category of ownership, moreover, there are restrictions on the use of land for different purposes, such as the transfer of farmland to construct residences in rural areas. An ADBI report concludes that local governments "have monopsony power in the rural land market and monopoly power in the urban land market," and "serve as a single-plank bridge between the urban and rural land markets[...]"[544] An economist observes:

> Formally, rural land [China] is collectively owned by the local village or township, and urban land is owned by the state. In both cases, local officials play the primary role in deciding whether a piece of land under their jurisdiction can be leased for commercial uses.[545]

Land market segmentation distorts land prices, particularly by driving a wedge between prices in rural and urban areas.[546] Segmented land markets also distort the broader allocation of resources in China's economy. As the OECD has noted, economic development should force certain changes in the use of a country's productive inputs. Populations transition from working in agriculture to working in industrial sectors. The rural population, and in particular the rural population employed in agriculture, consequently declines. Farms consolidate, economies of scale are realized, and the farmers that remain become more efficient and productive. Urban areas generally grow, and workers achieve a higher marginal product outside the farm sector. In China, however, government ownership and control over land impedes this process.[547]

China's farm sector remains inefficient. The average size of farm plots in China is under 2 acres,[548] only a fraction of the average in the U.S., which is about 445 acres.[549] Although the United States has one of the most consolidated agriculture industries, the order-of-magnitude difference illustrates the degree of farm plot fragmentation in China. Because farm plots are small, farmers generally lack the incentive to invest in technology and make other capital investments because they cannot recover their investment in the timeframe their contract

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[544] Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People's Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 7.

[545] Dwight Perkins, "China's Land System: Past, Present, and Future," in *Property Rights and Land Policies*, (eds.) Gregory K. Ingram and Yu-Hung Hong (Cambridge, Ma: Lincoln Institute of Land Policy, 2009), 89.

[546] Yanling Peng et al., *How Farmland Mortgages Could Stimulate Rural Entrepreneurship in China* (Paulson Institute, February 14, 2017), 7.

[547] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 5-6.

[548] According to the OECD, in 2010 the average size of farm plots was 0.6 hectares. OECD, *OECD Economic Survey: China* (Paris: OECD Publishing, 2015), 106.

[549] The Economist Intelligence Unit, *China Economy: Thinking Big: Modernizing Agriculture* (May 24, 2013).

spans.[550] According to NBS data, almost 30% of the employed population still works in agriculture,[551] but agriculture makes up only about 9% of GDP.[552]

The CCP's *Third Plenum Decision* pledges to "form a unified construction land market for both urban and rural construction areas."[553] This objective, short of permitting the free conversion of collectively owned agricultural land into state-owned urban land, implies a relaxation of the strict controls on the transfer of collectively owned rural construction land. The Chinese government has not passed any subsequent laws, however, to codify this policy of market unification.[554] Moreover, the proposed reform is constrained by the government's arable land conservation mandate. The *Third Plenum Decision* states that farmers may only transfer, rent out, and mortgage their rights to rural construction land on the condition that the overall scale of farmland remains unchanged.[555]

2.2. Government Allocation of Land Resources and State Industrial Policy

The Chinese government's systemic, nationwide management of land resource allocations further exacerbates distortions in China's land market. In 1997, the State Council issued the *Notice on Further Regulation of Land Management and Protection of Arable Land*,[556] which

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[550] *See e.g.,* World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 348. *See also* Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 6. In 2016, the Agricultural Development Bank of China (ADBC), a fully government-owned policy bank, agreed to lend $450 billion by 2020 to facilitate the modernization of agriculture. However, as a policy bank, ADBC is responsible for funding state development projects rather than individual farmers and small businesses. Douglas Elliott and Kai Yan, *The Chinese Financial System: An Introduction and Overview* (The Brookings Institution, July 1, 2013), 13; Fred Gale and Robert Collender, *New Directions in China's Agricultural Lending*, WRS-06-01 (United States Department of Agriculture, January 2006), 6; *Reuters*, "China to Invest $450 Billion Modernizing Agriculture by 2020," September 18, 2016.

[551] According to NBS, there are 800 million employed people in China, of which 219 million are classified under "primary industry," which comprises agriculture, forestry, animal husbandry and fishery. NBS, *China Statistical Yearbook - 2016* (Beijing: China Statistics Press, 2016). *See* Table 4-1 "Employment." Calculations performed by the Department.

[552] Lucy Hornby, "China Migration: Dying for Land," *Financial Times*, August 6, 2015.

[553] *Third Plenum Decision*, Article III(11).

[554] Samson Yuen, *China's New Rural Land Reform? Assessment and Prospects*, China Perspectives 2014/1 (2014), 61. ("[…] while the Third Plenum reforms point in the direction of reducing state monopoly on rural land transfer and restoring land-use rights to farmers, they are nothing very new. More importantly, these reforms cannot enjoy much success unless more drastic reforms are undertaken. Such reforms include reconfiguring the power relations between local governments and farmers in a way that owners of collective land will truly secure their land-use rights, as well as a thorough fiscal and tax reform that reduces the reliance of local government on land sales.")

[555] *Ibid*.

[556] *Notice on Further Regulation of Land Management and Protection of Arable Land* (Bureau of Land Management, Guo Tu Ban Zi [1997] No. 58, issued April 16, 1997, invalid since February 20, 2003).

elevated preservation of arable land to an important national strategy.[557] The *LAL* was subsequently amended in 1998 to incorporate arable land protection provisions.[558] Beginning with the 11th five-year planning period in 2006, the Chinese government has incorporated arable land conservation into five-year plans as one of a small number of binding targets (*i.e.*, targets that government officials are obligated to meet).[559] In 2008, the State Council issued the *Outline of the National Overall Planning on Land Use (2006-2020)*,[560] which sets forth a target to preserve 120 million hectares of arable land (*i.e.*, the "Red Line"), including 104 million hectares of basic agricultural land, and limits the conversion of arable land to construction land to 3 million hectares in total by 2020.[561]

In order to achieve these targets, the central government sets an annual national quota for the conversion of arable land for construction and distributes the quota to each province. Whenever arable land is used for construction purposes, an equal amount must be provided somewhere else to ensure the overall arable land area of the province is not reduced.[562] To ensure effective local implementation of this policy, the *Criminal Law of the People's Republic of China* was amended in 1998 to make it a criminal offence for local officials to grant approval for the conversion of arable land for development if the terms of the 1997 *Land Protection Notice* are not met.[563] This policy of quota allocation has given the central government significant influence over how and where to convert rural land for urban use.[564]

These land planning policies ostensibly support arable land conservation. In reality, however, there is a severe mismatch between supply and demand in China's land markets, and large swathes of urban land are underutilized. "Ghost towns" have sprung up in peripheral areas around many cities as local governments, competing for economic activity and investment,

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[557] Siu Wai Wong, "Land Requisitions and State-Village Power Restructuring," *The China Quarterly* 224 (December 2015): 901.

[558] Zhu Qian, "Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou," *Land Use Policy* 46 (2015): 251.

[559] *See e.g.*, *12th Five-Year Plan for Economic and Social Development*, discussed further in Factor 5.A.

[560] *Outline of the National Overall Planning on Land Use (2006-2020)* (State Council, Guo Fa [2008] No. 33, issued October 6, 2008).

[561] *Outline of the National Overall Planning on Land Use (2006-2020)* (State Council, Guo Fa [2008] No. 33, issued October 6, 2008). *See also* World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 268.

[562] Siu Wai Wong, "Land Requisitions and State-Village Power Restructuring," *The China Quarterly* 224 (December 2015): 901.

[563] *Ibid*.

[564] *See* Yuan Xiao and Jinhua Zhao, *Fixing China's Distorted Urban Land Quota System*, Paulson Policy Memorandum (Paulson Institute, March 2015).

transact land at very low prices.[565] A 2014 World Bank report estimates that average population density in China's cities has declined by over 25% over the past decade.[566] Land designated for industrial use is also underutilized; a nationwide survey suggests that 70% of the total land within China's 6,866 Development Zones is unused.[567] An ADBI report summarizes the problem:

> With its monopoly on land expropriation and transaction, local governments have held down land expropriation prices to acquire large amounts of rural land and turned them into urban lands, which directly led to the excessive expansion of urban land area, as in the massive construction of development zones and new towns. As the *hukou* system hinders rural–urban migration, it can be predicted that land urbanization will outpace population urbanization, with decreasing density of urban population and low efficiency of land use.[568]

Contrary to the objective of carefully conserving arable land, the Chinese government has also used its ownership and control over land to support state industrial policies. A 2013 World Bank study finds that one of the defining characteristics of industrial policies in China is to institute "direct administrative interventions" to shift resources, including land, from prohibited to preferred sectors.[569] The central government's ability to assign construction quotas by province is a particularly powerful tool in this regard, as it allows planners to influence the distribution and growth of industry across the country.[570]

Central government measures to influence the distribution of industrial assets expressly reference land. For example, the 2005 *State Council Decision on Implementing the Interim Provisions on Promoting the Structural Adjustment of Industry*, discussed in more detail under Factor 5,

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[565] World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 9, 34; Wade Shepard, "China's Ghost Cities Are Now Resorting To Coupons To Fill Vacant Homes," *Forbes*, November 18, 2016; Sarah Jacobs, "12 Eerie Photos of Enormous Chinese Cities Completely Empty of People," *Business Insider*, October 3, 2017; Steve Chao, "Inside China's Ghost Towns: 'Developers Run Out of Money," *Al Jazeera*, September 21, 2016; Lucy Hornby, "China Migration: Dying for Land," *Financial Times*, August 6, 2015.

[566] World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 10. *See also* Yasheng Huang, *Urbanization, Hukou System and Government Land Ownership: Effects on Rural Migrant Works and on Rural and Urban Hukou Residents* (OECD Development Center, March 2010).

[567] Jinfeng Du and Richard Peiser, "Land Supply, Pricing and Local Governments' Land Hoarding in China," *Regional Science and Urban Economics* 48 (2014): 183. *See also* Klaus Deininger et al., *Impact of Property Rights Reform to Support China's Rural-Urban Integration*, Policy Research Working Paper WPS7388 (World Bank, August 11, 2015), 5.

[568] Li Zhang and Xianxiang Xu, *Land Policy and Urbanization in the People's Republic of China*, ADBI Working Paper Series No. 614 (Asian Development Bank Institute, November 11, 2016), 7.

[569] World Bank and State Council DRC, *China 2030: Building a Modern, Harmonious, and Creative Society*, No. 76299 (March 23, 2013), 142.

[570] *See* Yuan Xiao and Jinhua Zhao, *Fixing China's Distorted Urban Land Quota System*, Paulson Policy Memorandum (Paulson Institute, March 2015).

provide that Chinese authorities "shall speed up the formulation and amendment of policies on…land…[to] intensify the coordination and cooperation with industrial policies, and further improve and promote the policy system on industrial structure adjustment."[571] Similarly, the *Guiding Opinions of the State Council on Central and Western Regions' Undertaking of Industrial Transfer* provides that the annual construction quotas allocated to central and western regions are to be increased, with "preferential allocation of construction land quotas for industrial parks."[572]

2.3. Misaligned Incentives of Local Government Actors

In a well-functioning market, economic actors are incentivized to put land to its most productive use, taking into account factors such as land quality and location. When the government exercises ownership and control over land, however, the dynamics of the land market are different. Government authorities take many administrative factors into account when deciding how to use land, such as revenue from land sales; future tax revenues from the opening of profitable businesses on the land; and the need to meet economic growth targets and implement industrial policy directives set by the government.[573]

Fiscal imbalances are a particularly important factor influencing land-use decisions in China. Local governments account for a greater share of total government expenditure than government revenue,[574] largely because they bear primary responsibility for financing public services such as policing, schools, hospitals, and roads.[575] At the same time, local governments are constrained in their revenue-raising activities. Pursuant to tax reforms introduced in 1994, the central government collects the majority of fiscal revenue from the two largest tax items – the value-added tax and the corporate income tax[576] – and power to pass tax legislation rests at the central

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[571] *State Council Decision on Implementing the "Interim Provisions on Promoting the Structural Adjustment of Industry* (State Council, Guo Fa [2005] No. 40, issued December 2, 2005).

[572] *Guiding Opinions of the State Council on Central and Western Regions' Undertaking of Industrial Transfer*, Article 28 (State Council, Guo Fa [2010] No. 28, issued August 31, 2010).

[573] World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 269.

[574] For the year 2015, local governments accounted for 85.5% of fiscal outlays, versus 50.2% of tax revenue. WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 19.

[575] *See* Athar Hussain and Nicholas Stern, "Public Finances, the Role of the State, and Economic Transformation, 1978-2020," in *Public Finance in China: Reform and Growth for a Harmonious Society*, (eds.) Jiwei Lou and Shuilin Wang (Washington, DC: World Bank, 2008), 13-38.

[576] As a share of China's national tax revenue in 2015, the domestic value-added tax accounted for 24.9% and the corporate income tax for 21.7%. The next-largest tax items were the business tax (15.5% share) and the VAT and consumption tax from imports (10.0% share, offset by a commensurate rebate on exports). WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/342 (June 15, 2016), 19. *See also* budget revenue statistics for the year 2015 (Ministry of Finance website, available at http://yss.mof.gov.cn/2015js/, accessed September 11, 2017.)

level. Authorities at the sub-province level lack the ability to raise capital through bond issuances.[577] Central government fiscal transfers are designed to plug funding gaps at the local level, but in practice, they do not suffice.[578]

Consequently, local governments sell land-use rights in order to meet their fiscal needs, typically following the conversion of collectively owned rural land into state-owned urban land.[579] Revenues from land sales are a primary source of local government revenue.[580] Revenue from land sales as a share of total government revenue fluctuates from year-to-year but was approximately 45% in 2013 after reaching a peak of nearly 70% in 2010.[581] Land concession income, which is the income local governments receive from leasing the land-use rights, grew from an estimated RMB 588 billion in 2006 to RMB 3.3 trillion in 2013.[582]

Property taxes could reduce local governments' reliance on land concession income as a major revenue source, and in so doing, mitigate land expropriation and increase the security of rural land-use rights. However, to date, property taxes have only been piloted in select regions, such as Shanghai and Chongqing municipalities, at low effective rates of taxation. An important reason is that individuals do not have the right to own the land.[583]

2.4. Land Titling and Registration

Rural land-use rights in China are poorly documented. A 2013 report by the World Bank states that in "the near to medium term, supplemental reforms will have to tackle the poor quality of current documentation on collective land ownership and individual use rights."[584] It also finds

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[577] A revised budget law passed in 2014 permits province-level authorities to issue bonds, but this authority does not extend to the sub-province level. Sandra Heep, "Public Finance," in *China's Political System*, (ed.) Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 109.

[578] Christine Wong, "Fiscal Reform: Paying for the Harmonious Society," *China Economic Quarterly* 14(2) (2010): 20-25.

[579] W. Raphael Lam and Philippe Wingender, *China: How Can Revenue Reforms Contribute to Inclusive and Sustainable Growth?*, IMF Working Paper WP/15/66 (IMF, March 2015), 21-22. *See also* Zhu Qian, "Land Acquisition Compensation in Post-Reform China: Evolution, Structure, and Challenges in Hangzhou," *Land Use Policy* 46 (2015): 251.

[580] World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 267.

[581] *Ibid*., 278.

[582] *Ibid*., 275. An important basis for this trend is the 1994 tax reform, which reclassified land concession income as local government income. Unlike other major tax items, land concession income does not need to be shared with the central government.

[583] *Ibid.,* 165.

[584] World Bank and State Council DRC, *China 2030: Building a Modern, Harmonious, and Creative Society*, No. 76299 (March 23, 2013), 131.

that land contract and certificate documentation has "not been sufficiently harmonized across the rural and urban spheres," and that China lacks a "reliable complete national inventory of land parcels."[585]

In lieu of comprehensive national statistics, experts rely on survey data to measure the extent of such documentation. A 2011 survey by the Landesa Rural Development Institute[586] found that only half of respondents possessed contracts and land-use rights certificates, and only a small share of the documents issued contained all the relevant legal information.[587] A separate survey, conducted between 2009 and 2010, records significant differences across provinces, with only 30% of households in Jiangxi province holding a land certificate versus 95% in Gansu province.[588]

Inadequate documentation affects the economic behavior of farmers. The Landesa survey, for example, identifies a statistical correlation between inadequate documentation and low levels of investment in farmland.[589] Similarly, an OECD report finds that poorly defined contract rights, combined with poor enforcement of those rights, often prevent farmers from renting out their land to more productive uses and seeking employment outside the farm sector.[590]

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[585] *Ibid.* ("While the full establishment of a national land inventory may not be feasible in the short or medium term, effective implementation of land rights will require some degree of clarity about the location and extent of the land to which the rights apply. More reliable, precise, and accessible records concerning the location of individual land parcels and who has what rights to a given parcel will help strengthen the trust and sense of security of contract owners, help reduce land disputes, and facilitate the more efficient implementation of land-related laws.")

[586] Landesa Rural Development Institute, *Summary of 2011 17-Province Survey's Findings* (April 26, 2012), 1. ("The survey is the sixth in a series by Landesa, in cooperation with China Renmin University and Michigan State University. Conducted in mid-2011, the survey covered 1,791 households in 17 provinces that together contain an estimated three quarters of China's rural population (Anhui, Fujian, Guangxi, Guizhou, Hebei, Heilongjiang, Henan, Hubei, Hunan, Jiangsu, Jiangxi, Jilin, Shaanxi, Shandong, Sichuan, Yunnan, and Zhejiang). The previous surveys were done in 1999, 2001, 2005, 2008, and 2010. The findings are accurate within ±2.3 percent (at the 95 percent confidence level) for the entire rural population of these 17 provinces.")

[587] *Ibid*. ("Two documents are supposed to record farmers' land rights and afford farmers some measure of protection: contracts (which 56.8% of the respondents have been issued) and land-rights certificates (which 57.0% of farm households have been issued). Overall, 77.1% of all households have at least one land document, and 36.7% have both documents as required by law and policy. However, only 20.9% of issued contracts and 40.3% of issued certificates contain all the legally required information and can be considered strictly law-compliant, reducing the contribution of documentation to the security of land rights.")

[588] Ma, X., N. Heerink, S. Feng, X. Shi, "Farmland Tenure in China: Comparing Legal, Actual and Perceived Security," *Land Use Policy* 42 (2015): 293-306.

[589] Landesa Rural Development Institute, *Summary of 2011 17-Province Survey's Findings* (April 26, 2012), 2. ("Preliminary data analysis shows that the quality of land certificates is highly correlated to farmers' decision in making investments. Surveyed farmers are 76.5% more likely to have made investments when they have law-compliant land certificates compared to noncompliant certificates. In addition, of all the investments made, 84.5% were made in or after the year of contract issuance, 78.2% made in or after the year of certificate issuance, and 81.3% made in the year of or following the issuance of both documents.")

[590] Ben Westmore, *Agricultural Reforms and Bridging the Gap for Rural China*, ECO/WKP(2015)36 (OECD, May 22, 2015), 12.

The Chinese government has adopted some initiatives to improve rural land-use rights documentation. A guiding document, *Communist Party of China Central Committee and State Council Several Opinions on Accelerating Development of Modern Agriculture and Further Increasing Rural Development Dynamism*, calls for completing registration of farmers' land rights throughout the country within five years.[591] Further, in November 2014, the State Council issued *the Interim Regulations on Real Estate Registration*, which requires that all collectively owned rural land be registered in a centralized registry.[592] Although the development of a national land registry marks an important step forward, reports suggest that the public will not have access to it, which may limit its utility in improving price discovery and developing land markets.[593]

C. Assessment of Factor

Under Factor 4, the Department finds that the Chinese government continues to exert significant ownership and control over the means of production, as demonstrated by the role and prevalence of SIEs throughout the enterprise sector and the system of land ownership and land-use rights. The average size of SIEs remains large when compared with private companies, and the relative "economic weight" of SIEs in China's economy is substantial in comparison with relevant sectors in other major economies. In fact, formal indicia of government investment in Chinese enterprises likely understate the actual extent of government ownership and control. The Chinese government allocates resources to SIEs in what it deems strategically important sectors, such that SIEs are not strictly disciplined by market principles of supply and demand. At the same time, however, the government requires that SIEs undertake large-scale investments to help stabilize China's macro-economy. The government also intervenes extensively in the enterprise sector to shield SIEs from the consequences of economic failure, facilitates mergers and acquisitions to achieve government, not enterprise, objectives, and enables the rise of large enterprise groups under government ownership and control.

Although the government has adopted policies to restructure and corporatize SIEs, it continues to fulfill its legal mandate to "maintain a leading role for the state sector." As a consequence, SIEs in China operate in sectors and industries beyond those that typically raise natural monopoly or public goods or services policy considerations. An important enabling factor for government control over firm decision-making is the manner in which the CCP reserves the right to make personnel appointments and participate in corporate decision-making through Party Committees

[591] World Bank and State Council DRC, *Urban China: Toward Efficient, Inclusive, and Sustainable Urbanization*, Natural Resources Forum 39(2) (2014), 39.

[592] *Interim Regulations on Real Estate Registration*, Articles 2 and 5 (State Council, Order [2014] No. 656, issued November 24, 2014). MLR issued pursuant implementing rules in January 2016, which contain detailed provisions on what types of documentation shall be submitted to the land registry by rural collectives. *See Implementing Rules for the Interim Regulations on Real Estate Registration* (MLR, Order [2016] No. 63, issued January 1, 2016), Chapter 3, Section 2.

[593] The Economist Intelligence Unit, *China Economy: China Hand: Land and Property* (July 29, 2015).

and other channels. Recent efforts to promote "mixed ownership" and the separation of "commercial" from "public interest" SIEs do not fundamentally alter this fact.

The Chinese government exercises significant control over land, another key means of production. There is no private land ownership, rural and urban land markets are segmented, and the government remains the final arbiter on how land is used (through extensive planning) and valued. Individuals, firms, and other entities may own land-use rights, but there are limits on the scope and tenure of these rights in both rural and urban areas. The result of these dynamics is an inefficient land market in which large swathes of land are misallocated either to small farm plots or to underutilized urban infrastructure.

In rural areas, the scope of individual use rights for agricultural land is limited, *inter alia*, by restrictions on non-agricultural use, conditions imposed on use-rights transfers, and inadequate land titling systems. Crucially, individual holders of agricultural land-use rights are not authorized to convert their land into state-owned urban land, and conversely, are not adequately compensated when the government requisitions their land for urban use. Rural residents remain effectively constrained in terms of how they use the land and the extent to which they can transfer their land-use rights or fully monetize their value. As a result, agricultural production in China remains inefficient due to small plots and underdeveloped leasing markets.

In urban areas, the government "allocates" use rights indefinitely for certain uses, or, as is more often the case, "grants" use rights – through auction, tender, or listing – for varying lengths of time to industrial, commercial, and residential users. On the basis of arable land preservation mandates, the Chinese government tightly manages the use of urban land through nationwide construction quotas and a complex system of land-use planning. A combination of fiscal imbalances and decentralized authority exacerbates non-market land-use policies at the local level. In practice, the government uses its discretion to make large amounts of land available for industrial uses, particularly in the central and western regions of the country, while limiting the supply of land available for residential and commercial uses, a practice that segments land markets and distorts prices.

Factor Five: The extent of government control over the allocation of resources and over the price and output decisions of enterprises.

Excessive government control over the allocation of resources and over the price and output decisions of enterprises undermines the functioning of a market economy. If resources are severely misallocated or the government unduly influences or constrains the price and output decisions of individual market actors, then prices and costs become distorted and non-market conditions prevail. Part A of this section assesses the Chinese government's industrial policies, including the formulation and execution of state plans; the tools used to implement industrial policies; key examples of industrial policies; and "supply-side structural reform" initiatives. Part B of this section assesses the Chinese government's regulation of prices, including the prevalence of price distortions; the status of formal price controls; and certain informal price controls. Part C of this section assesses the financial sector, including the formal banking sector, interbank markets, bond markets, and "shadow banking."

The Department discusses, in each of these areas, the Chinese government's direct and indirect control over the allocation of resources, which in turn distort price and output decisions of enterprises. In sum, the Department finds that the extent of government control is significant and far-reaching.

A. Industrial Policies

Part A of this section analyzes the Chinese government's industrial policies. It first examines the relevant legal and institutional framework, including the extent to which the Chinese government's system of state planning mobilizes government authorities, the CCP, and SIEs. It then assesses the mechanisms by which the Chinese government implements industrial policies, including the use of investment restrictions and approval procedures; access conditions and other industry standards; guidance catalogues; financial supports; and quantitative restrictions. Part A also examines how these mechanisms function in priority areas for industrial policy – industrial restructuring and upgrading, the geographic distribution of industry, and science and technology development. Part A concludes by analyzing excess capacity and excessive corporate debt issues in the context of the Chinese government's "supply-side structural reform" initiatives, in order to illustrate how recent developments in industrial policymaking have reinforced the government's role in managing the economy.

The analysis presented below is informed, in part, by the Department's 2012 analysis of public bodies in China ("*Public Bodies Analysis*"),[594] which identifies "[t]he development and dissemination of industrial policies" as "one of the formal means by which [the Chinese] government communicates its plans to uphold the socialist market economy." The planning process and the resulting documents are "the means (and roadmap) by which the government

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[594] U.S. Department of Commerce, *Section 129 Determination of the Countervailing Duty Investigation of Circular Welded Carbon Quality Steel Pipe; Light-Walled Rectangular Pipe and Tube; Laminated Woven Sacks; and Off-the-Road Tires from the People's Republic of China: An Analysis of Public Bodies in the People's Republic of China in Accordance with the WTO Appellate Body's Findings in WTO DS379* (May 18, 2012), 9.

seeks to fulfill its legal mandate to maintain the predominance of the state sector."[595] The *Public Bodies Analysis* is informed by the World Bank and State Council DRC report, *China 2030*, which observed that the Chinese government's extensive industrial policy interventions are "designed to affect the allocation of resources among economic activities (across or within sectors) to achieve a different outcome from what otherwise would have occurred."[596] *China 2030* describes several features of the Chinese government's industrial policies, including their implementation across all levels of government; the range of instruments that the Chinese government uses to achieve multiple, sometimes conflicting, objectives; and the focus on increasing scale, with a preference for larger enterprises with higher market concentration and favoring SIEs over private firms.[597]

While many countries may have some form of industrial policy, the Chinese government's system and implementation is distinctive in terms of its complexity and pervasiveness, as well as its reliance on direct administrative interventions to allocate resources to different sectors of China's economy. The objective of the Chinese government and the CCP is to uphold the "socialist market economy" in which the Party-state directs and channels economic actors to meet the targets of state planning, not for economic outcomes that reflect predominantly market forces acting independent of the Party-state. In China's economic framework, state planning through industrial policies conveys instructions regarding sector-specific economic objectives, particularly for those sectors deemed strategic and fundamental.

1. *Framework of State Planning and Industrial Policymaking*

1.1. The Preservation of State Planning after the "Planned Economy"

In China's command economy prior to 1978, the Chinese government established input-use and output-production targets for industry and agriculture by unit and locality with great specificity. A core objective of this system was to prioritize the allocation of resources to heavy industries such as steel.[598] Since 1978, the Chinese government has modified the system of state planning. The first phase in this process was the "dual track system" introduced in the 1980s, under which a traditional plan and market channel were permitted to coexist.[599] Subsequently, the 1993

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595 *Public Bodies Analysis*, 9.

596 World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 107-108.

597 *Ibid*, 107-109, 141-142.

598 Tony Saich, *Governance and Politics of China, Third Edition* (New York: Palgrave MacMillan, 2011), 45-53.

599 Barry Naughton, *The Chinese Economy: Transitions and Growth* (Cambridge: MIT Press, 2007), 91-92. ("Perhaps the most characteristic feature of China's initial departure from the planned economy was the dual-track system. The Chinese term *shuangguizhi* refers to the coexistence of a traditional plan and a market channel for the allocation of a given good. Rather than dismantling the plan, reformers acquiesced to a continuing role for the plan in order to ensure stability and guarantee the attainment of some key government priorities (in the Chinese case, primarily investment in energy and infrastructure). The dual track implied a two-tier pricing system for most goods: a single commodity had both a (typically low) state-set planned price and a (typically higher) market price.")

revision to the 1982 *PRC Constitution* introduced the concept of the "socialist market economy" to replace the "planned economy,"[600] which reflected this shift. Industrial policymaking became more complex, combining state planning with some ostensibly market-oriented instruments.[601]

Industrial policies in China today continue to be extensive. A core organizing principle of these policies remains the five-year planning period, first instituted in 1953-1957 based on the practice of the Soviet Union. At the apex of the five-year planning system is the *Five-Year Plan for Economic and Social Development* ("*FYP*").[602] The *13th Five-Year Plan for Economic and Social Development (2016-2020)* ("*13th FYP*"), issued in March 2016, is divided into twenty chapters, which unify plans for the national development of agriculture, industry, infrastructure and communications, regional economic zones, and foreign trade and investment; health, education, and welfare; the CCP-led political system; and national defense.[603] Each sub-national government authority issues its own *FYP*, pursuant to the central government document.[604]

The Chinese government has not only maintained the planning system, but also further formalized it. The State Council's *Several Opinions on Strengthening Drafting Work for the*

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600 *PRC Constitution*, Article 15.

601 Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 584.

602 The *PRC Constitution* expressly states that various government authorities are responsible for formulating and executing *FYPs*. In particular, Article 89, Paragraph 5 of the *PRC Constitution* provides that "to draw up and implement the plan for national economic and social development" is one of the "functions and powers" exercised by the State Council, China's "highest administrative organ." Article 62, Paragraph 9 of the *PRC Constitution* provides that "to examine and approve the plan for national economic and social development and the report on its implementation" is one of the "functions and powers" exercised by NPC.

603 Chapter I of the *13th FYP* presents "guiding thoughts," "principal targets," and "developmental concepts." Chapters II and III present the principal themes set by the Chinese government for the 13th FYP period: "innovation to spur development" and "establishing a new model for development." The ensuing nine chapters present plans for various aspects of economic development, including: agricultural modernization (Chapter IV); structural optimization of the industrial sector (Chapter V); expansion of the Internet economy (Chapter VI); buildout of basic infrastructure networks (Chapter VII); promotion of new forms of urbanization and regional economic zones (Chapters VIII and IX); the development of environmentally sustainable industries (Chapter X); and the promotion of the "One Belt, One Road" initiative and other policies to expand foreign trade and investment (Chapters XI and XII).

604 Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 586. ("The five-year plan begins with brief, fairly general guidelines approved by the [CCPCC] in the fall of the year before the start of the plan period, and with a more detailed – but still fairly broad – outline approved by the National People's Congress the following March. Collectively, they set national priorities and outline how they will be met, but these documents—which are commonly referred to as the five-year plan—are only *executed through a network of thousands of sub-plans* that evolve into detailed execution instructions for all levels of government. This web of plans evolves over the entire five-year period, and is better thought of as a planning coordination and evaluation cycle rather than a cohesive, unified blueprint. The planning system's layered and nested programs can be found in almost every single policy domain in China and across three core levels of government: the center, provincial-level jurisdictions, and cities or counties.")

National Economic and Social Development Plan, issued in 2005, provide for a “three-by-three” system according to which economic and social development plans are divided vertically into (1) national, (2) provincial, and (3) municipal/county level plans, and, by function, into (1) comprehensive plans, (2) macro-regional plans, and (3) specialized plans.[605] Macro-regional plans serve as a means for the Chinese government to coordinate various government authorities across sub-regions and sectors, particularly with respect to infrastructure and industrial investment.[606]

Specialized plans, in turn, translate industrial policy elements into sector-specific five-year plans drafted by government authorities under the State Council. For the 13th five-year planning period, there are over 100 such plans, including, *inter alia*, for energy, raw material, and farm sectors; technology- and capital-intensive industries; and important facets of economic regulation, such as intellectual property and fair competition.[607] As part of reinvigorating the planning system, the Chinese government has also formulated an increasing number of specialized plans for periods exceeding five years. In the high-tech sector, for example, China has issued the *Medium- and Long-Term Plan for Science and Technology* (2006-2020) (“*S&T MLP*”)[608] and the *Decision on Issuing “China Manufacturing 2025”* (“*Made in China 2025 Decision*”).[609]

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[605] *Several Opinions on Strengthening Drafting Work for the National Economic and Social Development Plan*, Section 1.1 (State Council, Guo Fa [2005] No. 33, issued October 22, 2005).

[606] Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993-2012,” *Modern China* 39(6) (2013): 591-594. Important macro-regions include the Western and Central region, the Northeast region, the Pearl River delta, and the Yangtze River delta.

[607] For the *11th FYP* period, Heilmann and Melton identify “roughly 160 national-level special plans.” Sebastian Heilmann and Oliver Melton, “The Reinvention of Development Planning in China, 1993-2012,” *Modern China* 39(6) (2013): 595.

[608] *Notice on Issuing the National Medium- and Long-Term Plan for Science and Technology (2006-2020)* (State Council, Guo Fa [2005] No. 44, issued December 26, 2005).

[609] *Decision on Issuing “China Manufacturing 2025”* (State Council, Guo Fa [2015] No. 28, issued May 8, 2015).

Targets remain numerous throughout China's state plans.[610] A subset of targets is formalized into a dual system of "binding targets" and "indicative targets."[611] For example, the *12th Five-Year Plan for Economic and Social Development (2011-2015)* ("*12th FYP*") contains a series of "binding targets" pertaining, *inter alia*, to arable land supply, energy intensity, pollution emissions, and welfare provision. It also contains a series of "indicative targets" pertaining, *inter alia*, to per capita income growth, the unemployment rate, the services sector share of GDP, the urbanization rate, grain comprehensive production capacity, R&D spending as a share of GDP, and patent ownership per 10,000 people.[612] Another example is the *National Mineral Resource Plan (2016-2020)*, which provides "indicative targets" for the level of production of one set of resources (including oil, gas, coal, iron ore, and various nonferrous metals) and "binding targets" for the level of production of tungsten and rare earths.[613] A 2017 policy document issued by the Ministry of Science and Technology, moreover, instructs officials to prescribe both "binding targets" and "indicative targets" when drafting science and technology development plans for the "2030 Sustainable Development Initiative Innovation Demonstration Zones."[614]

Studies indicate that the Chinese government uses a variety of methods to ensure implementation of planning targets. Fulfillment of "binding targets," in particular, is a formal component of evaluating the performance of government officials,[615] and also entails direct allocation of

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[610] *See e.g.*, the *Decision on Issuing "China Manufacturing 2025"* (State Council, Guo Fa [2015] No. 28, issued May 8, 2015), which contains a table that lists year 2020 and year 2025 targets for R&D spending and patents in large manufacturing industries, measured in relation to operating revenue. A related objective is to form a group of advantageous industries and backbone enterprises that possess global competitiveness. *See also State Council Notice on Issuing the Medium and Long-Term Development Plan for the Logistics Industry (2014-2020)*, Sections 4 and 5 (State Council, Guo Fa [2014] No. 42, issued September 12, 2014). Among the targets set forth in the plan are: for the logistics sector to achieve an annualized rate of growth of approximately 8% through the year 2020; for the logistics sector to achieve an approximately 7.5% share of China's GDP by 2020; and for total spending on logistics, as a share of GDP, to decrease from 18% to 16%; and for the formation of a "group of backbone logistics enterprises that possess relative strong goods transportation capacity."

[611] Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 609-611; Sebastian Heilmann, "Economic Governance: Authoritarian Upgrading and Innovative Potential," in *China Today, China Tomorrow: Domestic Politics, Economy, and Society*, ed. Joseph Fewsmith (Lanham: Rowman & Littlefield, 2010), 116-118.

[612] *See e.g., 12th Five-Year Plan for Economic and Social Development* (adopted by NPC on March 14, 2011). *See* also Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 587-589.

[613] *National Mineral Resources Plan (2016-2020)* (MLR, issued November 2016); *State Council Approval of the National Mineral Resources Plan (2016-2020)* (State Council, Guo Han [2016] No. 178, issued November 2, 2016), Chapter II(3).

[614] *Ministry of Science and Technology Notice on Issuing the "Guidance for Applying to National Sustainable Development Initiative Innovation Demonstration Zones,"* Part IV(2(3) (MOST, Guo Ke Ban She [2017] No. 24, issued April 14, 2017).

[615] Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 609. ("In China, the linkage between plan targets and cadre assessments was loose and unsystematic until the early 1990s. From the early 1990s on, as a result of a thorough overhaul of the party's personnel system, cadre evaluations became more systematic and started to include more economic and social

funding and stringent administrative oversight.[616] To fulfill "indicative targets," the government uses methods such as policy signaling (*e.g.*, announcements about changes to fiscal policy) and indirect incentives (*e.g.*, improved access to bank loans) to inform the behavior of government officials and economic actors.[617] The Chinese government enters into contracts – concluded between central and sub-central government authorities, or between government departments and major enterprises that take part in implementing state plans – that contain planning targets for items such as road construction, technology zones, and energy production. [618]

Another prominent feature of the current generation of planning documents is its specificity with respect to sub-sectors, products, materials, processes, and technologies for further development. Sector-specific plans frequently detail such items in textboxes and appendices. One example is the appendix to the *12th Five-Year Development Plan for New Materials*, which pinpoints industrial materials that Chinese industry should prioritize for the development of a wide range of high-technology applications.[619] As is further discussed below, these enumerative planning documents act in conjunction with various types of guidance catalogues in which the Chinese government lists specific items it encourages, discourages, restricts, or prohibits for investment or other market activity. As such catalogues are made public, they signal the government's preferences not only to government officials, but also to economic actors in individual sectors.

To ensure the implementation of state plans, the Chinese government maintains a formal system for assigning tasks and reviewing their execution. Tasking documents, which cascade from the level of the State Council and its subordinate ministries down to the local level, integrate a variety of government departments into the process of implementation. For the purposes of implementing the *11th Five-Year Plan for Economic and Social Development (2006-2010)* ("*11th FYP*"), for example, the State Council issued the *Notice on Principal Objectives and the Division of Work Tasks to Fulfill the Outline of the PRC 11th Five-Year Plan for Economic and Social Development*,[620] and a similar document was issued for the *12th FYP*.[621] These documents

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indicators than just GDP growth or unemployment in each leading cadre's jurisdiction. […] A breakthrough for systemically linking a more complex set of economic and noneconomic plan targets with cadre appraisals resulted from the re-institution of a "binding target" category in national, provincial- and local-level planning from 2006.")

[616] *Ibid.*, 610-611; Sebastian Heilmann, "Economic Governance: Authoritarian Upgrading and Innovative Potential," in *China Today, China Tomorrow: Domestic Politics, Economy, and Society*, ed. Joseph Fewsmith (Lanham: Rowman & Littlefield, 2010), 116-117.

[617] *Ibid*.

[618] *Ibid*.

[619] *12th Five-Year Development Plan for New Materials* (MIIT, issued January 4, 2012). *See also* the *Four Ministries Notice on Issuing the New Materials Industry Development Guide* (MIIT, NDRC, MOST, MOF, Gong Xin Bu Lin Gui [2016] No. 454, issued December 30, 2016).

[620] *Notice on Principal Objectives and the Division of Work Tasks to Fulfill the Outline of the PRC 11th Five-Year Plan for Economic and Social Development* (State Council, Guo Fa [2006] No. 29, issued August 24, 2006).

[621] *Notice on Principal Objectives and the Division of Work Tasks to Fulfill the "Outline of the PRC 12th Five-Year Plan for Economic and Social Development* (State Council, Guo Fa [2011] No. 34, issued October 11, 2011).

list which government department will be responsible for, or lead, the implementation of each item of the *FYP*.

In conjunction with tasking documents, China's institutional framework comprises a formal review process, formalized in 2005 through the State Council's *Several Opinions on Strengthening Drafting Work for the National Economic and Social Development Plan*.[622] One component of this review process is a mid-term evaluation of each *FYP*. The *Notice on Launching the Mid-Term Evaluation of "12th Five-Year Plan" Outline*,[623] issued by NDRC pursuant to the aforementioned State Council tasking document for the *12th FYP*, sets forth an intricate point-tallying system to evaluate implementation of each aspect of the *12th FYP*. Another component, carried out primarily within NDRC using market analysis tools, is an annual review of the previous year's performance and the setting of targets for the coming year, presented by NDRC each March at NPC's annual meeting. The most recent such presentation is contained in the *Decision of the 12th National People's Congress Fifth Meeting on the Status of Executing the 2016 National Plan for Economic and Social Development and on the 2017 National Plan for Economic and Social Development*.[624]

1.2. Institutional Framework for Industrial Policies

1.2.1. Planning Agencies with Broad Regulatory Authority

In China's system of government, the central government agencies that bear prime responsibility for state planning also have broad legislative and regulatory authority. In 2003, the Chinese government consolidated disparate authorities, including the former State Planning Commission,

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[622] *Several Opinions on Strengthening Drafting Work for the National Economic and Social Development Plan* (State Council, Guo Fa [2005] No. 33, issued October 22, 2005). Section 5 provides for establishing an evaluation and adjustment mechanism for plans. Article 12 provides: Implement a plan evaluation system. In the course of plan implementation, plan drafting departments are required to organize and carry out in a timely manner evaluations of the implementation status, promptly discover problems, earnestly analyze the causes of the problems, and provide recommendations for targeted counter-measures. The regions and departments concerned are also required to closely track and analyze the implementation status of the plan, and promptly provide feedback to the plan drafting departments. Article 13 further provides: Adjust and amend plans in a timely manner. If through evaluation or due to other reasons it becomes necessary to amend a plan, the plan drafting departments shall provide a plan revision program [fang'an]. Each region and each department is required to take full into account the realities of its region or department in earnestly and properly handling the implementation of this work. They shall constantly summarize experiences and lessons, reform the planning administration system, innovation plan drafting methods, and regularize plan drafting processes, so as to make plan drafting work better meets the demands of the socialist market economy system and the needs of economic and social development.

[623] *Notice on Launching the Mid-Term Evaluation of "12th Five-Year Plan" Outline* (NDRC, Fai Gai Gui Hua [2013] No. 328, issued October 11, 2011).

[624] The most recent such presentation is contained in the *Decision of the 12th National People's Congress Fifth Meeting on the Status of Executing the 2016 National Plan for Economic and Social Development and on the 2017 National Plan for Economic and Social Development*, [presentation] NPC, March 15, 2017.

to establish NDRC.[625] One of NDRC's key functions is to formulate the *FYP* through a complex process of inter-ministerial planning and coordination.[626] Other functions of NDRC also include planning components, such as promoting innovation and industrial restructuring, coordinating development of macro-regions, and balancing supply and demand of important commodities.[627]

At the same time, NDRC enjoys broad legislative and regulatory authority. One of its stated functions is to "draft relevant laws and regulations concerning national economic and social development, economic system restructuring and opening up to the outside world and formulate regulations; to guide and coordinate tendering in accordance with regulations."[628] As discussed further in Factor 5.B. below, NDRC also comprises a pricing department that formally guides and sets national prices for energy and other important factor inputs that influence prices and costs throughout the economy. NDRC also wields authority over the approval of large domestic and foreign investment projects, administration of import tariff-rate quotas, and the procurement and storage of raw materials.[629]

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[625] Tony Saich, *Governance and Politics of China* (New York: Palgrave MacMillan, 2011), 96; Sebastian Heilmann and Leah Shih, "The Central Government," in *China's Political System*, ed. Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 77-78.

[626] NDRC divides its "main functions" into 15 categories, of which the first category applies to high-level state planning. *Main Functions of NDRC* (NDRC, available at http://en.ndrc.gov.cn/mfndrc/, accessed on May 22, 2017). ("To formulate and implement strategies of national economic and social development, annual plans, medium and long-term development plans; to coordinate economic and social development; to carry out research and analysis on domestic and international economic situation; to put forward targets and policies concerning the development of the national economy, the regulation of the overall price level and the optimization of major economic structures, and to make recommendations on the employment of various economic instruments and policies; to submit the plan for national economic and social development to the National People's Congress on behalf of the State Council.") *See also* Sebastian Heilmann and Oliver Melton, "The Reinvention of Development Planning in China, 1993-2012," *Modern China* 39(6) (2013): 600. ("Top Party leaders and the State Council, and their affiliated research arms, sit at the apex of the planning process, but NDRC's various offices are the locus of many drafting and planning functions: they approve and oversee regional strategic plans down to the city level, manage major regional investment projects, and are deeply involved in virtually every macro-economic issue. The same is true at the local level, where province- and city-level Development and Reform Commissions enjoy an analogous leadership role […]")

[627] *Ibid*. ("[P]ush forward strategic economic restructuring," functions of which include, *inter alia*, to "balance and coordinate industrial development with relevant plans, major policies and plans for the national economic and social development"; "formulate strategies and plans for modern logistics development"; "formulate strategies, plans and major policies for the development of high-tech industries and advance of industrial technologies."[…] To "formulate strategies, plans and major policies for promoting the coordinated development of regional economy, development of western region, revitalization of northeastern region and other old industrial bases, and rise of central region of China." […] To "maintain the aggregate balance and overall control of important commodities," functions of which include, *inter alia*, to "formulate plans for the overall volume of import and export of important agricultural products, industrial products and raw materials, supervise the implementation of these plans and adjust them in accordance with the performance of the national economy" and "formulate plans for the state reserve of strategic materials and carry out collection, utilization, rotation and management of these materials.")

[628] *Ibid*.

[629] NDRC lists on its website 33 subordinate units. The Department of Development Planning, Department of National Economy, and Department of Economic System Reform are the units principally in charge of state planning. The Department of Price and the Bureau of Price Supervision and Anti-Monopoly administer pricing regulation. The Department of Fixed Asset Investment and Department of Foreign Capital and Overseas Investment

Another central government agency that combines planning with legislative and regulatory functions is the Ministry of Industry and Information Technology (MIIT). Established in 2008, MIIT has formulated dozens of state plans for specific sectors of China's economy, especially those pertaining to technology-intensive industries.[630] At the same time, MIIT houses over 20 departments responsible for regulating diverse economic activities; notably, science and technology research, telecommunications, the Internet, the production of electronic and information goods, and primary raw materials.[631]

1.2.2. Mobilizing Capacity through the Government and the CCP

The Chinese government has the capacity to mobilize a large number of government authorities to execute state industrial policies. These authorities comprise nearly all ministries and agencies across the government hierarchy, including, *inter alia*, over 80 different authorities under the State Council, comprising ministry-level departments, organizations, special organizations, administrative offices, institutions, and sub-ministerial state administrations and bureaus; and thousands of sub-central government authorities.[632]

The CCP also plays a leading role in implementing industrial policies. The CCPCC has formal power to approve each *FYP*, in conjunction with the State Council. Importantly, *13th FYP* also appears to contain more forceful language than previous *FYPs* regarding the CCP's role in overseeing implementation of the *FYP*.[633] This modification in the *FYP* has coincided with reports of increased CCP control over administrative and economic activity in China. CCP

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administer investment regulation. The State Bureau of Material Reserve, State Grain Administration, and National Energy Administration administer important facets of mining, grain, and energy regulation. *See* NDRC website, available at http://en.ndrc.gov.cn/.

[630] *See also* World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 108. ("Such [industrial] interventions are implemented by three broad classes of actors […] The first are high-level national bodies. The second are central government departments, including the *National Development and Reform Commission (NDRC), the Ministry of Industry and Information Technology (MIIT)*, and others. The third are sub-central governments and their departments. While such governments are expected to help execute national policy, their extensive responsibilities also give them the means to influence industrial development, such as industrial planning, fiscal policy, access to land, and ownership of local SOEs." (emphasis added)

[631] MIIT website, available at http://www.miit.gov.cn/.

[632] For a list of counties, *see* NBS website, available at http://www.stats.gov.cn/tjsj/tjbz/xzqhdm/201703/t20170310_1471429.html. For a list of State Council authorities, *see* State Council website, available at http://www.gov.cn/guowuyuan/zuzhi.htm.

[633] *13th Five-Year Plan for Economic and Social Development (2016-2020)* (adopted by NPC at the Fourth Session of the 12th Congress on March 16, 2013). Chapter XX(1) states: "We will see that the Party exercises overall leadership and coordinates all aspects of work and that Party committees and leading Party members' groups at all levels serve as the core leadership and exercise more effective leadership so as to provide a firm guarantee for the realization of this plan."

members at all levels are now subject to multiple new and wide-ranging disciplinary measures, which seek in part to ensure implementation of central government and CCP policies.[634]

The CCP's leading role in industrial policymaking is also evident in its institutional makeup.[635] At the central government level, the CCPCC comprises Departments,[636] Commissions,[637] and Central Leading Small Groups,[638] several of which participate in industrial policymaking. For example, at the policy formulation stage, the Central Finance and Economy Leading Small Group coordinates closely with NDRC.[639] The newly established Central Leading Small Group for Comprehensively Deepening Reforms, established at the Third Plenary Session of the 18th National Congress of the CCP and expected to run through the year 2020, also influences the current planning work of NDRC and other government departments.[640]

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634 Jude Blanchette, *Back to Basics: The CCP at 95*, (The Conference Board, September 2016), 1-4.

635 The Department previously concluded that "the constitutional, legal and de facto source of authority for governance in China lies with the CCP." *See* Shauna Biby, Christopher Cassel, and Timothy Hruby, *The Relevance of the Chinese Communist Party for the Limited Purpose of Determining Whether Particular Enterprises Should Be Considered to Be "Public Bodies" within the Context of a Countervailing Duty Investigation. Memorandum of Proceedings* (U.S. Department of Commerce, 2012), 3.

636 CCP Departments comprise: (1) Organization Department responsible for cadre and organization policy), (2) the Central Party School that functions as a forum for CCP members to exchange ideas and as a think tank for administrative reforms; (3) the CCP Propaganda Department in charge of propaganda work and information policy; and the (4) International Liaison Department; (5) United Front Work Department responsible for maintain contacts with non CCP forces (including entrepreneurs and the All-China Federation of Industry and Commerce). Sebastian Heilmann and Leah Shih, "The Chinese Communist Party," in *China's Political System*, ed. Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 68-72.

637 CCP Commissions comprise: (1) Central National Security Commission that consolidates all the relevant security institutions under the leadership of the CCP Secretary; (2) Political and Legal Affairs Commission, represented at the central, province, and sub-province level, that is responsible for overseeing the police and the judiciary; (3) Central Institutional Organization Commission, responsible for organizational planning and administrative reform at the various CCP and government levels; (4) Central Commission for Discipline Inspection. Sebastian Heilmann and Leah Shih, "The Chinese Communist Party," in *China's Political System*, ed. Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 68-72.

638 CCP Leading Small Groups comprise: (1) Central Foreign Affairs Work Leading Small Group and Central Taiwan Work Leading Small Group are inter-ministerial coordination and decision-making bodies with CCP headquarters; (2) Central Finance and Economy Leading Small Group, responsible for developing guidelines for economic planning and economic structural reforms, drawing on the expertise of a large number of government bodies and research institutes; (3) Central Leading Small Group for Rural Work, responsible for rural economic and social policy; (4) Central Leading Small Group for Comprehensively Deepening Reforms was set up specifically to implement the institutional and economic restructuring program established in 2013 to be completed by 2020.

639 Sebastian Heilmann and Leah Shih, "The Chinese Communist Party," in *China's Political System*, ed. Sebastian Heilmann (New York: Rowman & Littlefield, 2017), 77-78.

640 *Ibid*.

As discussed above in Factor 4, a particularly powerful CCP organ is the Organization Department, which operates the *nomenklatura* system that governs personnel appointments.[641] It also uses a cadre evaluation system in which the performance of government officials is calculated according to a weighted points system.[642] One scholar notes:

> The CCP's most powerful instrument in structuring its domination over the state is a system called the "Party management of cadres" (*dangguan ganbu*), or more commonly known in the West as the *nomenklatura* system. The *nomenklatura* system 'consists of lists of leading positions, over which Party units exercise the power to make appointments and dismissals; lists of reserves or candidates for these positions; and institutions and processes for making the appropriate personnel changes.' The system established was based on the Soviet model, and changes occurred from time to time, albeit not drastic ones. […] The CCP selects all government officials; almost all government officials and all top officials are themselves Party members; and in each government agency, Party members are organized under a Party committee that is subordinate to the Party committee at the higher administrative level.[643]

In addition to the *nomenklatura* system, Chinese law contains provisions that mandate the compliance of officials at all levels of government with the CCP. Article 4 of the *Law of the People's Republic of China on Civil Servants*, adopted in 2005, provides:

> The basic route of the preliminary stage of socialism and the [CCP] cadre routes, as well as the guidelines of the CCP, shall be carried out in the civil servant system. The principle that the CCP assumes the administration of cadres shall be insisted."[644]

1.2.3. The Formal Role of SIEs in Industrial Policymaking

As discussed in Factor 4, government ownership and control over enterprises in China's economy is extensive, particularly in industries the government deems essential or strategic. Government influence over SIE decision-making is thus a powerful tool for the implementation of state industrial policies. Indeed, through various laws and other measures, the Chinese government has formalized the participation of SIEs in industrial policymaking. First, the 2008

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[641] Tony Saich, *Governance and Politics of China, Third Edition* (New York: Palgrave MacMillan, 2011), 123. ("Basically, the [Organization] Department oversees the CCP's nomenklatura appointments, the cover all senior ministry appointments, senior judicial nominees, heads of major state-owned enterprises, top university presidents…the editors of key party publications and other media, provincial leaders and the directors of think tanks.")

[642] For a discussion of cadre evaluation systems, *see* Susan Whiting, "The Cadre Evaluation System at the Grass Roots: The Paradox of Party Rule," in *Holding China Together: Diversity and National Integration in the Post-Deng Era*, ed. Barry Naughton and Dali Yang (New York: Cambridge University Press, 2004), 101-119; Victor Shih, Christopher Adolph, and Liu Mingxing, "Getting Ahead in the Communist Party: Explaining the Advancement of Central Committee Members in China," *American Political Science Review* 106(1) (2012): 1166-1187.

[643] Zheng Yongnian, T*he Chinese Communist Party as Organizational Emperor: Culture, Reproduction, and Transformation* (London: Routledge, 2010), 103-104.

[644] *Law of the People's Republic of China on Civil Servants*, Article 4 (adopted by NPC on April 27, 2005, effective January 1, 2006).

Law of the People's Republic of China on the State-Owned Assets of Enterprises, which applies to all enterprises with any level of state investment, provides that the investments of state-invested enterprises shall *conform to state industrial policies*.[645] (emphasis added)

With respect to the over 100 SIEs administered by SASAC at the national level, the Chinese government has issued various policies to mandate compliance with industrial policies:

- The 2003 *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises* provides that SASAC shall perform its responsibilities as an investor with respect to major investment and financing decisions "in accordance with the *state development planning and industrial policies*."[646] (emphasis added)

- The 2004 *Measures for the Administration of Central State-owned Enterprise Development Strategies and Plans (Trial)* provides that the principal criteria SASAC shall use when examining and approving SIEs' development plans and targets are "whether [they] conform to state development plans and industrial policies" and "whether [they] comply with the strategic adjustment of the layout and structure of the state-owned economy."[647]

- The 2006 *Guiding Opinions of the SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises* encourages alliances between strong central state-owned enterprises that conform to state industrial policies in order to foster a group of especially large enterprise groups that possess global competitiveness.[648]

SASAC evaluates the SIEs it manages according to a points system. According to the 2006 *Implementing Rules for Central State-owned Enterprise Comprehensive Achievements Evaluation*, central SIEs will be rewarded for major science and technology innovation so as to incentivize enterprises to strengthen science and technology innovation. The same provision provides that enterprises that undertake major state S&T-related projects and achieve breakthroughs will be assessed an additional three to five points; when they undertake research for a major science and technology issue listed in the Catalogue of National Science and Technology Development Plan Outline, even if they do not achieve breakthroughs but have

[645] *Law of the People's Republic of China on the State-Owned Assets of Enterprises*, Article 36 (adopted by NPC on October 28, 2008).

[646] *Interim Regulation on the Supervision and Administration of State-owned Assets of Enterprises*, Article 31 (State Council 2003 Order No. 26, issued May 27, 2003, amended January 8, 2011).

[647] *Measures for the Administration of Central State-owned Enterprise Development Strategies and Plans (Trial)*, Articles 3 and 13(2) (SASAC, Order [2004] No. 10, issued November 26, 2004, effective January 1, 2005).

[648] *Notice of the General Office of the State Council on Forwarding the Guiding Opinions of SASAC about Promoting the Adjustment of State-Owned Capital and the Reorganization of State-owned Enterprises*, Articles 8 and 17 (State Council, Guo Ban Fa [2006] No. 97, issued December 5, 2006).

made fairly large investments, they will be assessed an additional one to two points.[649] The 2017 *Measures for the Supervision and Administration of Central State-Owned Enterprise Investment*[650] provide that the orientation of investments of central SIEs shall be guided by national development strategies and central state-owned enterprise five-year development plan outlines. Moreover, central SIE investments shall serve national development strategies and embody the wishes of its investor […] and foster and develop strategic and emerging industries.[651]

With respect to state planning specifically, the 2017 *Measures for the Supervision and Administration of Central State-Owned Enterprise Investment* provide that central SIEs are required to be "guided by the central SIEs' five-year plans."[652] Examples of SIE five-year plans include:

- In a report published on its website on July 5, 2010, Baosteel, China's second-largest steel producer, stated that in the middle of 2010, many entities, from enterprises to the government, were all busy with one thing – drafting the *2011-2015 Development Plan.* Baosteel, it reported, had taken the lead by announcing its *2010-2015 Development Outline* on June 25. Reportedly, Baosteel's plan calls for shedding capacity at the firm level so as to support the government's objective to reduce excess capacity in the steel industry.[653]

- A report published December 3, 2014 on the website of CNOOC, one of China's three major oil and gas companies, stated that the enterprise had initiated '13th Five-Year' Plan Drafting, and was conducting research to set oil and gas output volume plans for that period.[654]

- In a report published on the SASAC website on April 26, 2016, China National Petroleum Corp. announced it had formulated its *13th Five-Year Development Plan* after two years of drafting work. In so doing, it had fully carried out the spirit of the 18th National Congress of the CCP and the Third, Fourth, and Fifth Plenary Sessions of the 18th National Congress of the CCP, and profoundly carried out the spirit of the speeches

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[649] *Implementing Rules for Central State-owned Enterprise Comprehensive Achievements Evaluation*, Article 32 (SASAC, Guo Zi Fa Ping Jian [2006] No. 157, issued September 12, 2006).

[650] *Measures for the Supervision and Administration of Central State-Owned Enterprise Investment* (SASAC, Order [2017] No. 34, issued January 7, 2017).

[651] *Ibid*., Articles 3 and 5. As discussed further in Section C, strategic and emerging industries are an important component of technology-related industrial policies.

[652] *Ibid*, Article 3.

[653] *Zhong Jingying Bao*, "Baosteel Plan Five-Year Target for 30% Cut in Output, Plans for 'Non-Steel'," July 5, 2010.

[654] *China Offshore Oil News*, "CNOOC Launches '13th Five-Year Plan' Drafting," December 3, 2014.

of Secretary Deng Xiaoping and respectively adhered to the strategic thinking of the 'Four Comprehensives'[655] strategic constellation and the energy revolution.[656]

- In a report published on the SASAC website on March 22, 2016, COFCO announced it had formulated its *13th Five-Year Development Plan*, based on "earnestly studying the spirit of the CCPCC Economic Work Conference and the requirements of supply-side structural reform," *i.e.*, the reforms proposed by the CCP leadership in 2015.[657]

A book authored in 2008 by Zhou Xinmin, Deputy Director of Human Resources of the petroleum and gas SIE Sinopec, further demonstrates the manner in which large SIEs fulfill government mandates. Zhou states that "we must accurately comprehend the special positioning of SOEs in the economic society of China and master the development trend of SOEs under that grand objective of developing a Socialist market economy."[658] Further,

> As a unique kind of economic organization, SOEs are different from the Party or administrative departments, in that they have to create material wealth and compete in the market place. They are also different from enterprises under other forms of ownership, for they assume not only basic economic responsibilities, but also important political and social responsibilities. SOEs are considered a potent mechanism for the government to implement national policies while being the reliable instrument for the country to cope with major economic risks. [659]

As noted under Factor 4, the CCP also uses the *nomenklatura* system as a means to reward compliance or punish non-compliance of corporate executives with industrial policies.

Industry associations are another set of entities through which the government seeks to implement industrial policies. Many of China's largest industrial associations were not formed through private sector initiatives, but rather, were created to replace and assume the regulatory functions of national government bureaus abolished in 2003.[660] Such associations are often

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[655] Four Comprehensives, or the Four-pronged Comprehensive Strategy is a list of political goals for China, put forward by CCP General Secretary Xi Jinping: (1) Comprehensively build a moderately prosperous society; (2) Comprehensively deepen reform; (3) Comprehensively govern the nation according to law; (4) Comprehensively strictly govern the Party." Chris Buckley, "Xi Jinping's 'Four Comprehensives' Give Shape to a Crowded Agenda," *New York Times*, March 1, 2015; John Fei, *To Understand China's Economic Signals, Start With the 'Four Comprehensives'*, The Council on Foreign Relations, March 11, 2016.

[656] *CNPC*, "CNPC Announces '13th Five-Year' Development Plan," April 26, 2016.

[657] *COFCO*, "COFCO Group Formulates '13th Five-Year' Development Plan," March 22, 2016.

[658] Xinmin Zhou, *Core Capability of Leaders, Exploration and Practice of China's State-Owned Enterprises* (Manhattan Beach: East West Discovery Press, 2008), 8.

[659] *Ibid*., 7.

[660] These industrial associations include: China Iron and Steel Association, China Machinery Industry Federation, China Petroleum and Chemical Industry Federation, China Light Industry Federation, China Textile Industry Association, China Coal Industry Association, China Federation of Logistics and Purchasing, and China Non-Ferrous Metals Industry Association. In addition, a number of chambers of commerce were established in the import and export sector. These chambers of commerce include: China Chamber of Commerce for Import and Export of

"staffed by former government officials from the defunct ministries and have the same organizational structures and functions as those ministries. The industrial associations actively supervise the operations of firms in their respective industries and have retained much, if not all, of the power exercised by their state predecessors."[661]

2. *Implementation Mechanisms for Industrial Policies*

The Chinese government uses a diverse set of instruments to intervene in the economy in order to achieve industrial policy objectives. In its 2008 *Trade Policy Review* of China, the WTO has noted the growing complexity of these instruments as China's economic policymaking evolves:

> Direct intervention in the economy remains the main approach of industrial policy. Nonetheless, there has been a shift towards the use of various other policy tools to channel resources into certain activities that the Government believes are important for China's continued growth and development. In addition to tariffs and other border tax measures, tax incentives, and subsidies, these tools include 'guided credit,' various 'catalogues' identifying sectors eligible for incentives, as well as restricted or prohibited activities, various forms of 'guidance' including section-specific 'industrial development policies' (*e.g.* for steel, automobiles, and cement), and price controls.[662]

The World Bank has emphasized direct interventions:

> Industrial policies have relied heavily on direct administrative intervention to shift resources from prohibited to preferred sectors. While market mechanisms also play a role, the authorities often use very direct means to "close down, suspend operation, merge and shift" resources. These have included market access controls, project examination and approval, land supply approval, loan approval, industrial guidance catalogue, and compulsory elimination of outdated production capacity.[663]

Provided below is a list of the wide variety of mechanisms that China deploys to implement its industrial policy objectives, namely (1) investment restrictions and the approval process, (2) access conditions and other industry standards, (3) guidance catalogues, (4) financial supports, and (5) quantitative restrictions.

2.1. Investment Restrictions and Approval Process

Textiles, China Chamber of Commerce for Import and Export of Light Industrial Products and Arts-Crafts, China Chamber of Commerce of Metals, Minerals and Chemicals Importers and Exporters, China Chamber of Commerce for Import and Export of Foodstuffs, Native Produce and Animal By-Products, China Chamber of Commerce for Import and Export of Machinery and Electronic Products, and China Chamber of Commerce for Import and Export of Medicines and Health Products. Curtis J. Milhaupt and Wentong Zheng, "Beyond Ownership: State Capitalism and the Chinese Firm," *The Georgetown Law Journal* 103:665 (2015): 686, note 107.

[661] *Ibid.,* 686-687.

[662] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/199 (April 16, 2008), 89.

[663] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 142.

The Chinese government's framework for granting or denying access for a market entry of an entity, product, or activity serves important industrial policy objectives. First, in many cases, the Chinese investment regime reserves the right for the government to review and approve domestic and foreign investments. The *State Council Notice on Announcing the Catalogue of Government Approved Investment Projects (2016 Edition)* ("*2016 Investment Catalogue*")[664] stipulates that government approvals are necessary for certain investments in 12 categories: (1) agricultural irrigation; (2) energy; (3) transport infrastructure; (4) telecommunications infrastructure; (5) primary materials, including rare earths, iron ore, and nonferrous metals mining, petrochemicals, coal processing, rare earths processing, and gold processing; (6) automotive sector manufacturing; (7) tobacco processing; (8) civil aviation manufacturing; (9) urban infrastructure; (10) public goods; (11) foreign investment; and (12) outbound investments.

Large investments often require approval at the central or sub-central level by NDRC, the same agency responsible for formulating industrial policy.[665] Investment approvals can assume the character of industrial policy when they are carried out or denied in a coordinated manner so as to achieve a desired objective. This is the case, for example, in the 2006 *Opinion on Strengthening Adjustment and Control of Investment in Fixed Assets and Strictly Controlling Newly Started Projects*,[666] issued by NDRC in conjunction with MLR and the CBRC. This document constitutes a macro-economic tool to slow down rapid investment growth, calling for stricter approvals of new investment projects in tandem with tighter regulation of land allocations and stricter controls on lending to new infrastructure projects.[667]

To achieve its industrial policy objectives, the government regulates investment flows from both foreign and domestic sources, to favored and disfavored firms, products, technologies, and industries. Accordingly, China's domestic and foreign investment regimes have parallel structures, defining certain sectors as encouraged, restricted, or prohibited for investment. (See Factor 3 for more detail.) Notably, various industrial policy measures, including the *State Council Decision on Implementing the Interim Provisions on Promoting the Structural Adjustment of Industry* (discussed in more detail below), expressly state that an FDI catalogue and related measures should be formulated in accordance with these industrial policies. For example, the government encourages FDI in industries in upstream inputs, rather than downstream products, particularly in key components, equipment, and technologies that the

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[664] *State Council Notice on Announcing the Catalogue of Government Approved Investment Projects (2016 Edition)* (State Council, Guo Fa [2016] No. 72, issued December 20, 2016).

[665] S*tate Council Notice on Announcing the Catalogue of Government Approved Investment Projects (2016 Edition)* (State Council, Guo Fa [2016] No. 72, issued December 20, 2016). Article 7 states that projects for which State Council approval is stipulated will be reported to the State Council for approval following preliminary screening by the National Development and Reform Commission.

[666] *State Council Notice on Issuing NDRC Opinion on Strengthening Adjustment and Control of Investment in Fixed Assets and Strictly Controlling Newly Started Projects* (State Council, Guo Ban Fa [2006] No. 44, issued June 13, 2006, expired November 27, 2015).

[667] *Ibid.*, Sections 2, 3, and 4.

government deems critical to the development of each industry as well as to China's industrial capabilities as a whole.[668]

2.2. Access Conditions and Other Industry Standards

"Access conditions" are used by the Chinese government to achieve multiple objectives, including, *inter alia*, encouraging the adoption of new technologies, restricting market access, and shedding capacity in heavy industry sectors. Enterprises that meet industry access conditions may be entitled to certain benefits while enterprises that fail to meet the conditions may face closure or restrictions on expansion. Industry access conditions are used in a wide variety of industries. For example, with respect to NEVs, the Chinese government has issued access rules for manufacturers, such that conformity with the rules serves as a precondition for receiving government subsidies.[669]

With respect to excess capacity industries, there are several access conditions that set standards for the industry.[670] For example in the steel industry, the *Iron and Steel Industry Standard Conditions* were issued in 2010, 2012, and 2015.[671] According to its terms, the standards serve as the fundamental condition for the production and operation of the steelmaking industry.[672] In addition to setting environmental and safety standards, the standard conditions cover a wide range of topics that relate to basic operational and business decisions, including product quality, production method and equipment, and energy consumption and resource usage, and include

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[668] *See Catalogue for the Guidance of Foreign Investment Industries (2015 Amendment)* (NDRC and MOFCOM Order No. 22, issued March 10, 2015, effective April 10, 2015).

[669] NDRC first issued *Rules on the Administration of Access for New Energy Vehicle Manufacturing* in 2007. These access rules essentially consist of detailed technical and other criteria for NEV manufacturers and products, respectively; the requisite application materials to be submitted for approval, respectively; details on administrative procedures, including how regulators will verify, and entrust third-party specialists to verify, the information submitted; periodic reporting requirements for those who have qualified, together with other obligations, such as after-sales services; and penalties for violations. Those who meet the access rules are listed in a catalogue published by MIIT, which determines the NEV manufacturers and products eligible to receive subsidies under a purchase subsidy program. *See Rules on the Administration of Access for New Energy Vehicle Manufacturing* (NDRC 2007 Public Notice No. 72, issued October 17, 2007); *Rules on the Administration of Access for New Energy Vehicle Manufacturers and Products* (MIIT, Gong Chan Ye [2009] No. 44, issued June 17, 2009); *Provisions on the Administration of Access for New Energy Vehicle Manufacturers and Products* (MIIT 2017 Order No. 39, issued January 7, 2017).

[670] *See e.g., 2009 Nonferrous Metals Industry Adjustment and Revitalization Plan* (State Council, issued May 11, 2009), *Steel Industry Adjustment and Revitalization Plan* (State Council, Guo Fa [2009] No. 6, issued March 20, 2009), *Shipbuilding Industry Structural Adjustment and Transformation and Upgrade Action Plan* (2016-2020) (MIIT, NDRC, MOF, PBOC, CBRC, issued January 12, 2017). S*ee also Overcapacity in China: An Impediment to the Party's Reform Agenda* (European Chamber of Commerce in China & Roland Berger, 2016), 20-22.

[671] *Announcement on the Standard Conditions for the Iron and Steel Industry* (Revised 2015) and the *Measures for the Administration o Standards for Enterprises in the Iron and Steel Industry* (MIIT Order [2015] No. 35, issued May 19, 2015).

[672] *Ibid*., Article 1(3).

detailed specifications for each. For example, according to the 2015 standard conditions, under the production method and equipment category, for existing steelmaking enterprises, blast furnaces must have a capacity of at least 400 cubic meters and electric furnaces must have a capacity of at least 30 metric tons.[673]

These industry conditions offer incentives for compliance and disincentives for non-compliance. Enterprises that do not meet the standards may be forced to restructure, and local governments are directed to adopt legal, economic, and market measures to restructure these enterprises and phase out unqualified enterprises.[674] In April 2013, MIIT released a list of 45 steel enterprises that met the requirements of the 2012 steel standard conditions, which qualified these enterprise for various support policies.[675] The announcement also stated that MIIT will use differential electricity pricing, financial awards, accountability systems, and other economic, legal, and administrative processes to gradually consolidate the industry by forcing the non-qualifying enterprises out of the market thereby resolving excess capacity.[676] The standard conditions are intended to have a significant impact on the entire industry, with the 2013 notice setting a target of 80% of enterprises meeting the standards before the end of the 12th five-year planning period (2011-2015).[677]

2.3. Guidance Catalogues

China issues different catalogues that provide guidance on the implementation of its industrial policies that set forth, *inter alia*, sectors entitled to preferential treatment; sectors in which investment is "encouraged," "permitted," or "prohibited"; and products that are subject to licenses or export taxes.[678] As the WTO found in its *Trade Policy Review* of China, five-year plans will often provide the overarching industrial policy objective, while a detailed and often extensive guidance catalogue will provide the implementation details. The *Trade Policy Review* of China includes the following table of selected catalogues that have been issued by the Chinese government:[679]

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[673] *Ibid*., Article 2(2)(ii).

[674] According to the 2012 standards conditions for steel, enterprises that meet the conditions of this standard will become the fundamental basis for relevant policy support; enterprises that do not meet these standard conditions should carry out rectification. If after rectification, the enterprise is still unable to meet the requirements of these standard conditions, all localities should comprehensively use laws and regulations, economic and market means to push forward the enterprises' exit or transformation and development. *Ibid*., Article 1(4).

[675] *MIIT Public Announcement on the First Batch of Enterprises that Fulfill the Steel and Iron Industry Normative Conditions* (MIIT, published on MIIT website, April 2, 2013). According to the notice, these 45 enterprises together accounted for 300 million MT of steel capacity in 2012, representing 41.4 % of total crude steel capacity that year.

[676] *Ibid.*

[677] *Ibid.*

[678] WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/342 (June 15, 2016), 35.

[679] *Ibid*., 82. NDRC and MIIT maintain and regularly update a series of guidance catalogues. In 2017, for example, NDRC issued updated versions of the *Foreign Investment Catalogue, the Catalogue of Priority Industries for*

Table 3: Chinese Government Guidance Catalogues as Reported by WTO

	Remarks
Catalogue of Public Infrastructure Projects Eligible for Preferential Enterprise Income Tax Treatment (2008)	"Ministry of Finance, State Administration of Taxation announced the National Development and Reform Commission Catalogue of Public Infrastructure Projects Eligible for Preferential Corporate Income Tax Treatment (2008 edition), Notice" (Cai Shui [2008] No. 116). Viewed at: http://www.chinatax.gov.cn/n810341/n810755/c1225570/content.html
Catalogue of Priority Industries for Foreign Investment in the Central-Western Regions (2013)	Decree No. 1 of 2013, NDRC and the Ministry of Commerce. Viewed at: http://www.sdpc.gov.cn/zcfb/zcfbl/201305/t20130516_541505.html
Catalogue of Encouraged Technology and Product Imports	Jointly issued by NDRC, Ministry of Finance, and Ministry of Commerce on 6 July 2015. Viewed at:
Catalogue of Comprehensive Use of Resources for Preferential Enterprise Income Tax Treatment	"Ministry of Finance, State Administration of Taxation, the State Development and Reform Commission on Comprehensive Utilization of Resources announced the Corporate Income Tax Catalogue (2008 edition) Notice" (Cai Shui [2008] No. 117). Viewed at: http://www.mof.gov.cn/mofhome/gp/shuizhengsi/200809/t20080924_77975.html
Catalogue of Chinese High- Tech Products for Export (2006)	On the issuance of Chinese High-Tech Products Catalogue 2009 "Notice" No. 61 of 2009 by the Ministry of Science. Viewed at: http://www.most.gov.cn/tztg/200910/t20091009_73551.htm
Catalogue for the Guidance of Foreign Investment Industries	Directory (2015 Amendment) Foreign Investment Industrial Guidance, National Development and Reform Commission and MOFCOM, Order No. 22, 10 March 2015. Viewed at: http://www.sdpc.gov.cn/zcfb/zcfbl/201503/t20150313_667332.html
Catalogue of Imported Products not subject to Tax Exemption under Foreign Investment Projects	Customs Notice No. 65 of 2008 (regarding adjustments to Catalogue of Non-Duty-Free Products under Foreign Investment Projects and other merchandise tariffs) of 5 September 2008. Viewed at:
Catalogue of Imported Major Technical Equipment and Products not Eligible for Tax Exemption	Cai Guan Shui [2014] No. 2. Viewed at http://www.gov.cn/gzdt/2014-02/28/content_2625354.htm (in Chinese only)
Category of Non-Tax- Exempted Imported Items under Domestically Funded Projects	Ministry of Finance, Notice No. 83 of 2012. Viewed at: http://gss.mof.gov.cn/zhengwuxinxi/zhengcefabu/201212/t20121231_723618.html

Foreign Investment in Central and Western China, the *National Catalogue for Promoting Key Energy-efficient and Low-carbon Technologies*, and the *Strategic Emerging Industries Key Products and Services Catalogue*. Also in 2017, MIIT issued the *Catalogue of New Energy Vehicle Models Exempted from the Vehicle Purchase Tax*, the *Military-to-Civil Technology Promotion Catalogue*, the *Notice of the two departments on the recommendation of the "People's Army Technology and Product Recommendation Catalog (2017)"*, and the *Catalogue of Building Materials Industry Technologies and Products to Encourage the Popularization and Application (2016-2017).*

Source: WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/342 (June 15, 2016), 82.

Various government authorities also issue catalogues in accordance with a national program. For example, to implement the *12th FYP* goals for "strategic and emerging industry" (SEI) development, various central and sub-central government authorities have issued catalogues concerning SEIs, which provide details regarding the sub-sectors and specific products that qualify as SEIs. Sectors and products covered by these catalogues may be entitled to various forms of financial support, including preferred access to credit, grants, tax incentives, investments, and other preferential treatment.[680]

2.4. Financial Supports

Government control over the financial sector, as well as fiscal resources and fiscal policy tools, allows the Chinese government to provide a wide range of direct and indirect financial support in furtherance of industrial policy objectives. In its 2016 *Trade Policy Review* of China, the WTO concluded that China continues to provide various incentives to different sectors or industries, for the purpose of, *inter alia*, "upgrading production methods in industries that use obsolete technologies; promoting development in remote areas and narrowing the income gap between regions; and attracting FDI."[681] A 2015 report commissioned by AEGIS Europe and the Cross-sector Alliance Representing European Manufacturing, moreover, identifies government subsidies reported in the public filings of hundreds of listed Chinese companies, most of which are state-owned. The report finds that important objectives behind these subsidies are to promote domestic technology upgrading and high-tech sectors; promote strategic emerging industries; and fund revitalization and technological renovation in key industries.[682] Two in-depth studies of the steel and nonferrous metals sectors, respectively, list a broad set of financial supports offered by sub-central governments, including, *inter alia*, tax incentives, financial grants, "export subsidies," and "energy subsidies." In many cases, these supports are offered in a coordinated manner to support specific government initiatives. For example, "subsidies" related to technology renovation in key industries; in support of trademark and patent registration; as

[680] *See* Markus Taube, *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry* (Berlin: Think!Desk China Research and Consulting, April 24, 2017), 88-93. *See also* WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/342 (June 15, 2016), 80-81. ("[T]he 12th Five-Year Plan (2011-2015) called for the transformation and upgrading of key existing industries to increase the competitiveness of China's industrial core, and for the development of strategic emerging industries (SEIs). […] [S]upport policies, such as those for SEIs, are stated by the Central and provincial governments in legal documents, usually an administrative regulation or a local government rule. Thereafter, the governments at the city or county levels may promulgate more detailed rules to implement the measures.")

[681] WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/342 (June 15, 2016), 80.

[682] Markus Taube and Christian Schmidkronz, *Assessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 72-127.

compensation for R&D expenses; and in direct support of enterprises classified as high and new technology enterprises.[683]

International institutions have also taken note of financial supports provided by the Chinese government. The WTO has found that the Chinese government generally provides "tax preferences, direct transfers, and access to credit."[684] The OECD similarly concluded that the "widespread misallocation of resources" in China has been "exacerbated by local authorities' growth-seeking behaviour as they competed to offer low-cost or free land, cheap credit, tax concessions and other subsidies to attract investment."[685]

Some examples of such support programs have included: significant payments and other benefits offered to qualifying Chinese companies' exports under the "Famous Export Brand" and "World Top Brand" programs; import-substituting support provided by the Chinese government to promote the production of wind turbine systems in China; support provided by the central government and various sub-central governments in China to automobile and automobile-parts enterprises located in regions in China known as "export bases"; and export-contingent supports provided by central government and sub-central government to manufacturers and producers across seven industries located in designated clusters of enterprises called "Demonstration Bases."[686]

China has established various funds for the express purpose of supporting a long-term S&T policy. For example, for the SEI policy introduced in 2010, several provinces established dedicated technology funds.[687] For the MiC2025, the Chinese government established two funds worth over $20 billion to fund advanced manufacturing and national integrated circuit R&D

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[683] *See* Markus Taube and Peter in der Heiden, *China Steel Inc. – State-owned and State-run? An Investigation of State-Business Interaction in the World's Largest Steel Industry*, vol. 8 *of Economic Studies on Asia* (Marburg: Metropolis, 2010), 129-145; Markus Taube, *Analysis of Market Distortions in the Chinese Non-Ferrous Metals Industry* (Berlin: Think!Desk China Research and Consulting, April 24, 2017), 53-93.

[684] WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/342 (June 15, 2016), 80.

[685]OECD, *OECD Economic Surveys*: *China* (Paris: OECD Publishing, 2015), 31.

[686] *2016 USTR Report to Congress on China's WTO Compliance* (Washington, DC: Office of the U.S. Trade Representative, January 2017), 64-65.

[687] U.S.-China Business Council, *China's Strategic Emerging Industries: Policy, Implementation, Challenges, & Recommendations* (March 2013), 17-21. The report finds that, as part of SEI policies and actions, select provinces and cities in China have offered large funding amounts, including: Beijing ($6.4 billion); Fujian ($80.4 million); Hunan ($80.4 million); Jiangsu ($61.1 million); Jiangxi ($64.3 million); Shandong ($160.7 million); Shanxi ($80.4 million); Sichuan $321.5 million); and Zhejiang $80.4 million). *See also* list of measures counter-notified by the United States to the WTO Committee on Subsidies and Countervailing Measures in WTO, *Request from the United States to China Pursuant to Article 25.10 of the Agreement* G/SCM/Q2/CHN/53 (October 19, 2015). ("As we noted previously, in 2010, China's State Council announced its decision to support the development of SEIs through a wide range of support policies. Subsequently, China's central and sub-central authorities have issued dozens, if not hundreds of measures, for the 12th Five-Year planning period that target the development of the SEI sectors. The United States notes that the list below is merely illustrative of the universe of SEI measures in China.")

projects.[688] In recent years, the Chinese government has also diversified such financial support through new types of government-run financing entities.[689]

Under its approach to modifying the SIE system, the Chinese government is establishing asset management companies, also referred to as SCIOs, which are designed to play an active role in promoting the government's industrial policies, in conjunction with the aforementioned government-run investment funds. An important mission of SCIOs is to promote innovation and high technology enterprises during the *13th FYP*.[690] As a result, according to Barry Naughton, "every local government will be under a certain amount of pressure to show they are contributing to the technology effort by establishing an SCIO company and having it be actively engaged in concentrating state capital in key sectors."[691]

Investment funds and SCIOs thus have preferential access to capital and pursue state or local government industrial policy objectives. This trend exacerbates a pattern in which the state plays the preeminent role in directly allocating research and development funds. According to the OECD, Chinese GERD increased from 1.22% of GDP in 2004 to 2.05% of GDP in 2014; although the Chinese business sector accounts for 75% of China's GERD, the domestic private enterprise sector accounts for less than a third of this share.[692]

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[688] Jost Wubbeke et al., M*ade in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries*, Papers on China No. 2 (Berlin: MERICS, December 2016), 7. ("In order to achieve these goals, government entities at all levels funnel large amounts of money into China's industrial future. The recently established Advanced Manufacturing Fund alone amounts to 20 billion CNY (2.7 billion EUR). The National Integrated Circuit Fund even received 139 billion CNY (19 billion EUR). These national level funds are complemented by a plethora of provincial level financing vehicles. The financial resources are enormous compared to, for instance, the 200 million EUR of federal funding that the German government has provided for research on Industry 4.0 technologies so far.")

[689] For example, in order to implement the *Notice on Issuing the National Medium- and Long-Term Plan for Science and Technology (2006-2020)* (State Council, Guo Fa [2005] No. 44, issued December 26, 2005), the Chinese government established the NFTTC in 2011 under the auspices of the MOST and the MOF. In 2015 and 2016, nine different government venture capital funds were established as subsidiaries of the NFTTC. *See NFFTC*, "Major Historical Events of the Fund" and "Introduction to the Fund," available at http://www.nfttc.gov.cn/www/nfttc/212/index.html and http://www.nfttc.gov.cn/www/nfttc/209/index.html. The funds were established pursuant to the *Provisional Measures on Administering Government Investment Funds* (MOF, Cai Yu [2015] No. 2010, issued November 12, 2015).

[690] Barry Naughton, "Restructuring and Reform: China 2016," in R*eserve Bank of Australia Annual Conference 2016, Structural Change in China: Implications for Australia and the World* (2016), 67. ("The reforms introduce a new – and newly important – layer of management into the state enterprise sector, the state capital investment and/or operations companies (SCIOs) (State Council 2015). When this type of investment company was first suggested in the Third Plenum document, there was speculation that it would refer to a relatively passive, investment-return-oriented entity like a sovereign wealth fund. The explicit incorporation of the word 'operation' in their titles, however, shows that these investment companies are expected to take on an activist role, rather than a passive investment-oriented role.")

[691] *Ibid*.

[692] OECD, *Policies for Sound and Effective Investment in China,* (Paris: OECD Publishing, 2016), 21.

The government has reportedly budgeted RMB 500 billion to spend on *13th FYP* projects in 2016,[693] but a large share of the financing is likely to be provided by state-controlled banks and investment funds. At the end of 2015, there were 780 state-linked investment funds holding RMB 2.18 trillion in capital, and almost 300 of these funds holding RMB 1.5 trillion were established in 2015 alone.[694]

2.5. Export Restraints and Quantitative Restrictions

Export restraints and quantitative restrictions are another mechanism the Chinese government uses to implement industrial policies, particularly with respect to raw materials. The WTO, in its *Trade Policy Review*, has noted the manner in which the Chinese government has taken trade policy measures, such as taxes and reduced VAT rebates in respect of exports, that "discourage exports and increase the domestic supply of products concerned, and thus result in lower domestic prices of these products than otherwise."[695] The WTO's 2014 *Trade Policy Review* finds:

> Export restraints are an important feature of China's trade regime. China imposes export taxes on certain products, and quotas or even bans on others. The list of goods subject to "statutory" and interim export taxes is issued every year. Exports that are subject to interim taxes may also be subject to special export duties, which are applied seasonally and may be substantially higher than interim duty rates. In 2013 the special export duty rate was 75%, while interim duty rates varied from 5% to 35%. Export taxes were applied to some 4.2% of all tariff lines at the HS 8-digit level in 2013; as China is the leading world exporter of certain products subject to export taxes, their application may have an *impact on the world price of these products*. (emphasis added)[696]

Chinese law also authorizes the Chinese government to designate state trading enterprises (STEs) to import and export key commodities. Rules governing STEs are set out, *inter alia*, in the 2002 *Regulation of the People's Republic of China on the Administration of the Import and Export of Goods*[697] and the 2004 *Foreign Trade Law of the People's Republic of China*.[698] China's WTO

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[693] Center for Strategic and International Studies, *Perfecting China Inc.* (May 2016), 27 (citing to Li Keqiang, "Report on the Work of the Government," delivered at the Fourth Session of the 12th National People's Congress of the People's Republic of China, March 5, 2016).

[694] *Ibid.*

[695] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/199 (April 16, 2008), x.

[696] WTO, *Trade Policy Review, The People's Republic of China*, WT/TPR/S/300 (May 27, 2014), 12.

[697] *Regulation of the People's Republic of China on the Administration of the Import and Export of Goods (State Council)*, Chapter IV (adopted at the 46th executive meeting of the State Council on October 31, 2001, Order [2001] No. 332, effective January 1, 2002).

[698] *Foreign Trade Law of the People's Republic of China*, Article 11 (adopted at the 7th Meeting of the Standing Committee of the Eighth NPC on May12, 1994, revised at the 8th Meeting of the Standing Committee of the Tenth NPC, Order [2004] No. 15 of the President of the People's Republic of China on April 6, 2004, effective July 1, 2004). (The State may implement state trading on certain goods. The import and export of the goods subject to state trading will be operated only by the authorized enterprises unless the state allows the import and export of certain quantities of the goods subject to state trading to be operated by the enterprises without authorization. The lists of the goods subject to state trading and the authorized enterprises will be determined, adjusted and made public by the

Accession Protocol lists products subject to importation through STEs to include grain, vegetable oil, sugar, tobacco, crude oil and processed oil, chemical fertilizer, and cotton.[699] In an October 2015 notification to the WTO STE Committee, the Chinese government states that STEs determine import and export levels by, *inter alia*, "taking into account the domestic supply and *the prices of both domestic and international markets* among other factors."[700] (emphasis added)

Furthermore, China has imposed quotas on the export and production of raw materials for extended periods.[701] Several of the raw materials at issue play an important role as material inputs for downstream products used in electronics and other industries.[702] China also imposes restrictions on the domestic production and processing of certain minerals and metals. These include, *inter alia*, extraction quotas on rare earths and tungsten minerals[703] and quotas on the (post-extraction) production of rare earths, fluorspar, and certain rare metals.[704] As aforementioned, long-term "binding targets" and "indicative targets" for minerals and metals production are also set forth in province-level mineral resource plans, pursuant to the MLR

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authority responsible for foreign trade under the State Council in conjunction with other relevant authorities under the State Council. In the event of importation of the goods subject to state trading without authorization in violation of paragraph 1 of this Article, the Customs will not grant release.)

[699] WTO, *Protocol on the Accession of the People's Republic of China*, WT/L/432 (November 10, 2001), Annex 2A1 and 2A2.

[700] WTO, *State Trading: New and Full Notification Pursuant to Article VII:4(A) of the GATT 1994 and Paragraph 1 of the Understanding on the Interpretation of Article VII*, G/STR/N/10/CHN-G/STR/N/15/CHN (October 19, 2015), 9. (emphasis added)

[701] *See* WTO dispute settlement cases DS394 *China — Measures Related to the Exportation of Various Raw Materials*, DS431 *China — Measures Related to the Exportation of Rare Earths, Tungsten and Molybdenum*, and DS508 *China — Export Duties on Certain Raw Materials*.

[702] *See e.g.,* Ann Norman, Xinyuan Zou, and Joe Barnett, C*ritical Minerals: Rare Earths and the U.S. Economy*, Backgrounder No. 175 (Washington, DC: National Center for Policy Analysis, September 2014); Marc Humphries, *Rare Earth Elements: The Global Supply China* (Washington, DC: Congressional Research Service, July 28, 2010).

[703] *Notice on 2017 Total Extraction Quotas for Rare Earths and Tungsten Minerals* (MLR, Guo Tu Zi Fa [2017] No. 67, issued June 30, 2017); N*otice on 2016 Total Extraction Quotas for Rare Earths and Tungsten Minerals* (MLR, Guo Tu Zi Fa [2016] No. 316, issued June 22, 2016); *Notice on 2015 Total Extraction Quotas for Rare Earths and Tungsten Minerals* (MLR, Guo Tu Zi Fa [2015] No. 263, issued May 8, 2015); *Notice on 2014 Total Extraction Quotas for Rare Earths and Tungsten Minerals* (MLR, Guo Tu Zi Fa [2014] No. 65, issued June 5, 2014).

[704] *See e.g.*, *Circular on Passing Down the 2016 Fluorspar Total Output Control Plan* (Jiangxi Province MIIT Commission, Gang Gong Xin Jian Cai Zi [2016] No. 213, issued May 13, 2016); *Circular on Passing Down 2016 Batch 1 Rare Earths Total Output Control Plan* (MIIT, issued March 25, 2016); *Notice Passing Down 2015 Province-Wide Tungsten Total Production Quantity Control* (Jiangxi Province MIIT Commission, Gan Gong Xin You Se Zi [2015] No. 229, issued June 1, 2015); *Circular on Passing Down 2014 Rare Metals Total Production Quantity Control Indices* (Tibet Autonomous Region People's Government, issued October 8, 2014); *Circular on Passing Down 2014 Rare Metals Total Production Quantity Control Indices* (Jiangxi Province MIIT Commission, Gan Gong Xin You Se Zi [2014] No. 356, issued July 29, 2014).

Mineral Resource Plan.[705] These mineral resource plans outline administrative methods, such as mine zoning and mining licensing, to achieve these targets.[706]

3. *Examples of Industrial Policy Implementation*

The implementation mechanisms discussed above are widely applied throughout China's economy. This section focuses on three areas in which industrial policies have a particularly significant effect on the allocation of resources: (1) industrial restructuring; (2) the transfer of industrial assets to inland regions; and (3) the promotion of science and technology development and indigenous innovation.

3.1. Industrial Restructuring and Upgrading

"Industrial restructuring" is a focal point of China's industrial policies and is one mechanism by which the government influences the allocation of industrial assets within and among industries, as well as between regions. An important element of these policies is the *State Council Decision on Implementing the Interim Provisions on Promoting the Structural Adjustment of Industry* (State Council, Guo Fa [2005] No. 40, issued December 2, 2005) ("*No. 40 Document*"), which was issued by the State Council in 2005 and remains in effect.[707] The *No. 40 Document* details the government's long-term economic and industrial policy objectives for China, including, *inter alia*:[708]

- Redistribution of industrial assets from more developed to less developed regions;
- Technological upgrading and modernization of basic industries such as power, transport, steel, chemicals and cement;
- Indigenous innovation and Chinese-origin intellectual property;
- Localization of important manufacturing equipment;
- Development of advanced manufacturing capabilities;
- Development of high-tech and service industries that will drive China's future economy including information technology, computers, integrated circuits and computer software, new energy, aerospace, new materials, biomedical, petrochemicals, telecom, finance,

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[705] *National Mineral Resources Plan (2016-2020)* (MLR, issued November 2016); *State Council Approval of the National Mineral Resources Plan (2016-2020)* (State Council, Guo Han [2016] No. 178, issued November 2, 2016); *Notice on Issuance of the National Mineral Resources Plan (2008-2015)* (MLR, Guo Tu Zi Fa [2008] No. 309, issued December 31, 2008).

[706] *Ibid*.

[707] *State Council Decision on Implementing the "Interim Provisions on Promoting the Structural Adjustment of Industry* (State Council, Guo Fa [2005] No. 40, issued December 2, 2005).

[708] *Ibid.*, Articles 3, 6, 7, 8 and 10.

insurance, logistics and accounting,[709] and larger firms and higher industry concentration levels, and;

- Development of large enterprises and large enterprise groups with independent intellectual property rights and strong core competitive strengths.

The *No. 40 Document* covers the entire economy, from agriculture to manufacturing to service sectors and all sub-sectors included therein. In addition, the *No. 40 Document* explicitly directs all provincial governments to formulate specific measures to guide investment with supporting policies including those regarding land, credit, taxation, import and export.[710] To implement the *No. 40 Document*, NDRC issued the *Guidance Catalogue for the Structural Adjustment of Industry* ("*Structural Adjustment Catalogue*") in 2005, which was subsequently amended in 2011 and 2013.[711] The *Structural Adjustment Catalogue* divides industry segments into "encouraged," "limited," and "prohibited" for investors,[712] based on whether the Chinese government seeks to reduce or increase that segment's share of the industrial sector.[713]

By categorizing an industry as limited or prohibited, the *Structural Adjustment Catalogue* signals that the government may pursue restrictive policies, such as withholding approval for new projects, expanding existing projects, or eliminating existing facilities to facilitate industry consolidation and restructuring. On the other hand, the *No. 40 Document* accords priority to "encouraged" investments that are needed for the technological upgrading of industry, or to develop indigenous innovation and advanced manufacturing capabilities.[714] The sheer number and specificity of items listed in the *Structural Adjustment Catalogue* indicate the degree of government guidance and control of intra- and inter-industry investment allocations. In total, the *Structural Adjustment Catalogue* lists 761 "encouraged," 220 "restricted," and 424 "prohibited" investments.

In addition, the listed investments are remarkably detailed and are generally specified at the product, project, or technology level. For example, the *Structural Adjustment Catalogue* lists in the encouraged category of investments: energy-type drive battery packs, with energy density ≥

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[709] These industries overlap considerably with the "(economic) life-line," "backbone," "pillar" or (government-deemed) strategically important industries in which high-level government policy documents reiterate that the state sector must have a leading or dominant role, consistent with relevant PRC constitutional mandates.

[710] *See No. 40 Document*, Articles 12-19.

[711] The first edition is the *Guidance Catalogue for the Structural Adjustment of Industry (2005 Edition)* (NDRC, Order [2005] No. 40, issued December 2, 2005). The most recent edition is the *Guidance Catalogue for the Structural Adjustment of Industry (2011 Edition) (2013 Revision)* (NDRC, Order [2013] No. 21, issued February 16, 2013).

[712] Investments not listed are permitted. *No. 40 Document,* Article 13.

[713] *Decision of the National Development and Reform Commission on Amending the Relevant Entries under the Catalogue for Guiding Industrial Restructuring (Version 2011) (2013)* (NDRC, Order [2013] No. 21, issued March 27, 2011, amended May 1, 2013).

[714] *No. 40 Document,* Articles 12-19.

110Wh/kg and cycle life ≥ 2,000 times; and driving motors of electric vehicles, with peak power density ≥ 2.5kW/kg, high efficiency area: 65%, efficiency in working area ≥ 80%.[715] The *Structural Adjustment Catalogue* lists in the restricted category of investments: the manufacture of non-CNC metal-cutting machines tools; and new construction of free forging hydraulic machine projects of 10,000 tons or more continuous polymerization production units of conventional polyester (PET) with single-line annual production capacity < 200,000 tons.[716]

3.2. Geographic Distribution of Industry

The *Guidance Catalogue on Industrial Transfer (2012 Edition)* ("*Industrial Transfer Catalogue*"),[717] which was issued pursuant to the *Guiding Opinion of the State Council on Central and Western Regions' Undertaking of Industrial Transfer* ("*Guiding Opinion on Industrial Transfer*"),[718] is another industrial policy catalogue that channels investment based on government policy.[719] The *Industrial Transfer Catalogue* implements the government's efforts to optimize the geographic distribution of industry in China (*i.e.*, the distribution or allocation of industry across the north, northeast, central and western regions of China, by means of "industrial transfer," that is, the physical transfer or relocation of companies and/or plants from one region of China to another). According to the 2012 *Industrial Transfer Catalogue*, the purpose of the catalogue is to "specify the direction, guide inter-regional dislocated development, and turn disordered industrial transfer into ordered industrial transfer."[720] The *Guiding Opinion on Industrial Transfer* and the *Industrial Transfer Catalogue* make clear that the government's objective of achieving a rational, orderly, and scientific industrial transfer process is a response to a disorderly and dysfunctional industrial transfer process due to various factors including:

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[715] *Guidance Catalogue for the Structural Adjustment of Industry (2011 Edition) (2013 Revision)*, Item XVI.6 ("Encouraged Category") (NDRC, Order [2013] No. 21, issued February 16, 2013).

[716] *Guidance Catalogue for the Structural Adjustment of Industry (2011 Edition) (2013 Revision)* (NDRC, Order [2013] No. 21, issued February 16, 2013), Items XI.11, XI.47 and XIII.1 ("Restricted Category").

[717] *Guidance Catalogue on Industrial Transfer (2012 Edition)* (MIIT, Public Notice [2012] No. 31, issued July 26, 2012).

[718] *Guiding Opinions of the State Council on Central and Western Regions' Undertaking of Industrial Transfer* (State Council, Guo Fa [2010] No. 28, issued August 31, 2010).

[719] *See also* a corollary catalogue for foreign investments in central and western regions, issued by NDRC and implemented by the General Administration of Customs. The first edition is the C*atalogue of Advantageous Industries for Foreign Investment in Central and Western Regions* (GAC, Shu Shui [2000] No. 426, issued August 3, 2000); *Catalogue of Advantageous Industries for Foreign Investment in Central and Western Regions* (MOFTEC, SDPC, Order [2000] No. 18, issued June 16, 2000). The most recent edition is the *Catalogue of Advantageous Industries for Foreign Investment in Central and Western Regions (2017 Revision)* (NDRC, MOFCOM, Order [2017] No. 33, issued February 17, 2017); *Public Notice on Implementing the Catalogue of Advantageous Industries for Foreign Investment in Central and Western Regions (2017 Revision)* (GAC, Order [2017] No. 14, issued March 17, 2017).

[720] *Guidance Catalogue on Industrial Transfer (2012 Edition)*, Preface (MIIT, Public Notice [2012] No. 31, issued July 26, 2012).

regional protectionism, excessive government examination and approval, lack of inter-regional coordination and cooperation on enterprises licensing and registration, inadequate private sector development and private sector investment, and the pricing and allocation of the factors of production.[721] In addition, the government intends to increase the concentration of particular industries in zones, clusters, and parks to promote both regional and national economic development, and to slow the rate of international industrial transfer through these inter-regional resource allocations.[722]

The *Industrial Transfer Catalogue* assigns certain industry segments to each province in each of the four regions of the country based on the region's installed industrial base, comparative advantage, development needs, and national development priorities.[723] Fifteen industries are covered, namely electronic information, medicines and pharmaceuticals, aviation and aerospace, machinery, railway transportation, autos, chemicals, iron and steel, ships and marine engineering equipment, light manufacturing, food, textiles, building materials, nonferrous metals, and certain services industries.[724]

Similar to the *Structural Adjustment Catalogue*, the *Industrial Transfer Catalogue* covers a wide and detailed list of investments by supplying for each province explicit guidance for industrial transfer at the *product* level. This guidance takes the form of a list of industry segments that each province should develop, and specifies the *order* in which the industry segments should be developed, based on the government's industrial policy priorities.[725] Guidance on the *direction* of industrial transfer, either to or from a particular geographic region, is also provided in the discussion on industrial development orientation at the beginning of each of the four regional chapters.[726]

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[721] *Guidance Catalogue on Industrial Transfer (2012 Edition)*, Preface (MIIT, Public Notice [2012] No. 31, issued July 26, 2012); *Guiding Opinions of the State Council on Central and Western Regions' Undertaking of Industrial Transfer*, Items IV preamble, IV.13, IV.15, V.16, VI preamble, VI.19 (State Council, Guo Fa [2010] No. 28, issued August 31, 2010).

[722] *Guidance Catalogue on Industrial Transfer (2012 Edition)*, Preface (MIIT, Public Notice [2012] No. 31, issued July 26, 2012); *Guiding Opinions of the State Council on Central and Western Regions' Undertaking of Industrial Transfer*, Item III.10 (State Council, Guo Fa [2010] No. 28, issued August 31, 2010). *See also* BMI Research, "Offshoring Trend to Ramp Up Despite Beijing's Best Efforts," *Asia Monitor*, July 1, 2016.

[723] *Guidance Catalogue on Industrial Transfer (2012 Edition)*, Preface (MIIT, Public Notice [2012] No. 31, issued July 26, 2012).

[724] *Ibid*. *See also* Dezan Shira and Associates, *China Issues Industrial Transfer Guidance Catalogue*, China Briefing, (August 6, 2012).

[725] *Guidance Catalogue on Industrial Transfer (2012 Edition)*, Preface (MIIT, Public Notice [2012] No. 31, issued July 26, 2012).

[726] *Ibid.*, Preface, the Preamble to Section I in each of Chapters 2-5.

Although the *Guiding Opinions on Industrial Transfer* states that, in principle, markets should be given full play in the allocation of resources,[727] this principle conflicts with the explicit and detailed guidance that the *Industrial Transfer Catalogue* provides. Moreover, as noted above, the *Industrial Transfer Catalogue* is the government's response to a disorderly industrialization process that is primarily the result of misallocations from government intervention. In other words, the *Industrial Transfer Catalogue* is an administrative solution devised by the central government to address an administrative problem at the local government level that concerns inter-regional resource allocations.

3.3. Science and Technology Development

As a recent OECD report states, "innovation – or more precisely science and technology – has long been considered in China as key for development and is therefore supported by a plethora of industrial policies."[728]

The Chinese government's objective of promoting the indigenous development of S&T, which is not limited to basic research, has yielded a wide array of long-term industrial policies and plans. China's current S&T policy traces its roots to the *S&T MLP*, which identifies eleven "key areas," eight "frontier technologies," sixteen "engineering megaprojects," and four "science megaprojects" as priorities for development (see **Appendix Tables 1 and 2**). According to the *S&T MLP*, the sixteen megaprojects were chosen because they are closely linked to China's social and economic development, foster indigenous intellectual property, raise China's overall industrial competitiveness, and contribute to both civilian and military development thereby increasing China's overall strength. The plan suggests certain policy measures to achieve its goals, which include:

- financial and tax policies encouraging technological innovation at the enterprise level, policies designed to encourage imported technologies that can then be absorbed to foster new innovation;

- government procurement policies that advance indigenous innovation, financing policies to encourage innovation (including encouraging financial institutions to provide preferential loans to the National Major Science and Technology Projects); and

- policies that encourage the "going out" of Chinese enterprises, both in terms of exporting high technology products and greater international cooperation.

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[727] *Guiding Opinion of the State Council on Central and Western Regions' Undertaking of Industrial Transfer*, Item I.2 (State Council, Guo Fa [2010] No. 28, issued August 31, 2010).

[728] OECD, *OECD Economic Surveys: China*, (Paris: OECD Publishing, 2017), 72.

Following the adoption of the *S&T MLP*, several measures were enacted to implement a funding mechanism for the sixteen megaprojects.[729] The budget announced for the entire program (*i.e.*, all sixteen projects) was approximately RMB 32.8 billion, RMB 30 billion and RMB 43.5 billion in 2009, 2010 and 2011, respectively.[730]

Pursuant to the *S&T MLP*, the Chinese government formulated a *FYP* for S&T development for the first time during the *11th FYP* period (2006-2010). The stated purpose of the plan includes ameliorating the "lagging state" of China's high-technology industries, relatively weak indigenous innovation capacity, and weak core competitiveness of enterprises.[731] Accordingly, the document outlines numerous strategies to improve "indigenous innovation," including government S&T funding and targeted procurement programs.[732] Key targets set forth in the *S&T MLP* for the year 2020 include, *inter alia*, to achieve a total R&D spending level equivalent to 2.5% of GDP by 2020 and to reduce the rate of dependency on foreign technology to below 30%.

In 2010, the State Council issued the *Decision on Accelerating the Nurturing and Development of Strategic and Emerging Industries* ("*SEI Decision*").[733] The document identifies seven SEIs that overlap with some of the key areas and frontier technologies set forth in the *S&T MLP*. These seven industries are characterized as important forces to lead future economic and social development, and their development is characterized as an important strategy for the main nations of the world to occupy the high point of the new round of economic and science and technology development.[734] Pursuant to the *SEI Decision*, the Chinese government formulated the *12th Five-Year Plan for National Strategic and Emerging Industries Development* ("*12th Five-Year SEI Plan*")[735] which sets a target for the SEIs to account for 8% of China's economy by 2015 and 15% by 2020. Its successor, the *13th Five-Year Strategic and Emerging Industries*

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[729] *See e.g.*, *Interim Administrative Regulations on the National Science and Technology Major Projects* (MOST, MOF Guo Ke Fa Ji [2008] No. 453).

[730] China provided the 2008 and 2009 statistics in the WTO, *Chairperson's Report to the Council for Trade in Goods on Transitional Review of China*, Committee on Subsidies and Countervailing Measures, G/SCM/130.24. (October 28, 2009). This statement is corroborated by the *Implementation of Central and Local Budgets for 2009 and the Resolution of the Central and Local Budgets by Third Session of the Eleventh National People's Congress* (NPC, issued March 5, 2010). The 2011 budget figure is available online at http://news.xinhuanet.com/politics/2012lh/2012-03/16/c.111666182.htm.

[731] *11th Five-Year Plan for Science and Technology Development*, Part II(1) (MOST, issued October 27, 2006).

[732] *Ibid.*, Part III.

[733] *Decision on Accelerating the Nurturing and Development of Strategic and Emerging Industries* (State Council, Guo Fa [2010] No. 32, issued October 10, 2010).

[734] *Ibid.*

[735] *Notice on Issuing the 12th Five-Year Plan for National Strategic and Emerging Industries Development* (State Council, Guo Fa [2012] No. 28, issued July 9, 2012).

Development Plan ("*13th Five-Year SEI Plan*"),[736] issued in 2016, reviews the successes achieved during the *12th FYP* period, and sets new goals for the *13th FYP* period.

In conjunction with the *S&T MLP*, *12th Five-Year SEI Plan* and *13th Five-Year SEI Plan*, the Chinese government has also formulated industry-specific medium- and long-term plans. For example, for one of the seven technologies designated in the *SEI Plan*, NEVs, the State Council in 2012 released the *Energy-Saving and New-Energy Automotive Industry Development Plan (2012-2020)*,[737] which serves as the basis for numerous regulations and subsidy programs to support the domestic R&D, manufacturing, and utilization of NEVs. The document sets a target of achieving cumulative production and sales volume of 5 million NEV units by 2020.

Innovation policies have also been featured in China's *FYPs* for economic and social development.[738] The most recent editions of these plans, formulated for the *12th FYP* and *13th FYP* periods, also discuss the importance of indigenous innovation.[739] In the *13th FYP*, indigenous innovation is included as a focal point of the government's national development strategy.[740] The government intends for both indigenous innovation and technology acquisition to drive China's national economic development, lift total factor productivity growth, develop entrepreneurship, lead to breakthroughs in core technologies and key sectors, increase industry capacities and capabilities, facilitate the full integration of technology into the economy, and lead to an innovative society.[741] The explicit reference to "indigenous innovation" in the *13th FYP* signals that achieving technological "self-sufficiency" is an important goal for the government.[742] The *13th FYP* lists nine industrial policy initiatives that detail over 70 priority

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[736] *Notice on Issuing the 13th Five-Year Plan for National Strategic and Emerging Industries Development* (State Council, Guo Fa [2016] No. 67, issued November 29, 2016).

[737] *Energy-Saving and New-Energy Automotive Industry Development Plan (2012-2020)* (State Council, Guo Fa [2012] No. 22, issued June 28, 2012).

[738] China's most recent three five-year plans for national economic and social development, the *11th 12th* and *13th FYP*, as well as the *No. 40 Document*, all discuss the importance of indigenous innovation for the technological upgrading of China's industries and the development of advanced manufacturing capabilities, as well as the need to expand China's "talent reservoir" through science and technology education, training and research. *See* Government of China, "Outline of the 11th Five-Year Program for National Economic and Social Development of the People's Republic of China," March 2006. *See also* Part I, Chapter 3: Main Objectives, and Part VII; Government of China, "Outline of the 12th Five-Year Program for National Economic and Social Development of the People's Republic of China," March 2011. *See also* Part One, Chapter 2: Guiding Thought, and Part Seven; Government of China, "13th Five-Year Plan," March 2015. *See also* Part 1, Chapter 3: Main objectives, and Part II.

[739] *11th FYP*, Part I, Chapter 3: "Main Objectives" and Part VII; *12th FYP*, Part I, Chapter 2: "Guiding Thoughts" and Part VII; *13th FYP*, Part I, Chapter 3: "Main objectives" and Part II.

[740] *13th FYP*, Part I, Chapter 3: Main Objectives, and Part II.

[741] *Ibid*., Chapter 3: Main Objectives.

[742] *Ibid*., Part 1, Chapter 3: "Main objectives." *See also* Center for Strategic and International Studies, *Perfecting China Inc.* (May 2016), 27-28.

technology areas for development and commercialization, which in turn, cover many more specific products and technologies.[743]

In 2015, the State Council released the *Made in China 2025 Decision*,[744] which outlines a new medium- and long-term strategy for S&T development. The implementation period for this strategy is from 2016 to 2025, thereby overlapping with the *S&T MLP* and *12th Five-Year SEI Plan* and *13th Five-Year SEI Plan*. The *Made in China 2025 Decision* is novel in its focus on upgrading all stages of China's industrial supply chain, including manufacturing and service sectors and lower value-added industries (such as steel and textiles) rather than focusing exclusively on high-technology sectors.[745] Nonetheless, it also specifies plans for a subset of ten high-technology industries, which overlap to some extent with those identified in the *S&T MLP* and *12th Five-Year SEI Plan* and *13th Five-Year SEI Plan*. A document released in October 2015, the *"China Manufacturing 2025" Key Sectors and Technologies Roadmap*,[746] provides further details on the plans for these high-technology industries. As is the case for the *S&T MLP* and *12th Five-Year SEI Plan* and *13th Five-Year SEI Plan*, MiC2025 has informed the issuance of industry-specific plans, such as the *Agricultural Machinery Equipment Development Action Plan (2016-2025)*.[747]

One goal under the MiC2025 is production self-sufficiency. Specifically, the government's specific self-sufficiency (localization) target for domestically sourced essential parts and key materials under MiC2025 is a 40% share of the market by 2020, and a 70% share by 2025.[748] In 2017, the Chinese government continues to use an industrial policy-based approach to innovation that has the effect of selecting winners and losers by targeting specific technologies and sectors, and then encouraging their development, both directly and indirectly, through financial supports, investment, and other means.[749]

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743 *Ibid.*, 27.

744 *Decision on Issuing "China Manufacturing 2025"* (State Council, Guo Fa [2015] No. 28, issued May 8, 2015).

745 *See* Junko Yoshida, "Made in China 2025: Who Cares?" *EE Times*, July 20, 2017. In addition to "greatly pushing forward the breakthrough and development of major fields," the *Made in China 2025 Decision* outlines plans for "further pushing forward the structural adjustment of manufacturing industry," "Actively developing service-oriented manufacturing and producer service industries," and "improving the internationalized development of manufacturing industry."

746 *"China Manufacturing 2025" Key Sectors and Technologies Roadmap* (NMSAC, issued October 2015).

747 *Agricultural Machinery Equipment Development Action Plan (2016-2025)* (MIIT, MOA, and NDRC, Gong Xin Bu Lian Zhuang [2016] No. 413, issued November 28, 2016).

748 Jost Wubbeke et al., *Made in China 2025: The Making of a High-Tech Superpower and Consequences for Industrial Countries,* MERICS Papers on China No. 2 (Mercator Institute for China Studies, December 2016), 7, 11.

749 *See* European Union Chamber of Commerce in China, Ch*ina Manufacturing 2025: Putting Industrial Policy Ahead of Market Forces* (2017), 1. ("It is clear that this latest attempt [to promote S&T development through the MiC2025 policy] is not to be achieved through measures that will establish a market economy. Instead, government officials have tasked themselves with steering development and have handpicked the industries that they believe will drive China's economy in the future […] Despite the rhetoric of the Third Plenum's *Decision* of 2013—which

4. *Supply-Side Structural Reforms*

4.1. Background on Supply-Side Structural Reforms

In the 2013 *Third Plenum Decision*, the CCP acknowledged China's problematic industrial structure; its extensive, unbalanced, uncoordinated, and unsustainable growth path; and its weakness in scientific and technological innovation. The *Third Plenum Decision* outlined the CCP's concern with the Chinese government's role in the economy and the problem of excessive government interventions, including the government's direct allocation of resources.[750] It stressed the importance of resolving this problem and properly handling the relationship between state and market, so that the market plays a "decisive role" in resource allocations and the government's role is to ensure macroeconomic stability, promote economic development, strengthen market-supporting institutions, and address market failures.[751]

At the December 2015 Central Economic Work Conference of the CCP, high-level officials in the Chinese government, including President Xi Jinping, introduced a set of coordinated policies to address structural problems in China's economy, referred to as "supply-side structural reform," given the widely held view that a permanently slower growth environment in China is the "new normal."[752] Current levels of investment and production in many industries are widely viewed as unsustainable and threatening to China's long-term socio-economic development.[753] The five components of "supply-side structural reform" are summarized in the official phrase "three cuts, one reduction, one strengthening (*san qu yi jiang yi bu*)": (1) cutting industrial excess capacity; (2) reducing property inventory (also referred to as "destocking"); (3) reducing corporate debt (also referred to as "deleveraging"); (4) lowering corporate costs; and (5) improving weak links within industrial supply chains.[754]

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strongly advocates market forces—it seems that the Chinese Government is determined to maintain a prominent role in guiding the economy. This is highlighted by the large number of domestic and international market share targets that have been set, along with references to 'indigenous innovation included in the multiple planning documents related to [MiC2025]. The appearance of 'indigenous innovation'—along with mentions of the need to realise 'self-sufficiency'—is particularly concerning –it suggests that Chinese policies will further skew the competitive landscape in favour of domestic companies.")

[750] *CCP Central Committee Decision on Several Major Issues for Comprehensively Deepening Reform,* Section 1.(3) (CCP Central Committee, issued November 12, 2013).

[751] *Ibid.*

[752] Barry Naughton, "Two Trains Running: 'Supply-Side Reform, SOE Reform and the Authoritative Personage'," *Hoover Institution/China Leadership Monitor*, 50 (July 2016): 2, 3, 8; Barry Naughton, "Supply-Side Structural Reform at Mid-Year: Compliance, Initiative, and Unintended Consequences," *Hoover Institution/China Leadership Monitor*, 51 (August 2016): 1, 8.

[753] The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 3.

[754] *See Xinhua News Agency*, "Central Economic Work Conference Proposes Five Major Tasks for 2016," December 22, 2015. *See also* The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 3.

In the 2016-2017 period, government authorities at the central and sub-central level have issued multiple measures to implement "supply-side structural reform" policies. For example, "supply-side structural reform" has been inserted as a guiding principle into long-term plans for industry,[755] guiding opinions on reducing corporate debt and corporate costs,[756] and industry-specific policies to reduce excess capacity and enhance productivity.[757] In a further indication of the priority accorded to "supply-side structural reform," the State Council issued official statements in 2017 about the status of "supply-side structural reform" initiatives.[758]

The section below examines two of the fundamental problems underlying the "supply-side structural reform" initiative, namely (1) excess capacity in the industrial sector and (2) corporate sector leverage.

4.2. Excess Capacity

Excess capacity has been a longstanding and widespread problem in China's economy.[759] Its scale is indicated by low capacity utilization rates in numerous industries, including iron and

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[755] *See e.g.*, *Notice on Issuing the 13th Five-Year Plan for Strategic Emerging Industries* (State Council, Guo Fa [2016] No. 67, issued November 29, 2016); *Approval of the National Mineral Resource Plan* (2016-2020) (State Council, Guo Han [2016] No. 178, issued November 2, 2016); the *Notice on Issuing the 13th Five-Year Plan for Science and Technology Innovation* (State Council, Guo Fa [2016] No. 43, issued July 28, 2016); the *Notice on Issuing the Action Plan to Promote the Conversion of Science and Technology Achievements* (State Council, Guo Ban Fa [2016] No. 28, issued April 21, 2016).

[756] *See e.g.*, *Opinion on Actively and Steadily Reducing Corporate Leverage Rates* (State Council, Guo Fa [2016] No. 54, issued September 22, 2016) and the *Guiding Notice on Issuing the Work Plan for Lowering Corporate Costs in the Real Economy* (State Council, Guo Fa [2016] No. 48, issued August 8, 2016).

[757] *See e.g.*, Gui*ding Opinion on Structural Reform and Productivity Enhancement in the Petrochemical Industry* (State Council General Office, Guo Ban Fa [2016] No. 57, issued August 3, 2016); *Notice on Items Relating to the Utilization of Pricing Methods to Promote Structural Supply-Side Reform in the Steel Sector* (NDRC, MIIT, Fa Gai Jia Ge [2016] No. 2803, issued December 30, 2016); *Opinion on Shedding Excess Industrial Capacity in the Coal Industry to Achieve Development out of Difficulty* (State Council, Guo Fa [2016] No. 7, issued February 1, 2016).

[758] *Report on the Status of Work to Advance Supply-Side Structural Reform to Accelerate the Transformation and Upgrading of Manufacturing Industries* (State Council, issued April 24, 2017). *See also Government Work Report*, Section 1 (Premier Li Keqiang, at the 5th Session of the 12th National People's Congress, March 5, 2017). ("2016 Work Retrospective": Deepening the Promotion of Reform and Opening. Breakthrough progress has been achieved in the reform of important sectors and key linkages, with preliminary evidence of the efficacy of supply-side structural reform.)

[759] The government has also proceeded with efforts under SSSR to reduce excess housing stocks. A key problem is that excess housing stock for the most part is found in tier-2 and tier-3 cities and rural areas where relatively few people want to live and work. In many cases, excess housing stock arises because property developers build where land and financing are cheap, and local governments push land sales and development because it generates fiscal revenue and stimulates economic growth. Chinese government policies to reduce housing supply include, *inter alia*, limiting rural land conversions and the availability of construction land, and restricting land property developers' access to bond and equity market financing. For further discussion, *See* Factor 4 of this report. *See also* The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 10; *The*

steel, coal and coke, cement, flat glass, shipbuilding, semi-conductors, construction materials, chemical fertilizers, metal-cutting machine tools, micro-computer equipment, autos, consumer appliances, phone sets, cell phones, petrochemicals, aluminum, optic fiber, carbon fiber, power generation (thermal, solar, wind and hydro), solar panels, and lithium batteries.[760] According to the Economist Intelligence Unit, "for years [China's] authorities had tolerated expansions in capacity across a variety of industries, despite capacity utilisation rates dipping below 75% (normally a threshold for indicating a balanced relationship between supply and demand)."[761]

Excess capacity in China is largely the result of government policies. Key recurring factors include subcentral authorities protecting industries that support local industrial activity and employment; weak enforcement of regulations; low input prices due to government policies; and fiscal imbalances that incentivize local governments to attract excessive investment.[762] In addition, the government's large stimulus package, introduced in or around the global financial crisis (2007-2009), exacerbated excess capacity by facilitating a rapid increase in lending and other financial support to industrial enterprises, in combination with expedited regulatory approvals, in order to expand industrial capacity and start infrastructure projects.[763]

Excess capacity is a chronic problem in China's economy. Official measures dating back to at least 2003 illustrate that the Chinese government has repeatedly sought to mitigate this problem, although without preventing its recurrence. For example:

Economist, "China's Property Market: The Rotten Foundations of China's Real Estate Market (Print Edition|Leaders)," October 13, 2016; IMF, *Resolving China's Corporate Debt Problem*, WP/16/203 (October 2016), 6.

[760] *Guiding Opinions of the State Council on Resolving the Conflict of Rampant Overcapacity*, Article 1 (State Council, Guo Fa [2013], No. 41, issued October 6, 2013); Government of China, NDRC Macroeconomic Studies Institute, "Apply the Method of Reform to Resolve Production Overcapacity," *Beijing Jingji Ribao Online*, December 13, 2013 (from OSC); *China Development Institute*, "Work Tirelessly to Eliminate Excess Capacity," April 4, 2016; The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 5, 9.

[761] The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 5.

[762] European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party's Reform Agenda* (2016), 7-14.

[763] European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party's Reform Agenda* (2016), 2. ("Despite then National Development and Reform Commission (NDRC) Chairman Zhang Ping's statement in 2009, that 'there won't be a penny spent on enlarging mass production or highly polluting and resource-intensive sectors', the stimulus package resulted in a massive expansion of the production capacities of many state-owned enterprises (SOEs). This situation was perpetuated by a surge in lending – encouraged by the government, to meet the needs of the thousands of infrastructure investment projects that were being approved around the country – in conjunction with the ease with which producers were able to secure such loans. This wave of fixed asset investment (FAI) in infrastructure projects, as well as further FAI that has resulted from smaller subsequent stimulus measures, has only created short-term demand for input supplies, though. Consequently, the problem has worsened in many industries with easily available credit resulting from the stimulus package yet more expansion of industrial capacity that is disconnected from real market demand.")

- The 2003 *Several Opinions on the Prevention of Blind Investment in Iron and Steel, Electrolytic Aluminum and Cement Industries*[764] finds that some regions and industries, driven by self-interest, and without regard to market, resource, or other external conditions, have improperly built new or expanded, large-scale projects in the steel, aluminum, and cement sectors. Blind investment; low-quality, duplicative construction; and illegal production has resulted.

- The 2006 *Notice of the State Council Regarding Hastening and Promoting Adjustment of the Industrial Structure in Overcapacity Industries*[765] finds that because of the crude economic growth model and imperfect structures and mechanisms, several sectors have manifested blind investment, low-quality expansion, and other problems during their rapid development. Further, some regions and enterprises in these spheres continue to install new projects, and the contradictions of production capacity exceeding demand have been exacerbated. The measure identifies steel, aluminum, cement, calcium carbide, iron alloys, coke, automobiles, coal, electricity, and textiles as problem industries.

- The 2009 *Several Opinions on Suppressing Overcapacity and Redundant Construction in Certain Sectors and Guiding Healthy Industrial Development* (State Council, Guo Fa [2009] No. 38, issued December 22, 2009)[766] states that there is overcapacity in many sectors, and the problem of "redundant construction is still very prominent and even worsening in some areas," and specifically identifies overcapacity in steel, cement, flat glass, coal chemicals, polysilicon, wind power equipment, aluminum, shipbuilding, and soybean oil.

- The 2013 *Guiding Opinions of the State Council on Resolving the Conflict of Rampant Overcapacity* finds that excess capacity is increasingly obvious in some of the country's industries. Excess capacity is the norm in traditional manufacturing industries and is especially clear in high-energy, high-emissions sectors like steel, cement, and aluminum.[767] In describing the causes of excess capacity, the measure essentially describes a resource allocation problem that reflects the lack of an effective market mechanism or process: lagging factor market reforms; "blind" investment and capacity expansion by firms with overly optimistic market expectations; industrial development without the leaderships of excellent firms, which results in disorderly competition and

[764] *Notice on Issuing Several Opinions of the National Development and Reform Commission and Other Related Departments on the Prevention of Blind Investment in Iron and Steel, Electrolytic Aluminum and Cement Industries* (State Council, Guo Ban Fa [2003] No. 103, issued December 23, 2003).

[765] *Notice of the State Council Regarding Hastening and Promoting Adjustment of the Industrial Structure in Overcapacity Industries* (State Council, Guo Fa [2006] No. 11, issued March 12, 2006).

[766] *Notice of the State Council on Promulgating the Several Opinions of NDRC and Other Departments on Suppressing Overcapacity and Redundant Construction in Certain Sectors and Guiding Healthy Industrial Development* (State Council, Guo Fa [2009] No. 38, issued September 26, 2009).

[767] *Guiding Opinions of the State Council on Resolving the Conflict of Rampant Overcapacity*, Article 1 (State Council, Guo Fa [2013], No. 41, issued October 6, 2013).

> redundant buildup of the industry; excessive market entry promoted and facilitated by investment-driven, growth-focused local governments that supply cheap land, low-cost resources and tax breaks; poor market exit channels; and ineffective administrative controls regarding investment regulation, policy and planning guidance and supervision, inspection and accountability.[768]

The Chinese government issued measures in 2016 and 2017 to reduce excess capacity in the coal and steel sectors after the launch of the "supply-side structural reform" initiative. The solutions to excess capacity set forth in the measures continue to reflect a high level of government intervention.

At the highest level of government, the State Council issued guiding opinions for coal ("*Coal Guiding Opinion*") and steel ("*Steel Guiding Opinion*") capacity shedding in February 2016.[769] Both documents instruct authorities to limit approvals of capacity increases. To downsize existing capacity, the *Steel Guiding Opinion* also assigns a series of tasks to lower-level authorities: (1) forcing capacity-shedding "according to the law" by enforcing stricter standards regarding environmental protection, energy consumption, quality, safety, and technology; (2) encouraging firms to "proactively" shed capacity by relocating production, engaging in mergers and acquisitions, lowering output targets in firm-level strategic plans, and other means: and (3) disabling production facilities by demolishing steel smelting equipment, or alternatively, resorting to means such as cutting off supplies of water and electricity.[770] Both documents also specify a series of policy measures to incentivize capacity shedding among individual enterprises, including: moderating taxation rates and exemptions; moderating access to lines of credit; encouraging private investment in enterprise restructuring; relocating laid-off workers; and establishing compensation funds through which the government can help indebted enterprises finance different capacity shedding actions.[771] These actions draw upon government power, not market mechanisms.

Several government authorities have issued implementing measures pursuant to the State Council *Guiding Opinions* for steel and coal. For example, NDRC and MIIT, in conjunction with PBOC, CBRC, and China Securities Regulatory Commission (CSRC), have established provisions to condition access to loans and other forms of financing. Access to capital is

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[768] *Ibid*., Article 1.

[769] *Opinion on Shedding Excess Industrial Capacity in the Coal Industry to Achieve Development out of Difficulty* (State Council, Guo Fa [2016] No. 7, issued February 1, 2016); *Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (State Council, Guo Fa [2016] No. 6, issued February 4, 2016).

[770] *Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty*, Section 2 (State Council, Guo Fa [2016] No. 6, issued February 4, 2016).

[771] *Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty*, Section 3 (State Council, Guo Fa [2016] No. 6, issued February 4, 2016); *Opinion on Shedding Excess Industrial Capacity in the Coal Industry to Achieve Development out of Difficulty*, Section 3 (State Council, Guo Fa [2016] No. 7, issued February 1, 2016).

restricted for enterprises with excess capacity that do not take capacity-shedding actions prescribed by the government; conversely, capital is to be provided on a preferential basis to enterprises that take the prescribed capacity-shedding actions.[772] Similarly, MLR has issued an opinion to, *inter alia*, limit access to land and minerals among steel and coal producers that have excess capacity; support the reallocation of land idled through capacity reductions, suspended projects, and enterprise restructuring; and reward successfully restructured coal enterprises by offering priority approvals to extract mineral resources.[773]

At the provincial level, authorities have signed target responsibility documents for steel and coal capacity reduction demanded by the central government,[774] and have issued corresponding implementing opinions[775] and implementation plans.[776] Several of these documents mandate capacity-shedding targets, in tonnage and percentage terms, for specific enterprises, as well as for the province on aggregate. As with the policies described above, these are top-down directives, not market mechanisms.

Taken together, the capacity-shedding measures outlined above entail a high degree of government intervention, while not adequately addressing the root causes of excess capacity or adopting market structures. Physically moving capacity from one region to another does not necessarily eliminate any excess from the national market.[777] The effect of more stringent industry standards and less access to bank credit is often mitigated by other forms of government

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[772] *Opinion on Supporting the Shedding of Excess Industrial Capacity in the Steel and Coal Industry to Achieve Development out of Difficulty* (PBOC, CBRC, CSRC, CIRC, Yin Fa [2016] No. 118, issued April 17, 2016); *Several Opinions on Financial Debt and Debt Obligations Problems Relating to Shedding Excess Capacity in the Steel and Coal Industries* (CBRC NDRC, MIIT, Yin Jian Fa [2016] No. 51, issued December 1, 2016).

[773] *Ministry of Land and Resources Opinion on Supporting Shedding Excess Industrial Capacity in the Steel and Coal Industry to Achieve Development out of Difficulty* (MLR, Guo Tu Zi Gui [2016] No. 3, issued March 30, 2016).

[774] Barry Naughton, "Supply-Side Structural reform at Mid-Year: Compliance, Initiative, and Unintended Consequences," *Hoover Institution/China Leadership Monitor*, 51 (August 2016): 2.

[775] *See e.g. Anhui Province People's Government Implementing Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (Anhui Province People's Government, Wan Zheng [2016] No. 77, issued July 30, 2016); *Heilongjiang Province People's Government Implementing Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (Heilongjiang Province People's Government, Hei Zheng Ban Fa [2016] No. 83, issued July 29, 2016); *Jiangsu Province People's Government Implementing Opinion on Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (Jiangsu Province People's Government, Su Zheng Fa [2016] No. 170, issued December 27, 2016).

[776] *See e.g.*, *Jiangxi Province People's Government Implementation Plan for Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (Jiangxi Province People's Government, Gan Zheng Ting Zi [2016] No. 113, issued August 19, 2016) and *Yunnan Province People's Government Implementation Plan for Shedding Excess Industrial Capacity in the Steel Industry to Achieve Development out of Difficulty* (Yunnan Province People's Government, Yun Zheng Fa [2016] No. 51, issued June 28, 2016).

[777] *Ibid*.

support – for example, to purchase new equipment – such that many enterprises do not exit the market and aggregate capacity remains high.[778] In some of these industries, particularly steel and aluminum, excess capacity appeared to increase even as the government tried to reduce it.[779] Furthermore, by setting capacity-shedding targets, the government may under- or overestimate the degree of capacity reduction required to balance supply and demand. For example, in the case of steel, the reduction target is roughly 150 million metric tons (MMT) for the 13th *FYP* period;[780] however, current estimates of China's excess steel capacity are nearly 400 MMT.[781]

In a market-driven process, capacity reductions would not cease once an administratively-determined level had been reached. Instead, plant closures and market exits would reduce capacity and employment over time until prices and profits indicated that the capacity and production of firms still in the market was economically viable. In addition, capacity reductions would result in the least efficient producers facing the greatest cuts, rather than the government determining which enterprises must exit or reduce capacity. In China, government authorities, rather than the market, effectively control entry and exit, extend financial support to non-viable and troubled firms, and negotiate with other government authorities over the extent of administratively determined capacity cuts.

4.3. Excessive Corporate Debt

The credit intensity of China's GDP (new credit per unit of additional GDP) has doubled since before the 2008 financial crisis and it continues to rise.[782] At the end of 2015, total credit and bank credit to the private non-financial sector stood at 202% and 153% of GDP, respectively.[783] The total credit-to-GDP ratio stood at 27% above trend.[784] This is well over the 10% that the Bank of International Settlements (BIS) considers a warning signal.[785] These figures suggest that credit growth exceeds optimal financial deepening for a country at China's level of economic development.[786]

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[778] European Union Chamber of Commerce in China, *Overcapacity in China: An Impediment to the Party's Reform Agenda* (2016), 16-18.

[779] *Rhodium Group*, "Exporting Overcapacity: China and Trump Search for Answers," May 9, 2017.

[780] *Ibid.*

[781] *Ibid*.

[782] IMF, *People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (August 2016), 5.

[783] *Statistical Tables* (Bank for International Settlements website, available at http://www.bis.org/statistics/tables_f.pdf). Credit growth and level are high regardless of whether and to what extent local government financing vehicles are included in the private non-financial sector.

[784] *Ibid*.

[785] Bank for International Settlements, "Early Warning Indicators," *BIS March 2016 Quarterly Review* (March 6, 2016), 28.

[786] IMF, *People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (August 2016), 32.

Excessive debt in China is largely a corporate sector problem, particularly among SIEs.[787] A report by the Economist Intelligence Unit finds that corporate debt accounted for 65% of China's total debt in September 2016, equivalent to 166.2% of China's GDP.[788] The IMF's 2016 *Global Financial Stability Report* notes a sharp increase in the debt overhang of listed firms in China between 2009 and 2015, to the extent that there is now a large divergence between listed firms in China and in other regions of the world. Several indicators show that the increase in debt has been large and rapid, while at the same time, debt servicing capacity has been deteriorating.[789] First, credit growth is concentrated in the corporate sector at a time of rising financial stress, falling profitability and growing inter-enterprise payment arrears.[790] The debt-to-earnings ratio for the median Chinese firm has more than doubled since 2010.[791] Second, roughly two-fifths of new debt goes to pay interest on existing loans, and in 2014, 16% of the 1,000 largest Chinese companies owed more interest than their earnings before taxes.[792] Third, according to IMF methodology, "loans potentially at risk" were estimated to account for more than 15% of total commercial bank loans to the corporate sector in 2015.[793]

Moreover, credit is often provided to non-viable enterprises in industries with excess capacity.[794] The share of loans going to firms with low debt-service capacity is increasing, and the lenders to these firms are increasingly smaller, under-capitalized and under-provisioned banks that are least

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[787] The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 16.

[788] The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 16. *See also* IMF, *Resolving China's Corporate Debt Problem*, WP/16/203 (October 2016), 3. ("The corporate sector has been the main driver of the excessive credit creation. Credit to households is consistent with the ratio for countries at a similar level of development. In contrast, credit to the corporate sector is well above the level in emerging market peers (exceeding even the level typical for developed economies) and growing fast. The financial performance of the corporate sector has also been deteriorating. After the initial deleveraging phase, the leverage ratio has been rising while profitability has been steadily falling, suggesting deteriorating debt servicing capacity. This is further illustrated by the rising ratio of liabilities to earnings (EBIT) and the falling interest coverage ratio (ICR = EBIT / interest expenses).")

[789] IMF, *Resolving China's Corporate Debt Problem*, WP/16/203 (October 2016), 3 and 7. *See also* IMF, *People's Republic of China: 2016 Article IV Consultation – Press Release; Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 10.

[790] IMF, *Global Financial Stability Report: Potent Policies for a Successful Normalization* (April 2016), 13-16.

[791] *Ibid*.

[792] *The Economist*, "The Coming Debt Bust," May 7, 2016.

[793] IMF, *Global Financial Stability Report: Potent Policies for a Successful Normalization* (April 2016), 16. ("'loan potentially at risk' can be defined as a bank loan to a borrower that has an interest coverage ratio (EBITDA divided by interest expenses) below one. Put another way, it is a loan to a borrower that doesn't have sufficient income to cover its interest payments.)

[794] *Ibid*., 5.

able to manage the increased risk.[795] In addition, the banking sector continues to allocate resources disproportionately to SIEs, which according to the IMF account for a far greater share of total bank credit than industrial value-added.[796]

The causes of corporate debt are closely linked to excess capacity. The large stimulus program introduced in response to the global financial crisis combined expansionary fiscal and monetary policy with increased lending by state-owned commercial banks. The insertion of additional credit into the economy financed a rapid scaling up of industrial capacity, infrastructure, and real estate investment in excess of real demand. Consequently, many enterprises in China now have a large debt burden, but as a result of inefficient expansion, and owing to a general slowdown in the economy, are unable to turn over excess output and unsold housing stock. Borrowing costs not commensurate with returns and risks, together with easy access to financing, are key features distorting the allocation of resources and promoting the types of inefficiencies that have contributed to China's corporate debt problem.[797]

The Chinese government has used various methods to pursue corporate deleveraging under "supply-side structural reform." One method involves selling state-owned shares to private investors through capital injection, share acquisition, and debt-for-equity swaps, as stipulated in the 2015 *SOE Reform Opinion*.[798] Another involves the introduction of stricter accounting standards and corresponding government oversight.[799] Yet another is to restrict access to new credit; as discussed above, China's financial regulatory authorities have co-issued measures with NDRC and MIIT to condition access to loans and other forms of financing for coal and steel producers, based on their conformity with environmental, energy consumption, safety, quality and technical standards, as well as their progress in "actively shedding excess capacity."[800] These initiatives do not address the underlying causes of the problem, and as a result, the debt problem in the state sector continues to rise.[801]

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[795] Jason Bedford, "Are We Through the Worst of the Credit Cycle? What the Banks Tell Us," *UBS*, November 1, 2016, 17-18. *See also* Jason Bedford, "Have the Bailouts and Recapitalizations Begun?" *UBS*, August 11, 2016, 6.

[796] IMF, *People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (August 2016), 38.

[797] IMF, *Resolving China's Corporate Debt Problem*, WP/16/203 (October 2016), 5-8; IMF, *Global Financial Stability Report: Potent Policies for a Successful Normalization* (April 2016), 13-14.

[798] *Guiding Opinion on Deepening Reform of State-owned Enterprises*, Article 17 (CCP Central Committee and State Council, Guo Fa [2015] No. 22, issued August 24, 2015).

[799] *Notice on Issuing the "Provisions on Accounting Management for Activities Relating to "Three cuts, One Reduction, and One Strengthening* (MOF, Cai Hui [2016] No. 17, issued September 22, 2016).

[800] *Opinion on Supporting the Shedding of Excess Industrial Capacity in the Steel and Coal Industry to Achieve Development out of Difficulty* (PBOC, CBRC, CSRC, CIRC, Yin Fa [2016] No. 118, issued April 17, 2016); *Several Opinions on Financial Debt and Debt Obligations Problems Relating to Shedding Excess Capacity in the Steel and Coal Industries* (CBRC NDRC, MIIT, Yin Jian Fa [2016] No. 51, issued December 1, 2016).

[801] Andrew Batson, "The State of the State Sector," *Gavekal/Dragonomics*, March 2017, 21. *See also* The Economist Intelligence Unit, *China's Supply-Side Structural Reforms: Progress and Outlook* (2017), 16-18. The The Economist Intelligence Unit has noted that conventional deleveraging through tighter monetary policy does not

B. Price Regulation

Price regulation is an important means by which a government can influence the economy. Part B of this section begins by discussing the prevalence of price distortions. It then discusses the status of formal price controls, including an explanation of how the Chinese government divides prices for goods and services into "market-regulated prices," "government-guided prices," and "government-set prices." Part B concludes with a closer examination of Chinese government pricing policies in the electricity sector.

The Chinese government does not formally control prices directly for most goods and services, but nonetheless exerts a high degree of control over prices it deems essential or strategic. The government formally sets and guides prices for important factor inputs, including oil and gas, electricity, and transportation services, which undergird a complex system of price regulation at the sub-central and sectoral level. The government also influences prices through other means, such as trade policy measures and the administrative allocation of land-use rights.[802] To fulfill industrial policy objectives, the Chinese government also administers prices on a discriminatory basis through methods such as "differential pricing" of electricity. Thus, notwithstanding the aggregate reduction in China's direct price controls, the remaining controls, especially as applied to factor inputs, influence costs and prices throughout China's industry-intensive economy.

1. The Prevalence of Price Distortions

Reports by international institutions have pointed to significant price distortions in China's economy, particularly in factor markets.

- OECD. A 2015 report finds that energy prices "do not reflect the true social and environmental cost of production, making for a widespread misallocation of resources."[803] It recommends that China "move to full market-based pricing for natural gas and coal" and "[d]eregulate electricity prices, beginning in the generation sector, and avoid preferential electricity pricing for selected industrial users."[804]

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suffice in China because tightening credit tends to "affect private firms first, despite their higher levels of efficiency and ability to generate more GDP per unit of debt." Moreover: "[Debt-for-equity swaps] may buy some time for struggling companies, but if that time is not used to drive reforms and productivity gains, it will have only delayed the debt reckoning … The modest scope of SOE reforms does not provide much encouragement on this front. The other risk, highlighted by the structuring of the debt-for-equity swap programme, is that the authorities look to shift the burden for corporate debt repayment to the household sector.")

802 This determination's review of the Chinese government's institutional structure for intervention in the economy through mechanisms such as the SIE sector, land allocation, industrial policies, financial system, as well as in restrictions to foreign investment, and control of the legal system in aggregate establish the conditions for the distortion of supply and demand.

803 OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, March 2015), 31.

804 *Ibid*., 52.

- Asian Development Bank Institute. A 2011 report estimates the aggregate costs arising from the governmental interventions in the factor markets to lie in the range of about 10% of Chinese GDP each year during the first decade of the 21st century. It concludes:

> During the reform period, the PRC government focused on reform of the product markets, including abandoning policy interventions in domestic markets and liberalizing trade of goods and services. Today, free markets determine the prices of more than 95% of products. In contrast, factor markets, including markets for labor, capital, land, energy, and the environment, remain highly distorted. […] Some distortions in factor markets, such the *government's controls over energy prices* and land use fees for manufacturing investors, are deliberate policy measures to support economic growth.[805] (emphasis added)

- World Bank and the Development Research Center of the State Council. A 2012 report recommends higher prices on energy (carbon), water, and natural resources in the near to medium term because it "would encourage their more efficient use." The report also calls for China to establish a "level playing field" within the enterprise sector by allowing for "market-driven factor and input prices."[806]

- WTO. According to the WTO's 2008 *Trade Policy Review*:

> While China's high energy intensity may be partly explained by the share of industry (which tends to be relatively energy intensive) in GDP, it is also undoubtedly due to the existing insufficiently market-oriented price mechanism for oil, coal, electricity and natural gas, which sets artificially low prices and, as a consequence, leads to a waste of energy, to the detriment of the environment.[807]

Various academic studies have also discussed the extent of price distortions in China's economy.[808]

2. *The Status of Formal Price Controls*

2.1. The System of Set, Guided, and Market-Regulated Prices

Under the command economy, the Chinese government set prices for all goods and services in the economy. Changes initiated in the 1970s culminated in the passage of the 1997 *Pricing Law*

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[805] Yiping Huang and Kunyu Tao, *Causes of and Remedies for the People's Republic of China's External Imbalances: The Role of Factor Market Distortion*, Working Paper Series No. 279 (Asian Development Bank Institute, April 2011), 12.

[806] World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 94, 103.

[807] WTO, *Trade Policy Review – Report by the Secretariat – China*, WT/TPR/S/199 (April 16, 2008), xiii.

[808] *See* Shi Xunpeng and Sun Sizhong, "Energy Price, Regulatory Price Distortion and Economic Growth: A Case Study of China," *Energy Economics* 63 (March 2017), 261-271.

of the People's Republic of China ("*Pricing Law*"),[809] which divides prices for goods and services[810] into three categories: (1) "market-regulated prices," (2) "government-guided prices," and (3) "government-set prices."[811] Most prices in China today fall under the category of market-regulated prices.[812] The *Pricing Law* provides that the government "practices and gradually perfects the price mechanism shaped mainly by the market under macroeconomic regulation and control"[813] and "supports and promotes fair, open and lawful market competition."[814]

The *Pricing Law* defines the types of goods and services for which the government may implement when necessary government-set prices and government-guided prices: (1) a small number of goods that have a significant bearing on national economic development and people's livelihoods; (2) a small number of goods for which resources are scarce; (3) goods operated by natural monopoly; (4) important public utilities; and (5) important services that benefit the public.[815] Articles 22 through 25 provide that private and public interested parties may submit information to the state with respect to the setting of guidance prices, to ensure that pricing is in line with prevailing market conditions.[816]

Government authorities are required to formulate and administer government-set and government-guided prices in accordance with government-issued pricing catalogues.[817] Though not expressly set forth in the *Pricing Law*, central government authority to formulate prices rests primarily with NDRC, which publishes the *Catalogue of Pricing by the Central Government*

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[809] *Pricing Law of The People's Republic of China* (adopted at the 29th Meeting of the Standing Committee of the Eighth National People's Congress on December 29, 1997. effective May 1, 1998).

[810] The *Pricing Law* does not apply to interest rates, securities prices, insurance rates, or foreign exchange rates, which are regulated by other laws and administrative regulations. *Ibid.*, Article 47.

[811] *Ibid*., Article 3. Market-regulated prices are defined as prices formulated independently by business operators and formed through market competition. Government-guided prices are defined as benchmark prices and their range of fluctuation that guide prices formulated by business operators, stipulated by the government department in charge of pricing or related departments within the price-setting rights and scope set forth in the provisions of this law. Government-set prices are defined as prices formulated by the government department in charge of pricing or related departments within the price-setting rights and scope set forth in the provisions of this law.

[812] The Economist Intelligence Unit, *China Country Commerce Report* (February 2017), 56. The WTO's bi-annual Trade Policy Review for China typically lists those items for which prices were liberalized during the period in question, as well as those prices still subject to various levels of government control. *See e.g.* WTO, *Trade Policy Review*, The People's Republic of China WT/TPR/S/342, (June 15, 2016), 91-93.

[813] The *Pricing Law*, Article 3.

[814] *Ibid*., Article 4. The *Pricing Law* defines a number of unfair price acts, including price discrimination. *Ibid*., Article 14.

[815] *Ibid*., Article 18.

[816] *Ibid*., Article 22 and 25.

[817] *Ibid*., Article 19.

("*Central Pricing Catalogue*"). The *Central Pricing Catalogue* lists all goods and services subject to government-set and government-guided prices at the central level.[818]

The most recent edition of the *Central Pricing Catalogue*, effective January 1, 2016, lists 11 items (and sub-items) of goods and services subject to price controls:

- (1) Natural gas; (2) water; (3) electricity; (4) special medicines and blood; (5) transportation services (divided into (a) railway, (b) civic air, (c) ports, and (d) tunnel transportation); (6) postal services; and (7) banking services.[819] These items are presented in a table that details how the prices are administered and which central government authorities participate in their formulation.

- (8) Refined oil products, (9) telecommunications and internet services, (10) edible salts, and (11) charges for certifying academic credentials.[820] These items are listed in a more informal manner in the footnotes of the *Central Pricing Catalogue*.

According to the WTO, prices for natural gas, refined oil products, and transportation services (railway, civic air, and ports) are subject to government-*guided* prices. Prices for the other categories listed above are subject to government-*set* prices.[821] In addition, local governments independently determine government-set or government-guided prices for land, residential real estate, and related services; municipal services (environmental protection, household garbage disposal, and sewage); and entrance fees to tourism sites.[822]

Upon accession to the WTO in 2001, China was permitted to maintain price controls on certain goods and services listed in Annex 4 of its Accession Protocol.[823] China, in turn, committed to use "best efforts" to reduce or eliminate these price controls.[824] China also committed that additional goods and services would not be added to the list of those subject to price controls

[818] *Catalogue of Pricing by the Central Government* (NDRC, Order [2015] No. 29, issued October 8, 2015, effective January 1, 2016). *See also Pricing Catalogue of the State Development and Planning Commission and Related Departments* (SDPC, Order [2001] No. 11, issued July 4, 2001). The SDPC is the predecessor of NDRC, which was established in 2003.

[819] *Ibid*.

[820] *Ibid*.

[821] WTO, *Trade Policy Review*, The People's Republic of China, WT/TPR/S/342 (June 15, 2016), 92.

[822] *Ibid*., 12.

[823] WTO, *Protocol on the Accession of the People's Republic of China*, WT/L/432 (November 10, 2001), Annex 4.

[824] *Ibid*., 6. Before China's WTO accession, tobacco, edible salt, natural gas, pharmaceuticals, and certain services and utilities (such as electricity tariffs and bank service fees) were subject to government-set prices. Grain, vegetable oil, processed oil, fertilizer, silkworm cocoons, and cotton were subject to government-guided prices. *See also* WTO, *Trade Policy Review*, The People's Republic of China, WT/TPR/S/161 (February 28, 2006), 126.

"except in exceptional circumstances," which must be reported to the WTO.[825] Since WTO accession, the Chinese government has not increased the number of goods and services formally subject to government-guided and government-set prices, and as of 2016, NDRC has removed several items from the *Central Pricing Catalogue*, including grain, cotton, sugar, filature silk, crude oil, processed oil, and chemical fertilizers.[826]

2.2.Residual Government Control through Formal Price Controls

Notwithstanding the aggregate reduction in formal price controls, the formal price controls that remain allow the government to exert substantial control over key prices in China's economy. First, the *Pricing Law* provides the government with vague and expansive justifications to impose price controls, in particular controls on goods that have a significant bearing on national economic development and people's livelihoods.[827] It is important to recognize that NDRC, which has primary authority to set prices at the central level, is also the principal authority responsible for formulating and implementing industrial policies. (See Factor 5.A. for further discussion.)

Second, for those goods and services for which the Chinese government maintains price controls, it employs a complex and extensive system of government measures to set and guide prices. Lists published by NDRC in December 2016 contain more than 2,500 laws, regulations, and normative documents issued by national and sub-central authorities.[828] The WTO also points out in its 2015 *Trade Policy Review*:

> Although the list of goods and services subject to government prices and government-guided prices has not changed since the previous Review, there have been numerous adjustments to rates and fees. In 2013 (up to 10 December), NDRC issued a total of 22 announcements concerning the pricing of commodities and services, 13 of which related to increases or decreases in the price of fuels."[829]

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[825] *Ibid*.

[826] WTO, *Trade Policy Review*, The People's Republic of China, WT/TPR/S/342 (June 15, 2016), 12. ("China applies price controls, at both the central and provincial levels, on commodities and services deemed to have a direct impact on the national economy and people's livelihoods. These take two forms: government prices, which are fixed prices set by the authorities, and government-guided prices, set within a range. The commodities and services subject to price controls are listed in a Central Government Pricing Catalogue and in Local Government Pricing Catalogues. Since the last Review, China has liberalized the price of several goods and services, such as the ex-factory price of explosive materials, the charges for some construction projects, and the prices of military goods and of tobacco leaves. Government-set prices are currently applied to refined oil products, natural gas, certain medicines, and some services. Products classified as important central reserve materials (grain, cotton, sugar, filature silk, crude oil, processed oil, and chemical fertilizers) are no longer subject to government-set prices.")

[827] The *Pricing Law*, Article 18.

[828] NDRC website, available at http://jgs.ndrc.gov.cn/zcfg/201612/t20161208_829529.html and http://jgs.ndrc.gov.cn/zcfg/201612/t20161208_829527.html, accessed September 13, 2017).

[829] WTO, *Trade Policy Review*, The People's Republic of China, WT/TPR/S/342 (June 15, 2016), 93.

Most importantly, China's formal price controls for natural gas, refined oil, electricity, water, and transportation services result in some of the most significant distortions in China's economy. These goods and services constitute factor markets that influence costs of production and the final prices of industrial goods, particularly in resource-intensive industries. According to the WTO, China has specific rationales for maintaining price controls for these goods and services, in conformity with provisions set forth in the *Pricing Law*.[830] Yet, authoritative studies have noted the extent to which price controls distort factor markets in China.

Owing to the importance of energy prices for the allocation of resources in China's economy, the electricity sector is discussed in more detail below as a prominent example of government control over key prices.

2.3.Electricity Pricing Policies

Electric power use in China has mirrored the country's rapid and sustained economic growth. Production increased from 590 terawatt hours ("TWh") in 1990 to a world-leading 5,388 TWh in 2014, an eight-fold increase and almost one-quarter of the world's total.[831] Coal-fired generators account for approximately 60% of installed power generating capacity.[832] Studies suggest that Chinese electricity consumers pay low prices by international standards. For example, the World Energy Council, which aggregates cross-country data on the cost of electricity per kilowatt-hour, , estimates the 2012 cost at 5 cents in China, compared to 12 cents in the United States and 28 cents in Japan.[833]

The Chinese government conducted an overhaul of China's utility regulators and operators in 2002-2004. It established an independent electricity regulator, the State Electricity Regulatory Commission (SERC), and divided up the state's power monopoly into five state-owned power generation companies and two transmission and distribution companies—State Grid and the smaller China Southern Power Grid.[834] Concurrent with this institutional change, the government

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[830] *Ibid*., 92. *See e.g.*, electricity price controls: "The rationale for maintaining a price control is that power transmission and distribution are natural monopolies due to the network nature and should be regulated by the Government. In the case of feed-in and users' sales tariff not participating in market competition, the price-setting rationale is to guarantee the interests of producers and consumers." *See also* refined oil price controls: "The rationale for maintaining a price control is the lack of market competition." *See also* natural gas price controls: "The rationale for maintaining a price control is that natural gas is of vital importance to the public and that the natural gas system needs to be reformed comprehensively before prices are liberalized." *See also* railway transportation price controls: "The rationale is that state railways and railways operated by joint ventures in which the Central Government has a controlling stake are under the direction of the China Railway Corporation and therefore should be subject to prices regulated by the Government."

[831] U.S. Department of Energy/Energy Information Agency, *International Energy Statistics* (June 6 2017).

[832] *China Electricity Council*, "Power statistics China 2016: Huge Growth of Renewables amidst Thermal-based Generation," February 9, 2017.

[833] World Energy Council, *2013 Energy Sustainability Index* (2013).

[834] OECD, *China's Power Sector Reforms* (Paris: OECD Publishing, 2006), 13; Ma Chunbo and He Lining, "From State Monopoly to Renewable Portfolio: Restructuring China's Electric Utility," *Energy Policy* 36 (2008): 1703-

began to revise the system for pricing electricity. One important element of the current pricing system is that the government sets different rates at the wholesale (*i.e.* power transmission) and retail (*i.e.* power distribution) level; by province; and for agricultural, industrial, and residential uses, respectively.[835] Another important element of the pricing system is that electricity prices are to be set in accordance with changes in the price of coal, the main feedstock for electricity, based on a price co-movement system. This arrangement is designed so that higher coal prices are transmitted to end-users of coal-fired electricity.[836] This change was instituted after the government began to reduce price controls on power coal in 2004.[837]

In spite of these actions to modify electricity price regulation, several aspects of Chinese government policies serve to distort electricity prices. The first aspect is that SERC, China's independent electricity regulator, does not set electricity prices. Rather, prices are set by NDRC, the government authority that also has authority over industrial policies.[838] This arrangement weakens the ability of SERC to make independent decisions in response to developments in the electricity sector.

A second aspect is that the Chinese government has exercised inordinate discretion over when and how to adjust electricity prices in response to changes in coal prices. Coal prices rose exponentially in the 2006–2012 period, due to the coal price reforms and the rapid growth in Chinese energy consumption. This trend should have prompted an increase in the wholesale and retail electricity price, but NDRC did not make commensurate adjustments to electricity prices.[839] One academic study on this period notes:

1705; Todd J. Edwards, "China's Power Sector Restructuring and Electricity Price Reforms," *Asia Papers* 6(2) (Brussels: Brussels Institute of Contemporary China Studies, January 18, 2012): 17-20.

835 Yiping Huang and Kunyu Tao, *Causes of and Remedies for the People's Republic of China's External Imbalances: The Role of Factor Market Distortion*, Working Paper Series No. 279 (Asian Development Bank Institute, April 2011), 14; WTO, *Trade Policy Review*, The People's Republic of China, WT/TPR/S/342 (June 15, 2016), 92.

836 Michael G. Pollitt, Chung-Han Yang, and Hao Chen, *Reforming the Chinese Electricity Supply Sector: Lessons from International Experience*, Working Paper 1704 (Energy Policy Research Group, March 2017), 5-6. OECD, *China's Power Sector Reforms* (Paris: OECD Publishing, 2006), 54-55. *See also* Ma Chunbo and He Lining, "From State Monopoly to Renewable Portfolio: Restructuring China's Electric Utility," *Energy Policy* 36 (2008): 1703-1705; Todd J. Edwards, "China's Power Sector Restructuring and Electricity Price Reforms," *Asia Papers* 6(2) (Brussels: Brussels Institute of Contemporary China Studies, January 18, 2012): 17-20.

837 Zhong Xiang Zhang, "Energy Prices, Subsidies, and Resource Tax Reform in China," *Asia & Pacific Policy Studies* 1(3) (September 2014): 440. ("In 2004, NDRC abolished its guidance price for power coal and set price bands for negotiations between coal producers and electricity generators. NDRC widened those bands in 2005; in 2006, it scrapped them altogether.")

838 Yiping Huang and Kunyu Tao, *Causes of and Remedies for the People's Republic of China's External Imbalances: The Role of Factor Market Distortion*, Working Paper Series No. 279 (Asian Development Bank Institute, April 2011), 15. ("Electricity tariffs are set by the National Development and Reform Commission (NDRC), although the authorities sometimes hold public hearings to improve decision-making quality.")

839 Todd J. Edwards, "China's Power Sector Restructuring and Electricity Price Reforms," *Asia Papers* 6(2) (Brussels: Brussels Institute of Contemporary China Studies, January 18, 2012): 19-22.

> To respond to electricity generators' concerns, NDRC proposed in May 2005 a coal electricity price 'co-movement' mechanism that would raise electricity tariffs if coal prices rose by 5 per cent or more in no less than six months, and allowed electricity generators to pass up to 70 per cent of increased fuel costs on to grid companies, and grid companies to pass costs on to consumers. However, because of fears of inflation, the co-movement policy had not been implemented as the conditions met, and power tariffs continue to remain flat while coal prices rise.[840]

Ryan Rutkowski, an economist at the Peterson Institute for International Economics, notes that "[i]f coal prices rise once again, the state still has complete control over end user pricing, and thus can limit pass-through of rising on-grid tariffs. The 5% threshold for annual adjustment to on-grid tariffs also leaves plenty of room to squeeze thermal power producers once again."[841] Notably, a similar disconnect between upstream and downstream prices is evident in China's regulation of oil prices.[842]

A third aspect that distorts electricity prices in China is the Chinese government's use of discriminatory pricing measures to achieve industrial policy objectives. An important facet of this policy is the use of "differential pricing." In 2006, NDRC issued the *Opinion on Optimizing Differential Electricity Pricing Policies*.[843] The measure calls for using differential energy pricing as a regular tool for pursuing national industrial policies to reduce excess and obsolete capacity, streamline industrial structures, and upgrade production technologies. It also calls for energy price increases specifically for companies that employ production technologies listed in the restricted or prohibited categories of the *Guidance Catalogue for the Structural Adjustment of Industries*.[844] According to one study:

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[840] Zhong Xiang Zhang, "Energy Prices, Subsidies, and Resource Tax Reform in China," *Asia & Pacific Policy Studies* 1(3) (September 2014): 440.

[841] Ryan Rutkowski, "Rebalancing and Rising Electricity Prices in China," *China Economic Watch* (Peterson Institute for International Economics, February 18, 2014).

[842] *See* Yiping Huang and Kunyu Tao, *Causes of and Remedies for the People's Republic of China's External Imbalances: The Role of Factor Market Distortion*, Working Paper Series No. 279 (Asian Development Bank Institute, April 2011), 15. ("In 1998, in an important step of oil price liberalization, the State Council announced a formula linking domestic prices to the weighted average of prices in New York, Singapore, and Rotterdam. NDRC would adjust domestic prices, with a couple of months' delay, if the international weighted average moved by more than 8%. In 2000, NDRC raised oil prices seven times in order to bring domestic prices closer to international levels. However, when international prices moved violently, NDRC became reluctant to follow for fear of disrupting economic growth. For instance, when international crude prices reached their recent peak at close to US$150 per barrel in 2008, the equivalent domestic prices were only around US$80 per barrel. But oil price distortions are highly volatile, given the State Council's formula and fluctuations in the international markets.")

[843] S*tate Council Notice on Reissuing the National Development and Reform Commission Opinion on Optimizing Differential Electricity Pricing Policies* (State Council, Guo Ban Fa [2006] No. 77, issued September 17, 2006).

[844] NDRC further specified differential pricing policies in subsequent measures, in conjunction with barring the use of "preferential prices" for specific industries. *Notice on Problems Relating to Further Carrying Out and Implementing Differential Pricing Policies* (NDRC, Fa Gai Jia Ge [2007] No. 155, issued September 30, 2007).

> By 2015, the practice [of differential electricity pricing] has not only been implemented nationwide, it has also been generally accepted as a way to guide corporate decision making. While the actual contribution of differential energy pricing is hard to gauge and has been overshadowed by changing economic trends and policy strategies, differential pricing has become a mainstay of the industrial policy tool box. The number of laws, circulars, opinions, guidelines and measures that include this concept and similar approaches has increased across a wide range of policy fields.[845]

Recently, in the context of the "supply-side structural reform" initiative (see discussion in Factor 5.B.), the Chinese government has recommended the use of "differential pricing," as well as "scaled pricing" and "punitive pricing," as a tool to shed excess capacity. The 2017 *Guiding Opinion of 16 Government Departments on Utilizing Comprehensive Standards to Promote the Shedding of Obsolete Industrial Capacity According to the Law* calls for the application of these pricing policies to industrial capacity in the steel, cement and aluminum industries as well as other industries with energy and electricity consumption that exceed the mandatory standards. The guiding opinion also calls for application of these pricing policies to industries with obsolete industrial capacity as defined under the *Structural Adjustment Catalogue*.[846] The result of these policies is that the government not only sets prices, but also sets individual rates for specific end-users, thereby further distorting the electricity market.

The Chinese government recently reiterated its goals to modify electricity sector policy in its 2015 *Several Opinions on Further Deepening Institutional Reform of the Electric Power Industry*.[847] The proposed modifications focus on the wholesale market, introducing competition to the retail market, direct power sales to large industrial end-users, and cost-based transmission and distribution tariffs (the latter two on a trial basis).[848] Electric power distributors can now vary rates for residential users directly with demand and peak usage times.[849] Generators and large industrial end-users also in some cases directly negotiate electricity prices.[850] While these modified policies could mark an important step forward, they fall short of establishing true

[845] Markus Taube and Christian Schmidkonz, *Assessment of the Normative and Policy Framework Governing the Assessment of the Normative and Policy Framework Governing the Chinese Economy and Its Impact on International Competition*, Final Extended Report for AEGIS Europe (Think!Desk China Research & Consulting, August 13, 2015), 196.

[846] *Guiding Opinion of 16 Government Departments on Utilizing Comprehensive Standards to Promote the Shedding of Obsolete Industrial Capacity According to the Law* (MIIT, Gong Xin Bu Lian Chan Ye [2017] No. 30, issued February 17, 2017).

[847] *Several Opinions on Further Deepening Institutional Reform of the Electric Power Industry* (CCPCC, State Council, Zhong Fa [2015] No. 9, issued March 15, 2015).

[848] National University of Singapore/Energy Studies Institute, *A New Chapter in China's Electricity Market Reform*, Policy Brief No. 13 (March 21, 2016).

[849] Se Yan and Shuang Ding, *China – Price Guidelines Advance 'Deep Reforms'* (Standard Chartered Global Research, November 2015), 4-5.

[850] The Energy Collective/Regulatory Assistance Project, *Wholesale Electricity Markets and Pricing in China: How is Reform Going?* (October 5, 2016).

market-based power markets and energy pricing. China's electricity sector lacks independent systems operators; spot markets have yet to develop; and the government has yet to articulate the "rules of the game" in the retail market. In this institutional framework, competition is governed by administrative rules rather than market rules, particularly as the government still sets prices for industrial and residential users. Notably, some studies indicate that the return on assets of power companies in China remains below their cost of capital, suggesting that prices are still below cost.[851]

C. The Financial Sector

The financial sector is central to the allocation of resources in China's economy. Prior to 2017, the Department's last full assessment of China's financial sector for trade remedy purposes was in the *2006 PRC NME Determination*. The Department found a significant state role in the banking sector, particularly through the high degree of state-ownership or control; the lack of policy independence of PBOC from the Chinese government; and tight regulation of both retail deposit and lending interest rates. The Department concluded that China's banking sector fundamentally distorted not only the allocation of financial resources in China, but also that of material inputs and other important resources.[852]

In July 2017, the Department issued a new review of China's financial sector for the purposes of benchmarking countervailing duty rates ("*2017 CVD Review*"), updating the findings of *2006 PRC Lined Paper*.[853] At the time of *2006 PRC Lined Paper*, China's financial sector was bank-dominated, such that the Department's analysis focused exclusively on the formal banking sector. Due to financial sector growth outside the formal banking sector in the ensuing years, the *2017 CVD Review* expands the scope of analysis to include the interbank market, the bond market and "shadow banking," as well as corresponding interest rates and yields.[854]

Part C begins by discussing institutional features of the formal banking sector. It then discusses interest rate controls and dynamics, including an evaluation of the recent changes to lending and deposit rate policy. Section C concludes with a discussion of "shadow banking" and bond markets.

The Department's *2017 CVD Review* finds that in spite of PBOC's relaxation of interest rate controls and other adjustments to financial regulation since 2006, fundamental distortions remain in China's financial sector from both a risk pricing and a resource allocation standpoint. These

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[851] *Ibid. See also* Se Yan and Shuang Ding, *China – Price Guidelines Advance 'Deep Reforms'* (Standard Chartered Global Research, November 2015), 4-5; National University of Singapore/Energy Studies Institute, *A New Chapter in China's Electricity Market Reform*, Policy Brief No. 13, March 21, 2016; and Ryan Rutkowski, "Rebalancing and Rising Energy Prices in China," in *China Economic Watch* (Washington: Peterson Institute for International Economics, February 18, 2014).

[852] *2006 PRC NME Determination*, 51-62.

[853] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017).

[854] *Ibid*., 3.

distortions are the result of government ownership and control, and the state's pervasive and intrusive role in China's financial system. The Department incorporates the *2017 CVD Review*, a summary of which is provided below, in its entirety into the current review of China's status as a NME country.

1. *Institutional Features of the Formal Banking Sector*

China's banking sector is the largest in the world, and China's four largest banks are also the world's four largest. Although other types of financial institutions are emerging, China's financial sector remains bank-dominated. For example, bank loans in the first quarter of 2016 were 142% of GDP, compared to 79% for "shadow banking" loans, 23% for net corporate bond financing, and 7% for non-financial enterprise equity.[855]

In spite of banking sector reforms and ownership diversification, effective state control over the banking sector remains dominant. China's banking sector is principally comprised of the following institutions:

(1) five large commercial banks ("Big Five") that are majority state-owned, operate large branch networks on a nationwide basis, and accounted for approximately 40% of bank assets in 2015;

(2) 12 joint-stock commercial banks (JSBs) that operate with generally lower levels of direct government ownership, operate on a nationwide basis, and accounted for approximately 19% of bank assets in 2015;

(3) approximately 145 city commercial banks and credit unions that generally remain under local government control, serve local markets, and accounted for approximately 14% of bank assets in 2015;

(4) three wholly state-owned policy banks that focus on infrastructure, agriculture and rural development, and foreign trade, respectively, and accounted for approximately 10% of bank assets in 2015;[856] and

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[855] *Ibid*., 4. *See e.g.*, IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 42; Moody's Investor's Service, *Quarterly China Shadow Banking Monitor* (April 2016), 6, for figure on shadow banking.

[856] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 4-6. *See e.g.*, China Banking Regulatory Commission, *China Banking Regulatory Commission 2015 Annual Report* (2015), 26, 192; Douglas Elliott and Kai Yan, *The Chinese Financial System: An Introduction and Overview*, Monograph Series, Number 6 (The Brookings Institution, John L. Thornton China Center, July 2013), 3; *KPMG*, "2016 Q3 China's Banking Sector: Performance of Listed Banks and Hot Topics," December 2016, 88. *See also Reuters*, "BRIEF – China Bank Sector's Total Assets Reach $29.8 Trillion - Regulator," September 26, 2016.

(5) foreign-owned banks and bank branches that accounted for 2% of bank assets in 2015, unchanged from 2006.

In addition to government ownership, government influence over banking decisions is evident from the following indicia:

- The CCP, through its Organization Department, appoints executive officials in state-owned banks and financial institutions. According to a report by the Brookings Institution, "[u]nlike in the West, the careers of the most important bankers are determined by the Party."[857]

- PBOC meets frequently with large banks to ensure that their lending decisions align with PBOC and government objectives. PBOC "window guidance" on where (and where not) to direct credit is industry-specific and sometimes firm-specific.[858]

- The *Commercial Banking Law of the People's Republic of China* ("*Commercial Banking Law*") provides that "commercial banks shall conduct their business of lending in accordance with the needs of the national economic and social development and under the guidance of the industrial policies of the State."[859]

- Industrial policy catalogues, such as *the Guidance Catalogue for the Structural Adjustment of Industry*, call on financial institutions to provide credit in support of investment projects.[860]

In many transactions in China's banking sector, both the lender and the borrower are state-owned and -controlled. Several problems arise from this dynamic. First, according to the World Bank, there is "*disintermediation of the non-state sector*, especially micro, small, and medium enterprises that have significantly less access to formal financial institutions than state

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[857] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 6. *See also* Douglas Elliott and Kai Yan, *The Chinese Financial System: An Introduction and Overview*, Monograph Series Number 6, (The Brookings Institution, John L. Thornton China Center, July 2013), 3.

[858] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 7. *See also* Aidan Shevlin, and Lan Wu, *China: The Path to Interest Rate Liberalization* (J.P. Morgan Asset Management, 2015), 7; *PRC Macro*, "Bailing China 'In' to the Great State Refinancing," February 19, 2016, 3.

[859] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 6-7.

[860] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 6-7. *See e.g.*, the first edition, *Guidance Catalogue for the Structural Adjustment of Industry (2005 Edition)* (NDRC, Order [2005] No. 40, issued December 2, 2005). *See also* the most recent edition, *Guidance Catalogue for the Structural Adjustment of Industry (2011 Edition) (2013 Revision)* (NDRC, Order [2013] No. 21, issued February 16, 2013).

enterprises and large firms." (emphasis added)[861] Second, many loans are backed by *implicit government guarantees*, wherein government assumption of the risk on the loans incentivizes both state-owned and non-state-owned banks to lend to SIEs, even if it is clear over time that SIEs are not putting the funds to best use.[862] Third, SIE borrowers experience *soft budget constraints*, *i.e.*, the lack of any meaningful budget constraint that makes an enterprise responsible for its own investment or production losses because the enterprise receives financial assistance or support to cover those losses on an ongoing basis. Soft budget constraints exacerbate the problems of implicit guarantees by further insulating SIE managers from the consequences of imprudent production and investment decisions.[863]

Whereas market-based banking systems in principle allocate credit to its best use, a significant share of total credit in China is put to unproductive use, owing largely to the problems described above. Several facts, taken together, point to systemic misallocation of credit. At the macro-level, the credit intensity of China's GDP (new credit per unit of additional GDP) has doubled since before the 2008 financial crisis, in conjunction with an increase in the share of bank loans as a percentage of GDP.[864] Credit growth is concentrated in the corporate sector in spite of rising financial stress, falling profitability and growing inter-enterprise payment arrears.[865] Within the corporate sector, SIEs account for only 16% of value-added (down from 40% a decade earlier) but account for half of total bank credit.[866] Non-viable companies in industries with over-

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[861] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 7. *See also* World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 28.

[862] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 8. *See e.g.*, IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 33; *BNP Paribas*, "China: Moving Towards a New Monetary Policy Era," November 4, 2015, 2.

[863] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 8. *See e.g.*, IMF, *Resolving China's Corporate Debt Problem,* IMF Working Paper WP/16/203 (October 2016), 7, 14.

[864] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 9-10. *See e.g.*, IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 5; Moody's Investor Service, *Quarterly China Shadow Banking Monitor* (April 2016), 6. *See also* IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 39.

[865] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 9. *See e.g.*, IMF, *Global Financial Stability Report: Potent Policies for a Successful Normalization* (April 2016), 13-16.)

[866] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 9. See *e.g.*, IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 38.)

capacity continue to receive financing,[867] and the share of loans going to firms with low debt-service capacity continues to increase.[868]

As a result of systemic credit misallocation, China now faces a serious debt problem. Two-fifths of new debt has gone toward paying interest on existing loans, while non-performing loans (NPLs) and special mention loans (SMLs) (loans with which borrowers are experiencing difficulties) have also increased rapidly in recent years.[869] Asset management companies, first established in the late 1990s to help commercial banks dispose of bad loans, have become a persistent presence in China's financial sector.[870]

2. *Interest Rate Controls and Dynamics*

As recently as 2013, PBOC set benchmark lending (and deposit) rates on an administrative basis, as well as floors (ceilings) under (above) which banks could not set their loan (deposit) rates. The combination of a lending rate floor and a deposit rate ceiling effectively guaranteed banks a minimum mark-up on all the RMB loans they made. As a result, banks became accustomed to viewing loan pricing as primarily an administrative process and did not sufficiently collect and

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[867] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 9. *See e.g.*, IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 5.

[868] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 9. *See e.g.*, IMF, *Resolving China's Corporate Debt Problem*, IMF Working Paper WP/16/203 (October 2016), 7. *See also* IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 10.

[869] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 10. *See e.g.*, IMF, *Global Financial Stability Report: Potent Policies for a Successful Normalization* (April 2016), 14; IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 20. *See also The Economist*, "Breaking Bad," May 7, 2016. *See also* Jason Bedford, "Are We Through the Worst of the Credit Cycle: What the Banks Tell Us," *UBS*, November 1, 2016, 1.

[870] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 11. *See e.g.*, AMCs were first established in 1999 to deal with the NPL problem at the time and help China's four largest banks clean up their balance sheets. Although these AMCs were to have a limited life span, they remain in operation today and continue to bleed NPLs out of the system. The original ten-year life span of the AMCs suggests they were established to deal with what was supposed to be a temporary problem. Their continued existence suggests that they have been simply treating symptoms, and not addressing underlying causes, of the NPL problem. The AMCs also refinance loans, which in many cases just delays NPL recognition, and banks sell some NPLs through repurchase agreements to AMCs, where the bank agrees to buy back the loans at a future date. For these reasons, many believe the actual NPL rate is much higher than official estimates suggest. *The Economist*, "Lipstick on a Pig," August 24, 2013; Jason Bedford, "China's AMCs: Cleaning Up or Kicking the Can?" *UBS*, February 6, 2017, 1 and 11; OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2017), 17.

analyze credit and market data to price risk.[871] Further reinforcing these tendencies were the implicit guarantees on loans to SIEs, as described above.[872]

Since 2006, China has removed formal interest rate controls – most recently, the floor on lending rates in July 2013 and the cap on deposit rates in October 2015. However, PBOC continues to publish benchmark deposit and lending rates, which are now referred to as "reference rates."[873] While there may be some legal or policy distinction between the terms "benchmark rates" and "reference rates," there appears to be little practical effect of this change.[874] For example, PBOC and other PRC government agencies continue to refer to "benchmark interest rates" in notices published in 2016, including one that directs lenders to set mortgage rates on the basis of PBOC's "benchmark rate."[875] A recent PBOC working paper found that benchmark deposit and loan rates remain the primary basis for pricing deposits and loans.[876] Indeed, respected analysts of China's economy find that actual deposit rates are still closely tied to the benchmark deposit rate, and since benchmark deposit rates are well below market-clearing levels, actual deposit rates are still well below market-clearing levels as well.[877] Moreover, in a formal legal sense, the

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[871] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 13. *See e.g.*, World Bank, *China 2030: Building a Modern, Harmonious, and Creative Society*, Report No. 96299 (March 2013), 119.

[872] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 13.

[873] *Ibid*., 13. *See e.g.*, Fitch Ratings, *China Deposit Cap Removal – Little Impact on Bank Margins* (October 27, 2015). *See also* Jinyue Dong and Le Xia, *China: Looking for New Monetary Policy Tools in the Liberalized-Interest-Rate Environment* (Banco Bilbao Vizcaya Argentina, February 2016, 2.

[874] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 14-15. *See e.g.*, In 2013, the PBOC launched the loan prime rate, essentially an average of commercial banks' lending rates to their best clients, in an attempt to establish a reference rate that would encourage market-determined loan pricing. But if commercial banks for whatever reason are, to a large extent, still referring to the PBOC reference rate for loan pricing purposes, the loan prime rate would track the reference rate and in doing so would not function as an independent reference rate. Data indicate this is indeed the case. In 2015, two years after the lending rate floors were removed, approximately 90% of rates still clustered closely around the benchmark. Aiden Shevlinand Lan Wu, *China: The Path to Interest Rate Liberalization* (J.P. Morgan Asset Management, 2015), 5; IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 14; OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2017), 17.

[875] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 13. *See e.g.*, *Notice of the People's Bank of China, the China Banking Regulatory Commission, the China Insurance Regulatory Commission, and Other Departments on Issuing the Interim Measures for the Pilot Program of Granting Mortgage Loans Secured with Farmers' Housing Property Rights*, Article 7 (PBOC, CBRC, CIRC, issued March 15, 2016).

[876] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 13. *See e.g.*, Jun Ma, Min Ji, Muhong Niu, and Xiang Zhang, *Transmission of Monetary Policy Via the Banking System*, Working Paper No. 2016/4 (PBOC, April 8, 2016), 6.

[877] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 14. *See* OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2017), 17, on benchmark deposit rates being below market-clearing levels before controls were

Chinese government has not amended Article 38 of the *Commercial Banking Law*, which provides that "a commercial bank shall determine its loan rate in accordance with the upper and lower limit of loan rates set by the People's Bank of China."[878]

The distortive effects of PBOC interest rate guidance and administratively-set reference rates are further visible in the context of the interbank market, where controls on lending and repo rates have long been removed. In a market system, retail lending rates (as well as other financing rates, both short- and long-term) tend to rise and fall with changes in the (wholesale) cost of funds in the interbank market. Borrowers pay more for loans when interbank funding is relatively scarce, and less for loans when such funding is abundant. In China, however, the correlation between interbank rates and retail financing rates is relatively weak. A key reason is that banks set loans rates based on PBOC's administratively-set reference rates rather than their interbank cost of (borrowed) funds. The same is true for (short-term) money market rates, which are one step removed from interbank rates towards the retail end of the market, because PBOC actually calibrates the liquidity impact of its policy actions to ensure that these rates closely track its own administratively-set benchmark rates.[879]

3. *Shadow Banking*

The Financial Stability Board broadly defines shadow banking as credit intermediation involving entities and activities outside the formal banking sector.[880] Because of binding regulatory constraints that limit the flow of loans in the formal bank channel, much of shadow banking in China is formal bank channel lending flowing or spilling over into the informal finance channel. Roughly two-thirds of shadow banking is effectively "bank loans in disguise," where a bank serves as the driving force behind a loan transaction and assumes all the risk, but "channels" new loans through a non-bank financial institution (NBFI) intermediary to avoid costly capital and loan-loss provisioning requirements, reserve requirements, and government lending directives.[881]

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removed; Moody's Investor Service, *Quarterly China Shadow Banking Monitor* (April 2016), 24. *See also Financial Times*, "China Lifts Interbank Rates Following Fed Hike," March 15, 2017, on benchmark deposit and lending rates remaining unchanged.

878 U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 14. (*See also Commercial Banking Law*, Article 38.)

879 U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 15-16. *See e.g.*, Nathan Porter and Tengteng Xu, "Money-Market Rates and Retail Interest Regulations in China: The Disconnect Between Interbank and Retail Credit Conditions," *International Journal of Central Banking* (March 2016), 143; Jun Ma, Min Ji, Muhong Niu, and Xiang Zhang, *Transmission of Monetary Policy Via the Banking System*, Working Paper No. 2016/4 (The People's Bank of China, April 8, 2016), 6. *See also* IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 8.

880 U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 16. *See e.g.*, Financial Stability Board, G*lobal Shadow Banking Monitoring Report* (November 14, 2013), 1.

881 U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 18. *See e.g.*, Trade Beneficiary Rights (TBRs) and Directed Asset

There are several important institutional features of "shadow banking" in China:

- *Trust companies*. These NBFIs are the largest lenders in the Chinese shadow-banking sector and combine bank and investment company functions.[882] Most trust companies are state-owned.[883] Trust companies lend in increasing volumes to local government (-owned) financing vehicles (LGFVs) with inadequate risk pricing.[884]

- *Entrusted loans*. Non-financial companies lend and borrow money between themselves[885] in the form of entrusted loans.[886] A bank often facilitates the transaction for legal reasons, sometimes involving on-lent bank funds borrowed by the first company. The first company can be an SIE leveraging its preferential access to bank credit. Corporate subsidiaries account for 74% of this lending, and 7% is accounted for by more loosely associated group affiliates.[887]

Management Plans (DAMPs) are two investment vehicles that banks use to make new loans that they keep on their books as investment products, rather than loans, thus avoiding the cost of meeting reserve, loan provisioning and capital requirements. Douglas Elliott, Arthur Kroeber, and Qiao Yu, *Shadow Banking in China: A Primer* (The Brookings Institution, March 2015), 1, 9-11.

[882] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 16-17. *See also* Douglas Elliott, Arthur Kroeber, and Qiao Yu, *Shadow Banking in China: A Primer* (The Brookings Institution, March 2015), 7.

[883] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See e.g.*, there is a segment of shadow banking that is essentially made up by private actors on both the borrowing and lending sides. But this segment is only roughly 13.5% of shadow banking assets and 3.7% of total banking assets. The lenders are typically small micro credit companies, and the borrowers are small- and medium-sized firms with effectively no access to formal financing channels. Moody's Investors Service, *Quarterly China Shadow Banking Monitor* (April 2016), 7.

[884] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 16-17. *See also* Moody's Investors Service, *Quarterly China Shadow Banking Monitor* (April 2016), 18.

[885] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See e.g.*, there is a segment of shadow banking that is essentially made up by private actors on both the borrowing and lending sides. But this segment is only roughly 13.5% of shadow banking assets and 3.7% of total banking assets. The lenders are typically small micro credit companies, and the borrowers are small- and medium-sized firms with effectively no access to formal financing channels. Moody's Investors Service, *Quarterly China Shadow Banking Monitor* (April 2016), 7.

[886] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See also* Moody's Investors Service, *Quarterly China Shadow Banking Monitor* (April 2016), 7.

[887] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 17. *See also* Douglas Elliott, Arthur Kroeber, and Qiao Yu, *Shadow Banking in China: A Primer* (The Brookings Institution, March 2015), 7.

- *Banker's Acceptances* (BAs). BAs account for a sizable share of total shadow banking assets.[888] They are essentially IOUs issued by a bank client that constitute a claim on the bank, and as such, function as an off-balance sheet loan from the bank to the bank client, typically backed by the client's deposits with the bank. BAs are priced on the basis of either bank deposit rates (cost of funds basis) or bank lending rates (opportunity cost basis), both of which are set on the basis of administratively set PBOC rates.[889]

- *Wealth management products* (WMPs). Off-balance sheet bank activities in shadow banking are in large part funded through WMPs, which are essentially investment products sold by banks through trust companies and other NBFIs, as well as independently by NBFIs. Retail investors view these as a high-yield, risk-free substitute for bank deposits. The estimated stock of such WMPs increased from nearly RMB 13 trillion in 2012 to over RMB 44 trillion in 2015.[890]

The available evidence indicates that many shadow banking loans are of a non-commercial nature and include refinanced troubled or special mention loans in support of economically unviable firms or financially stressed LGFVs.[891] This high-risk lending by banks (working with NBFIs) is increasingly concentrated in smaller banks with inadequate capital buffers, loan-loss provisioning and risk weighting.[892] This is a spillover of credit misallocation and risk-pricing problems from the formal banking sector into shadow banking.

The spillover problem is exacerbated by the implicit guarantees and soft budget constraints faced by many of the state-owned or state-linked lenders and borrowers.[893] On the funding side of

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[888] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 17. *See also* Moody's Investors Service, *Quarterly China Shadow Banking Monitor* (April 2016), 7.

[889] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 17-18.

[890] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 19. *See also* Lan Shen and Shuang Ding, *China – Taking Stock of Wealth Management Products* (Standard Chartered Global Research, June 7, 2016), 9.

[891] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 19. *See* Jason Bedford, "Are We Through the Worst of the Credit Cycle? What the Banks Tell Us," *UBS*, November 1, 2016, 9. *See also* Lan Shen and Shuang Ding, *China – Taking Stock of Wealth Management Products* (Standard Chartered Global Research, June 7, 2016), 4. *See also* IMF, *Resolving China's Corporate Debt Problem*, IMF Working Paper WP/16/203 (October 2016), 4.

[892] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See* Jason Bedford, "Shadow Loan Books, WMPs and a Rmb3.1trn Capital Hole," *UBS*, June 2, 2016, 1, 3-5, 11, 13, 15-16. *See also* IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 10.

[893] U.S. Department of Commerce, Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes (July 21, 2017), 19. *See* Douglas Elliott and Kai Yan, *The Chinese Financial System: An*

shadow banking, retail investors frequently treat WMP investments as fully protected and backed by a bank or ultimately the government,[894] and therefore accept a lower yield than they would otherwise. Investors have also purchased WMPs sold by smaller institutions that tend to be more aggressive in pursuing risky investments.[895] Because investors are willing to accept returns lower than what would reflect the true risk of the investment, the cost of funds for the borrowers is also lower.[896]

Shadow banking attempts to meet the growing needs of China's household and SME sectors, which are under-served by the formal banking sector. However, it does so within an institutional framework in which it is not, and indeed cannot be, isolated or insulated from the distortions that pervade the formal banking sector.

4. Bond Markets

China hosts a rapidly growing domestic bond market,[897] now the world's third largest. Yet, measured as a share of GDP, China's bond market is only the tenth largest in the world, and it is much smaller than China's banking sector.[898] Corporate sector bonds account for only one-third

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Introduction and Overview, John L. Thornton China Center Monograph Series Number 6 (The Brookings Institution, July 2013), 27.

[894] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See* Douglas Elliott and Yu Qiao, *Reforming Shadow Banking in China* (The Brookings Institution, May 2015), 10.

[895] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See also* IMF, *2016 Article IV Consultation – Press Release: Staff Report; and Statement by the Executive Director for the People's Republic of China*, IMF Country Report No. 16/270 (August 2016), 10.

[896] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 20. *See also* OECD, *OECD Economic Surveys: China* (Paris: OECD Publishing, 2017), 20.

[897] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 21-22. *See e.g.*, Contributing to the growth of municipal and corporate bonds is the new budget law, passed in 2014, which permits local governments to issue bonds, and the relaxation of government restrictions on access to the market. All companies, not just those listed on exchanges, now have access to the corporate bond market, and the approval process has been simplified. Becky Liu and Shankar Narayanaswamy, *China's Bond Markets: The Start of a Golden Age* (Standard Chartered Global Research, February 29, 2016), 15.

[898] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 21. *See also* Becky Liu and Shankar Narayanaswamy, *China's Bond Markets: The Start of a Golden Age* (Standard Chartered Global Research, February 29, 2016), 1, 5, 8.

of China's bond market; they largely constitute short-term bonds including commercial paper and medium term notes, as well as enterprise bonds, which include local government bonds.[899] In several respects, China's bond markets do not operate on a market-oriented basis. First, similar to bank loan transactions, state-owned and government-linked entities predominate on both the supply and demand sides of the bond market. Ninety-four percent of bonds are issued by government-owned entities,[900] including policy banks, SIEs, local governments, and LGFVs.[901] SIEs and LGFVs have issued an estimated 94% of the corporate bonds outstanding, including shorter-dated instruments such as commercial bills and medium-term notes.[902] With commercial banks holding over 60% of all bonds and over 70% of Treasury bonds,[903] government-owned entities account for the majority of bond holdings. Experts believe banks will remain the primary buyers of local government bonds in the near-term.[904] Such transactions raise concerns about the possibility of non-arm's-length relationships and "aligned interests" among the parties that do not characterize market-determined transactions.[905] Moreover, funds raised through the issuance of corporate bonds are required under the *Securities Law of the People's Republic of China* to comply with state industrial policies and yield rates are not to exceed the interest rate level set by the State Council.[906]

Second, bond yield curves are not fully market-determined. In a market system, a (risk-free) government bond yield curve typically serves as a reference point or benchmark for the pricing

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[899] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 22. *See also* Kenneth Ho, MK Tang, Hao Tang, and Maggie Wei, *China's Domestic Bond Market* (Goldman Sachs, September 21, 2015), 8-9.

[900] *Ibid*.

[901] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 22. *See also Financial Times*, "China Local Governments Revive Off-Budget Fiscal Stimulus," September 21, 2016.

[902] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 22-23. *See also* IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 32-33.

[903] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 23. *See also* JC Sambor and Kevin Sanker, *China Spotlight: Onshore Bond Market: Where to from Here?* (Institute of International Finance, April 27, 2016), 6.

[904] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 23. *See also* Becky Liu and Shankar Narayanaswamy, *China's Bond Markets: The Start of a Golden Age* (Standard Chartered Global Research, February 29, 2016), 22.

[905] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 23.

[906] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 23. *See also Securities Law of the People's Republic of China*, Articles 16(4) and 16(5) (National People's Congress, issued December 29, 1998, amended August 28, 2004, further amended June 29, 2013 and August 31, 2014).

of corporate bonds, which are essentially marked up to produce a higher yield for risk the investor assumes.[907] In China, however, the benchmark effect of the Treasury yield curve remains weak due to lower trading volumes and frequencies. Problems with the issuance structure impact the completeness of the yield curve.[908] Commercial banks do 70% of all trading in the interbank bond market, but at the same time hold 75% of all outstanding bonds to maturity.[909]

Finally, the implicit guarantees for state-owned and -controlled entities encourage commercial banks to view bond purchases and sales purely in paperwork or administrative terms, rather than as market transactions requiring careful consideration of economic and financial factors. According to a recent IMF report, "the prevalence of implicit state guarantees prevents the appropriate (usually countercyclical) pricing of credit risk in the bond market."[910]

D. Assessment of Factor

Under this factor, the Department analyzed China's (1) state industrial policies; (2) price regulation; and (3) financial sector. The Department discussed in each of these areas the government's direct and indirect role in resource allocations, which in turn distort price and output decisions of enterprises. In sum, the Department finds that the extent of government control over the allocation of resources is significant and far-reaching.

Industrial policies remain a prominent mechanism through which the Chinese government influences the allocation of resources in China's economy. State planning remains an important feature of industrial policies, as evidenced by formal mechanisms of plan formulation and review and the scope and specificity of sectoral-level plans. Various institutions participate in plan formulation and execution, including central regulatory authorities, local governments, organs of the CCP, and the enterprise sector. Indeed, industry policy-making is a key instrument linking the CCP to state administration: formulating and executing state plans remains one of the most important tasks for government officials, the majority of whom are CCP members and are subject to internal evaluation by the CCP for future promotion.

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[907] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 24. *See also* J.P. Morgan, *China Onshore Bond Market: Kill Two Birds with One Stone*, August 2015, 2.

[908] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 24. *See also* Jun Ma, Min Ji, Muhong Niu, and Xiang Zhang, *Transmission of Monetary Policy Via the Banking System*, Working Paper No. 2016/4 (PBOC, April 8, 2016), 9. *See also Bloomberg News*, "Figuring Out China's Monetary Policy Just Got Trickier," October 26, 2015.

[909] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 24. *See also* J.P. Morgan, *China Onshore Bond Market: Kill Two Birds with One Stone* (August 2015, 7).

[910] U.S. Department of Commerce, *Review of China's Financial System for Countervailing Duty (CVD) Benchmarking Purposes* (July 21, 2017), 24-25. *See also* IMF, *The People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (July 2016), 14.

The Chinese government is also able to employ numerous mechanisms to implement industrial policy objectives, including, *inter alia*, investment approvals, access standards, guiding catalogues, financial supports, and quantitative restrictions. Science and technology development and industrial restructuring are two areas that demonstrate the extent to which the government is willing and able to use industrial policies to achieve objectives such as transferring industrial assets between sectors and regions and promoting indigenous innovation. Efforts to reduce corporate debt and shed excess capacity, in the context of the recent SSSR initiative, also demonstrate how the government seeks to increase government intervention in the economy to resolve problems that primarily affect SIEs and that are largely the result of government policies.

An essential element of a market-based economic system is the predominance of prices that reflect relative scarcity. In a well-functioning market economy, scarcity-based prices determine the allocation of resources, guide the selection of investments, and help determine the relationship between supply and demand of factors of production and goods and services. The prices of most goods and services in China today are not formally controlled by the government. However, the Chinese government retains substantial discretion and employs an extensive system of national and local government policies and regulations through which it explicitly determines or otherwise exerts a high degree of control over prices it deems essential or strategic. The system of price controls is characterized by an extensive web of national and local price control regulations, and by the prominent role of NDRC in setting prices in tandem with its functions in formulating industrial policies.

The Chinese government's ability to set and influence factor input prices, in particular, results in distorted costs and prices throughout the economy and a serious misallocation of resources. In the electricity sector, the government has altered institutional arrangements and pricing systems, partly in order to better align electricity prices with the cost of coal inputs. However, these alterations have not significantly reduced the government's ability to set prices at very low levels, and to employ "differential pricing" as a policy tool to achieve capacity shedding and other industrial policy objectives. Government-set and -guided prices do not reflect the real degree of scarcity in the economy, and the government's tight control over the allocation of factors of production means that the role of the market in setting factor and input prices is subordinate to the government's discretionary intervention.

Although there has been nominal liberalization of most prices in China, the state continues to directly influence or regulate the price of key inputs and primary factors of production, including capital, land, labor and energy. Moreover, the state's pervasive and intrusive role in how these factors and other resources are allocated necessarily distorts prices, in general, on a systemic basis.

The financial sector remains fundamentally distorted, from both a risk pricing and a resource allocation standpoint. In addition, although the government nominally removed the last remaining control on lending and deposit rates at the end of 2015, an analysis of interest rate dynamics suggests that interest rates are still closely tied to government-published "reference rates," and are thus not yet market-determined. Soft budget constraints, non-arm's-length pricing, implicit government guarantees and government policy directives directly or indirectly distort the formal banking sector, the interbank market, the bond market, and "shadow banking."

These distortions can be directly tied to government ownership and control and to the state's pervasive and intrusive role in China's financial system, and most clearly manifest themselves in the growing corporate debt problem. At the end of 2015, total credit and bank credit to the private non-financial sector stood at 202% and 153% of GDP, respectively,[911] with a very high total credit-to-GDP ratio some 27% over trend.[912] This is well over the 10% that the BIS considers a warning signal,[913] and suggests credit growth that far exceeds optimal financial deepening for a country at China's level of economic development.[914] Much of this credit is allocated to economically unviable firms that do not make productive use of the borrowed funds.

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[911] *Statistical Tables* (Bank for International Settlements website, available at http://www.bis.org/statistics/tables_f.pdf). Credit growth and level are high regardless of whether and to what extent local government financing vehicles are included in the private non-financial sector.

[912] *Ibid*.

[913] Bank for International Settlements, "Early Warning Indicators," *BIS March 2016 Quarterly Review* (March 6, 2016), 28.

[914] IMF, *People's Republic of China: Selected Issues*, IMF Country Report No. 16/271 (August 2016), 32.

Factor Six: Such other factors as the administering authority considers appropriate.

Under this factor, the Department can address any additional issues relevant to its consideration of NME status.[915] In this section, the Department will review the role of China's legal system as a factor bearing on China's economy.[916] Part A considers the institutional role of the CCP that is enshrined in China's legal system, and its impact on economic outcomes. Part B reviews the extent to which individuals and firms are afforded the opportunity to have meaningful independent input into administrative rulemaking or to challenge administrative decisions. Finally, Part C describes how corruption remains a serious concern in China and continues to affect market decisions.

A. China's Legal System and the CCP

The *PRC Constitution* formally entrenches the CCP at the apex of China's legal hierarchy, where it occupies a position "above the law."[917] The *PRC Constitution* repeatedly emphasizes the "leadership" role of the CCP and does not limit the CCP's exercise of power.[918] In particular, the preamble to the constitution includes several references to the CCP's leadership role, while it is otherwise unmentioned in the articles of the constitution that limit the powers of Chinese government institutions.[919] Accordingly, to the extent the CCP acts beyond or even in

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[915] This section also incorporates by reference the discussion of law and legal process in earlier sections of this determination, including, but not limited to, the state's instrumental use of law and the limitations of law in labor dispute resolution, land-use, bankruptcy, antimonopoly, and administrative licensing and regulation.

[916] The Department's analysis focuses on certain key structural features of the Chinese legal system in connection with the Department's analysis of the preceding five factors. This analysis cannot address fully within the context of this memorandum all of the issues in China's legal system. There is a wide body of literature concerning rule of law issues in China, including, *inter alia*, Jianfu Chen, *Chinese Law: Context and Transformation* (Leiden, The Netherlands: Brill Nijhoff, 2015); Yuhua Wang, *Tying the Autocrat's Hands: The Rise of the Rule of Law in China* (New York: Cambridge University Press, 2014); Weifang He, *In the Name of Justice: Striving for the Rule of Law in China* (Washington, D.C.: Brookings Institution Press, 2012); R.P. Peerenboom, *China's Long March Toward Rule of Law* (Cambridge U.K.: Cambridge University Press, 2002); and Stanley Lubman, *Bird in a Cage: Legal Reform in China After Mao* (Stanford, California: Stanford Univ. Press, 2001).

[917] *See e.g.,* Donald Clarke, *China's Legal System and the Fourth Plenum*, Public Law Research Paper No. 2015-27 (George Washington University Law School, 2015), 1-2. (Noting recently announced legal reforms, "the party will remain above the law" and that "the system in which powerful interests can override the law if they wish remains comfortably in place.")

[918] The preamble of the *PRC Constitution* reads: "Under the leadership of the Communist Party of China and the guidance of Marxism-Leninism, Mao Zedong Thought, Deng Xiaoping Theory and the important thought of Three Represents, the Chinese people of all nationalities will continue to adhere to the people's democratic dictatorship and the socialist road […]"

[919] *See PRC Constitution*, Chapter III. *See also* Cheng Li, *Chinese Politics in the Xi Jinping Era: Reassessing Collective Leadership* (Washington, D.C.: Brookings Institution Press, 2016), 43. ("[China's constitution] is rather vague about who wields supreme political power in China. In practice, the CCP is unequivocally in charge at all levels, and the state merely executes party directives.") Larry Cata Backer and Keren Wang, "The Emerging Structures of Socialist Constitutionalism with Chinese Characteristics: Extra-judicial Detention and the Chinese

contravention of a particular law, it may be acting consistently with the *PRC Constitution*.[920] The *PRC Constitution* supports the CCP's instrumental use of law to achieve its political and economic objectives.[921] The CCP's primacy over the law is reflected in its control over China's chief legal and lawmaking institutions, including the People's Congresses at the central and local levels of government, and the People's Courts.

1. *The Legislature*

China's national legislature, NPC, is formally the "highest organ of state power" under the *PRC Constitution*.[922] In this capacity, NPC is empowered to enact and amend basic laws, and the NPC Standing Committee is empowered to enact and amend all other laws, ratify and abrogate treaties, and approve economic and social development plans.[923] According to the *PRC Constitution*, the NPC Standing Committee supervises the State Council, the Central Military

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Constitutional Order," *Pacific Rim Law and Policy Journal* 23 (2014): 252, 256. ("The CCP is organized on the basis of its own constitutional instrument, and its constitutional role is not specified within the State Constitution.") Jianfu Chen, "Out of The Shadows and Back to the Future: CPC and Law in China," *Asia Pacific Law Review* 24(2) (2016): 176-201, 188, 200. ("China, until very recently, had followed the practice found in other socialist countries, that is that the leadership of the Party is to be recognized in the preamble of the constitution, with its actual exercise of power to be carried out through extra-legal constitutional methods." "The Xi-Li administration has now brought the integration of the Party with the state into the open, and thus effectively regressed back to the 1970s in terms of separation of the Party and the state.")

[920] Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 92. ("[T]he] CCP, as the ultimate decision-maker, decides which questions shall be decided by it (jurisdiction) and when it intervenes (timing). It can also review its own previous decisions, and make changes without clear constitutional constraints.") *See also* Kjeld Erik Brødsgaard, "Assessing the Fourth Plenum of the Chinese Communist Party: Personnel Management and Corruption," *Asia Policy* 20 (2015): 35. (Noting that notwithstanding recent CCP statements supporting the "rule of law," "the party will continue to define the law and the Chinese constitutional order.") Stanley Lubman, "The Future of 'Rule According to Law' in China," *Asia Policy* 20 (2015): 2. ("Although the CCP intends to enhance the role of the courts in the party-state governing structure…many questions remain concerning China's legal environment, and the continued primacy of the party, which remains above the law and constitution.")

[921] Rogier Creemers, "China's Constitutionalism Debate: Content, Context And Implications," *The China Journal* 74 (2015), 108. (The "[l]aw is considered as one among many political instruments that can be used to achieve [the CCP's] desired outcomes and coordinate actors' activities."). *See also* Jacques de Lisle, "Law in the China Model 2.0: Legality, Developmentalism and Leninism under Xi Jinping," *Journal of Contemporary China* 26 (2017): 83. ("[The Xi regime's] narrowly instrumentalist conception of law (which implies that perceived conflicts between law reform and the goals of economic development and political stability will not be resolved in law's favor.")

[922] *PRC Constitution*, Article 57.

[923] *Ibid.*, Articles 52, 57, 62, and 67. Similarly, local people's congresses and their respective standing committees are constitutionally empowered to formulate and promulgate local regulations; ensure the implementation of the constitution, the law, and administrative rules and regulations at the local level; adopt and issue resolutions; decide on plans for economic and cultural development; and elect and recall local political and judicial leaders. *See e.g.*, *PRC Constitution*, Chapter III Section 5. ("The Local People's Congresses and Local People's Governments at Various Levels.")

Commission, the Supreme People's Court, and the Supreme People's Procuratorate.[924] NPC also has formal power to appoint and remove the leading officials of each of those organizations, including the President and Vice President, as well as the officials in charge of various ministries and commissions.[925]

In practice, however, the CCP retains strict control over all legislative activity and administrative appointments. First, the CCP generally deliberates and approves all major legislation internally before consideration by NPC.[926] Despite its formal power, NPC has not vetoed legislation referred to it by the CCP.[927] NPC has primarily served the role of translating pre-approved CCP policies into formal laws or regulations. Similarly, provincial people's congresses typically consult provincial Party Committees to vet major legislative decisions.[928] Second, while the *PRC Constitution* formally empowers NPC to appoint officials to key leadership positions of the Chinese state, the CCP's Organization Department and *nomenklatura* process decide who serves in these positions.[929] NPC lacks the institutional authority to reject candidates referred to it by the

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[924] *Ibid*., Article 67.

[925] *Ibid*., Articles 62, 63, and 67.

[926] Tony Saich, *The National People's Congress: Functions and Membership* (Ash Center for Democratic Governance and Innovation, Harvard Kennedy School, 2015), 3.

[927] *See* Jianfu Chen, "Out of the Shadows and Back to the Future: CPC and Law in China," *Asia Pacific Law Review* 24 (2016), 188. ("One thing however is clear: neither the NPC nor its Standing Committee has ever refused to adopt a law suggested by the Party and neither of them has ever adopted law without the prior approval of the Central Committee of the Party."). *See also* Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 79. ("Indeed, it is still not realistic for the NPC to veto a bill or a nominee proposed by the party.")

[928] Guobin Zhu, "Constitutional Review in China: An Unaccomplished Project or a Mirage?" *Suffolk University Law Review* 43 (2010): 627. *See also* Tony Saich, *The National People's Congress: Functions and Membership* (Ash Center for Democratic Governance and Innovation, Harvard Kennedy School, 2015), 3. ("At first glance, these powers seem extensive, as indeed they are, but in practice it is not the NPC that actually exerts them. Major decisions and appointments are made by the CCP, usually ratified by the Central Committee before the NPC and passed on to the NPC for its 'consideration.'")

[929] Susan Lawrence, *China's Political Institutions*, CRS Report No. R43303 (Congressional Research Service, November 12, 2013), 8. ("The head of the [CCP] Organization Department [is] responsible for the recruitment of Party members and their assignment to jobs across the party and state, the legislatures, state-owned corporations, universities, and other public institutions."); Tony Saich, *Governance and Politics of China* (Houndmills, Basingstoke, Hampshire: Palgrave Macmillan, 2011), 123. ("Basically, the [Organization] Department oversees the CCP's *nomenklatura* appointments, these cover all senior ministry appointments, senior judicial appointees, heads of major state-owned enterprises, top university presidents…the editors of key party publications and other media, provincial leaders and the directors of think tanks.") *See also* Kjeld Brødsgaard, "Cadre and Personnel Management in the CPC," *China: An International Journal* 10(2) (2012): 69–83.

CCP.[930] Moreover, in practice, CCP officials typically occupy all key leadership positions of the Chinese state.[931]

More recently, CCP leadership has reaffirmed its control over lawmaking activities in China.[932] For example, in a September 2014 speech, China's President Xi Jinping emphasized that NPC and local people's congresses "must adhere" to the leadership of the Chinese Communist Party.[933] Later that year, the CCPCC proclaimed the CCP's intent to strengthen its leadership over law-making and further stipulated that any major legislative issue that affects a major institutional system or involves major policy adjustment must be submitted to the [CCPCC] for discussion and decision.[934]

2. The Judicial System

The *PRC Constitution* provides that courts at all levels of government are to exercise judicial power independently and without interference from any administrative organ, public organization or individual.[935] The constitution further provides that the NPC Standing Committee is responsible for supervising China's court system.[936] In practice, however, China's courts also remain under CCP control and are expected to perform their judicial functions consistent with the CCP's political, social, and macroeconomic policy objectives.[937] Notwithstanding recent

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[930] Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 79.

[931] Cheng Li, *Chinese Politics in the Xi Jinping Era: Reassessing Collective Leadership* (Washington, D.C.: Brookings Institution Press, 2016), 42. ("Because China operates under a one party-state structure, it is no accident that since the establishment of the PRC, the top leaders have concurrently held the most important positions in the government.")

[932] *China Daily*, "CPC to Strengthen Leadership in Law Making," October 28, 2014.

[933] Xi Jinping, *In the Celebration of the 60th Anniversary of the Founding of the National People's Congress*. [Speech] at the 60th Anniversary of the Founding of the National People's Congress, September 2014. ("In supporting and improving the People's Congress system we must unswervingly adhere to the leadership of the Communist Party.")

[934] *CCP Central Committee Decision Concerning Certain Major Issues in Comprehensively Moving Forward Ruling the Country According to Law*, Article II(2) (adopted by the 18th Central Committee of the CCP at the Fourth Plenary Session on October 23, 2014) ("Fourth Plenum Decision"). *See also Law on Legislation of the People's Republic of China* (*Law on Legislation*), Article 3 (adopted by NPC on March 15, 2000, amended March 15, 2015). (Law-making shall observe the basic principles of the Constitution, take economic construction as its central task, follow the socialist road, adhere to the people's democratic dictatorship, uphold the leadership of the Communist Party[…]) (emphasis added)

[935] *PRC Constitution*, Article 126. ("The people's courts exercise judicial power independently, in accordance with the provisions of law, and not subject to interference by any administrative organ, public organization or individual.")

[936] *Ibid.*, Article 67.

[937] Carl Minzner, "Legal Reform in the Xi Jinping Era," *Asia Policy* (July 2015), 7. ("Party political-legal committees remain intact, and courts are still expected to follow their guidance.")

initiatives to change aspects of the judicial system, the CCP retains the ability to intervene in judicial proceedings and obtain preferred outcomes in individual cases as needed.

The CCP has the ability to exert control over the judicial system through a variety of mechanisms. First, the CCP plays a central role in selecting and promoting judges and other judicial officers, most of whom are themselves members of the CCP.[938] In addition, the CCP supervises the courts through the Central Political and Legal Affairs Committee (CPLC). The CPLC, which falls under the CCPCC, oversees China's courts and other legal institutions on behalf of the CCP, and a member of the Politburo typically serves as its chairperson.[939] The CPLC sets broad judicial policies to ensure that courts carry out their functions consistent with the CCP's policy objectives, including specific regulatory policy objectives being advanced by the CCP.[940] The CPLC also operates as a channel through which the CCP communicates it views on how the courts should handle sensitive cases.[941] While there is no singular definition of what constitutes a "sensitive" case, sensitive cases are generally those that could affect China's political or social stability or economic development,[942] which may include bankruptcy, antidumping, price-setting, antimonopoly, and other types of competition law cases.[943] Local court presidents are usually members of the local-level political and legal affairs committee (PLC) and are obligated to implement policy directives and instructions issued by the CPLC.[944]

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[938] Jacques Delisle, "China's Legal System," in *Politics in China: An Introduction*, (ed.) William A. Joseph (Oxford: Oxford University Press, 2014), 227. *See also* Harry Liu, "Court System" in *Doing Business in China*, (ed.) Moser M., F. Yu (Huntington, NY: Juris Publishing, 2014), Section 2.1.05[1]. ("The Organizational Department of the Central Party Committee screens candidates for top judicial positions before the Standing Committee of the NPC appoints the judges. The same occurs at the local level with the corresponding Party organizational department.")

[939] Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 43.

[940] Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 60. ("The party is likely to take initiatives and instruct courts to issue certain judicial policies if concerted judicial actions are deemed a necessary step to enforcing particular regulatory policies that the party is advancing at the time.")

[941] Yuhua Wang, *Tying the Autocrats Hands* (New York: Cambridge University Press, 2014), 44. ("A concrete mechanism to manipulate judicial cases is the 'three heads meeting' in which the political and legal committee secretary convenes the court president, procuratorate president, and police chief to discuss politically sensitive cases."); Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 83 (on "difficult" and "significant" cases).

[942] Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 67-68.

[943] Yulin Fu and Randall Peerenboom, "A New Analytic Framework for Understanding and Promoting Judicial Independence in China," in *Judicial Independence in China: Lessons for Global Rule of Law Promotion*, (ed.) Randall Peerenboom (New York: Cambridge University Press, 2010) 96. *See also* Harry Liu, "Court System," in *Doing Business in China*, (ed.) Moser M., F. Yu (Huntington, NY: Juris Publishing, 2014), Section 2.1.05[1].

[944] *Ibid. See also* Ling Li, "Chinese Characteristics of the 'Socialist Rule of Law': Will the Fourth Plenum Cure the Problems of the Chinese Judicial System?" *Asia Policy* 20 (2015): 19. ("As party institutions, these groups are mandated to carry out any instructions that they receive from their party superiors through their work as key decision-makers of the courts. When the party engages in judicial decision-making, it does not argue its case.

The CCP thus retains the ability to direct courts to adopt judicial policies that support the advancement of CCP policies and to mandate outcomes in individual court cases. Courts overseeing high profile or "sensitive" cases are expected to adjudicate them in accordance with the CCP's instructions.[945] In high profile cases, CCP officials have issued instructions for the court through either formal letters or discussions with judicial officers.[946] For example, between 2010 and 2011, the Supreme People's Court (SPC) of China received instructions from central CCP leaders regarding food safety scandals and subsequently issued notices urging all courts to increase the severity of punishment for violations of food safety regulations.[947] Moreover, while Chinese courts might be able to accept cases brought against government institutions and adjudicate claims of administrative overreach under the letter of the law,[948] the courts may lack the authority to compel institutions to comply with their rulings without CCP support.[949] The CCP ultimately has the power to shape judicial activities on a large scale by retaining the ability to directly intervene on a case-by-case basis.[950] While the CCP may not intervene in day-to-day judicial activities, since the courts are accountable to the CCP, the judicial system is not designed to operate as a meaningful independent check on the CCP or other state institutions.[951]

Instead, it is entitled to instruct courts in an authoritarian manner… Such a decision-making mechanism is institutionalized in all courts nationwide, which enables the CCP to communicate its instructions and have them implemented by courts and judges of every level and rank whenever and wherever necessary.")

945 Harry Liu, "Court System," in *Doing Business in China*, (ed.) Moser M., F. Yu (Huntington, NY: Juris Publishing, 2014), Section 2.1.05[1].

946 Benjamin Liebman, "China's Courts: Restricted Reform," *Columbia Journal of Asian Law* 21 (2007): 14.

947 Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 61.

948 In fact, China has permitted citizens and enterprises to litigate in court against the government, with administrative laws in place since the early 1990s. *See e.g.*, *Administrative Litigation Law of the People's Republic of China* (adopted by NPC on April 4, 1989, amended November 1, 2014, further amended June 27, 2017).

949 Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 64-66. Even where courts are able to render judgments without significant interference from the CCP, they have little power to enforce those orders without its affirmative backing. This is in part a feature of China's "bureaucratic ranking" system, under which every state institution—including the courts—is assigned a "rank" and the accompanying rule that institutions of equal rank cannot issue binding orders to each other. A court can "command compliance by institutions and individuals of lower or no rank, but not by those of equal or higher rank or those who can draw influence from the former, unless the party authorizes it." *Ibid*. 50-51.

950 Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 72-74.

951 Xin He, "The Party's Leadership as a Living Constitution in China," *Hong Kong Law Journal* 42(1) (2012): 85. ("Most importantly, judicial innovation, just like judicial independence and the interference of the party in significant and difficult cases, has also conformed to the interests of the party. If allowing the courts to handle mundane cases independently and efficiently improves certainty in investment and boosts the legitimacy of the regime, some judicial innovation in judicialization of administrative behavior helps the upper-level government and ultimately the Central Party Committee to oversee the administrative agencies.") *See also* Ling Li, "Chinese Characteristics of the "Socialist Rule of Law": Will the Fourth Plenum Cure the Problems of the Chinese Judicial

In recent years, the CCP has announced several efforts to modify China's court system.[952] However, none of the announced modifications contemplate a change in the fundamental relationship between the legal system and the CCP.[953] In fact, some of the changes are designed to address the problem of local protectionism, a phenomenon whereby local courts may display favoritism toward local litigants, often in response to pressure from local government officials.[954] Although proposals from the Third Plenary Session and Fourth Plenary Session of the 18th National Congress of the CCP may seek to reduce the incidence of local political interference into judicial proceedings, they do not alter the fact that China's courts do not operate independently of the CCP or other state institutions.[955] For example, the *Third Plenum Decision*, despite its focus on "promoting rule of law," repeatedly emphasizes the leadership of the CCP.[956] Similarly, the SPC's *Opinions on Court Reform* stress that people's courts must adhere to the leadership of the CCP.[957] The *Fourth Plenum Decision* states that judges should be loyal to the Party, the country, the people, and the law[958]— in that order of precedence, which legal experts note is of significance.[959] Furthermore, in a January 2017 widely reported address, the president of the SPC explicitly rejected the notion that China's courts should seek to operate independently

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System?" *Asia Policy* 20 (2015):19. ("[I]t is important to point out that the party does not regularly exercise this interfering power in day-to-day judicial activities because it would be neither possible nor necessary to do so. After all, most run-of-the-mill court cases do not generate the immediate interest of the party. However, once the channel to legitimize interference with judicial decision-making is installed and institutionalized, it cannot be switched off.")

952 For example, proposals have been introduced to establish a more professional track for judges. Other proposals include the creation of circuit courts that cross provinces to address issues of local protectionism. Donald Clarke, *China's Legal System and the Fourth Plenum*, Public Law Research Paper No. 2015-27 (George Washington University Law School, 2015), 10-13.

953 *Ibid.*, 9.

954 Yuhua Wang, "Court Funding and Judicial Corruption in China," *The China Journal* 69 (2013): 46. ("Rampant corruption in economic litigation has become a hurdle for business. One consequence is local protectionism. Local courts, under pressure from local governments, tend to favor firms in their jurisdiction.")

955 George Chen, *China's New Circuit Tribunals Allow Tighter Control of Judiciary*," OxHRH Blog, March 6, 2017. ("[E]ach circuit tribunal has a party committee whose members are appointed and dispatched by the SPC, and a full-time CCP official ensures party control and oversees anti-corruption affairs at the tribunal."); Matt Schiavenza, Carl Minzner, and Neysun Mahboubi, "The Future of China's Legal System," *China File*, August 11, 2016. (Minzner: "Chinese authorities are interested in figuring out how to make courts more independent from local interest groups, even if there is no interest in making them independent from Party control.")

956 *See Third Plenum Decision*.

957 *Ibid.*

958 *CCP Central Committee Decision Concerning Certain Major Issues in Comprehensively Moving Forward Ruling the Country According to Law*, Article 6 (adopted at the Fourth Plenary Session of the 18th Central Committee of the CCP, October 2014).

959 Donald Clarke, *China's Legal System and the Fourth Plenum*, Public Law Research Paper No. 2015-27 (George Washington University Law School, 2015), 2.

of the CCP.[960] Moreover, even if the CCP seeks to lessen the overall incidence of political interference in judicial proceedings,[961] the chief institutional mechanisms through which it exerts control over the courts – the political legal committees and the adjudication committee system – remain intact. While the CCP references the need to improve the professionalism and technical competence of the judiciary,[962] it has not signaled any intent to relinquish the CCP's control over the selection and promotion of judges.

B. Administrative Law and Regulatory Transparency

Administrative regulations and procedures play an important role in China's economic legal framework. According to one study, China issued more than 500 trade and economic related administrative regulations and departmental rules in a single year.[963] In addition, as discussed under Factor 5, administrative approval is one of the key mechanisms through which the Chinese government implements industrial policy. As a result, if firms effectively lack the ability to challenge administrative rules and procedures, their ability to make investment and operational decisions that fall outside the scope of government-determined outcomes is undermined. In this section, the Department will analyze the formal legal mechanisms through which market actors are permitted to challenge administrative actions and participate in the administrative rulemaking process, namely (i) judicial review of administrative action under the *Administrative Litigation Law of the People's Republic of China* ("*ALL*"),[964] (ii) reconsideration of administrative action under the *Administrative Reconsideration Law of the People's Republic of China* ("*ARL*"),[965] and (iii) the extent of public participation and transparency in the formation of administrative regulations. In addition, the Department will analyze the extent to which market actors have been able to avail themselves of these mechanisms in practice.

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[960] Lucy Hornby, "China's Top Judge Denounces Judicial Independence," *Financial Times*, January 17, 2017. ("China's top judge has fired a warning shot at judicial reformers by formally acknowledging that China's court system is not independent of the Communist Party and rejecting attempts to make it so.") The SPC president's rejection of judicial independence is especially striking given that the Supreme People's Court most recent five-year plan expressly emphasized the need to ensure that the people's courts exercise judicial power independently and impartially in accordance with the law. *See Opinions on Deepening People's Courts Reform – Fourth Five-Year Reform of the People's Courts (2014-2018)* (Supreme People's Court of China, SPC Release 2015 No. 3, February 26, 2015).

[961] Sui-Lee Wee and Li Hui, "With Legal Reforms, China Wants Less Interfering in Cases, Fewer Death Penalty Crimes," *Reuters*, March 9, 2014.

[962] *Third Plenum Decision*, Article 32. ("We will establish a judicial personnel management system fitting their professional characteristics, improve the system for unified recruitment, orderly exchange and level-by-level promotion of judges, procurators and the police […]")

[963] U.S. China Business Council, *China 2014 Regulatory Scorecard* (2014), 5.

[964] *Administrative Litigation Law of the People's Republic of China* (adopted by NPC on April 4, 1989, amended November 1, 2014, further amended June 27, 2017).

[965] *Administrative Reconsideration Law of the People's Republic of China* (adopted by NPC on April 29, 1990, amended August 27, 2009, further amended September 1, 2017).

1. *Administrative Litigation Law*

The *ALL* provides detailed procedures for bringing administrative lawsuits against Chinese government agencies at the central and local levels of government. NPC enacted the *ALL* in 1989, with the stated purpose of "ensur[ing] the impartial and timely trial of administrative cases by the people's courts, settl[ing] administrative disputes, [and] protect[ing] the lawful rights and interests of citizens, legal persons, and other organizations."[966] Specifically, the *ALL* allows citizens and legal persons to file a legal claim in "a people's court" if they consider that administrative action taken by an administrative agency has infringed on lawful rights and interests.[967] In 2014, NPC amended the *ALL* to address certain substantive and procedural features that have reportedly limited its effectiveness.[968] Nonetheless, in many cases administration action remains effectively immune from review under the *ALL* as both a formal and practical matter.

The *ALL* strictly limits the sorts of administrative acts that members of the public can challenge under the law. In particular, the *ALL* specifically enumerates the types of administrative actions subject to judicial review under the law and excludes any administrative acts not so-specified from court review.[969] While the 2014 version of the *ALL* expands the list of permissible subject matter from eight to twelve types of administrative actions,[970] it remains unclear whether courts have any authority to review administrative actions beyond those specifically enumerated. In addition, the *ALL* prohibits courts from conducting challenges to an administrative regulation or departmental rule that is generally binding.[971] Instead, under the *ALL*, courts are limited to

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[966] *ALL*, Article 1.

[967] *ALL*, Article 2.

[968] *Decision of the Standing Committee of the National People's Congress on Amending the Administrative Procedure Law of the People' s Republic of China* (NPC Standing Committee, Order No.15 of the President, issued November 1, 2014).

[969] Jianfu Chen, *Chinese Law: Context and Transformation* (Leiden, The Netherlands: Brill Nijhoff 2016), 333. *See also* Qianfan Zhang, "From Administrative Rule of Law to Constitutionalism? The Changing Perspectives of the Chinese Public Law," *Asia Law Review* (3)1 (2006): 56. ("According to the prevailing understanding of the Chinese legal community, Articles 11 and 12 work in conjunction to limit the jurisdiction of administrative litigations. In essence the ALL defines jurisdiction by the model of enumeration. While Article 11 enumerates the specific areas of administrative acts reviewable by the courts, Article 12 further takes away certain areas of acts from judicial review.")

[970] *Decision of the Standing Committee of the National People's Congress on Amending the Administrative Procedure Law of the People' s Republic of China*, Article 12 (NPC Standing Committee, Order No.15 of the President, issued November 1, 2014).

[971] *ALL*, Article 13. Under Chinese law, administrative actions are divided into two main categories: (1) "specific administrative acts" and; (2) "abstract administrative acts." Specific administrative acts refer to an administrative action that is are directed at a specific person or entity (in relation to a specific matter), rather than the public at large. Abstract administrative acts, in contrast, are actions directed to unspecified persons in relation to unspecified matters, with general applicability to the public. Abstract administrative acts usually take the form of issuing administrative regulations, rules, and other normative documents of general applicability. *See* Jianfu Chen, *Chinese*

assessing the legality of the particular application of a regulation, rule, or other measure to a particular individual or legal person, in a particular instance.[972] The *ALL* does not permit courts to determine whether a regulation, rule, or other regulatory document is itself unlawful.[973] Therefore, as a practical matter, agency rulemaking remains difficult for Chinese courts to review.[974]

In practice, Chinese courts have tended to reject administrative litigation cases outright or otherwise pressure plaintiffs to withdraw their complaints.[975] Even when courts do accept and adjudicate cases under the *ALL*, courts decide such cases in favor of the administrative agency in the vast majority of cases.[976] The 2014 version of the *ALL* includes provisions that may narrow courts' discretion in deciding whether to accept or reject administrative lawsuits.[977] However, given the overall context of the courts in the Chinese legal system, the amended *ALL* does not suggest a greater scope of independence for courts.

2. *Administrative Reconsideration Law*

The *ARL* provides for a formal administrative review process under which members of the public can request that a Chinese government agency "reconsider" the legality or propriety of a specific

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Law: Context and Transformation (Leiden, The Netherlands: Brill Nijhoff 2016), 298; Randall Peerenboom and Xin He, "Dispute Resolution in China: Patterns, Causes and Prognosis," *East Asia Law Review* 4(1) (2016): 45.

972 *ALL*, Article 2.

973 Nicholas Howson, "Enforcement without Foundation: Insider Trading and China's Administrative Law Crisis," *American Journal of Comparative Law* 60(4) (2012): 989. ("The Administrative Litigation Law proves equally unhelpful for private claims seeking to challenge any properly-issued administrative norms on their face, because that Law provides no affirmative legal basis for abstract review of such norms by the PRC judiciary (permitting only judicial review of specific administrative acts.") Jianfu Chen notes that even after the 2014 amendment, "abstract administrative acts will continue to be outside the scope of the ALL, with the 'normative documents' being the only exception." Jianfu Chen, *Chinese Law: Context and Transformation* (Leiden, The Netherlands: Brill Nijhoff 2016), 335.

974 *See ALL*, Article 77. *See also* Wei Cui, "What is the 'Law' in Chinese Tax Administration?" *Asia Pacific Law Review* 19(1) (2010): 76-94, 82. ("This is partly attributable to the fact that, according to the ALL, no suits may be brought to court against government agencies merely for the adoption of 'administrative regulations, regulations, or decisions and orders with general binding force'.") The amended version of the *ALL*, now also allows courts to examine whether an administrative act is "inappropriate."

975 Ian Johnson, "China Grants Courts Greater Autonomy on Limited Matters," *New York Times*, January 3, 2016; Stanley Lubman, "China: The Quest for Procedural Justice," in *A Revolution in the International Rule of Law: Essays in Honor of Don Wallace, Jr.*, (eds.) Borzu Sabahi et al. (New York: Juris Publishing, 2014), 86.

976 *Caixin*, "Less than 10% Success Rate for Citizens Who Sue Government Officials," November 5, 2014.

977 *ALL*, Article 51 (as amended in 2014). In particular, courts must now (1) document the receipt of all legal complaints submitted to the court; (2) accept (or "register") all legal complaints that are properly-filed; and (3) provide a written legal explanation whenever a court declines to register a complaint (*e.g.*, for jurisdictional, standing reasons, *etc.*). In addition, under the amended *ALL*, a court's decision to reject a legal complaint can be appealed to the People's Court at the next highest level.

administrative act taken by the agency.[978] If the agency determines that the administrative act under review is "unlawful" or "improper," the *ARL* requires the agency to "revoke" or "alter" the administrative act within a fixed period of time, and in some circumstances, to provide compensation to the individual or entity that requested administration reconsideration.

In practice, the *ARL* is even less frequently used as a means of redressing administrative action than the *ALL*.[979] One reason for this is that the *ARL* does not permit a challenge to the legality of departmental rules.[980] As a practical matter, this is problematic because Chinese government agencies frequently – and by some accounts primarily – rely on departmental rules to carry out their regulatory functions.[981] In addition, it is recognized that those who decide administrative reconsideration cases within an agency are not independent of the agency, and there is a lack of professional staff to hear cases.[982] As noted under Factor 3, the lack of transparency in the foreign investment approval process and the broad discretion granted to approval authorities creates an environment in which government authorities are able to impose requirements beyond what is written in the law (see Factor 3 for further detail). This problem has been able to persist in part because of the lack of meaningful administrative or judicial review. Moreover, foreign investors rarely invoke such processes given the low likelihood of success and the potential for retaliation from Chinese government approval authorities that have considerable power to affect their business prospects in China.[983]

3. Regulatory Transparency

China has promulgated a variety of legal instruments and directives related to promoting regulatory transparency and "open government" more broadly. While the NPC Standing Committee and State Council are generally required to publish all draft laws and administrative

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[978] Under the *ARL*, citizens, legal persons, and other organizations that consider that their lawful rights or interests have been infringed by the specific administrative act apply for administrative reconsideration with the administrative organ (*i.e.*, the government agency or department) that took the act. *See ARL*, Article 2.

[979] Li Cheng, "On the Improvement of the Administrative Reconsideration Committee System of China: From the Quasi-Judicial Perspective," *Canadian Social Science* 11 (2015): 70.

[980] *ARL*, Article 7. (The provisions listed in the preceding paragraph do not include rules formulated by the ministries and commissions under the State Council and by local people's governments.)

[981] Peking University Center for Legal Information, available at LawInfoChina.com, accessed July 25, 2017, indicating that departmental rules constitute a majority of the legal instruments governing areas such trade and commerce (~90%), customs administration (~87%), banking and finance (~78%), industry and commerce (~58%), and intellectual property (~56%).

[982] Li Cheng, "On the Improvement of the Administrative Reconsideration Committee System of China: From the Quasi-Judicial Perspective," *Canadian Social Science* 11 (2015): 73; OECD, *OECD Reviews of Regulatory Reform - China: Defining the Boundary between the Market and the State* (Paris: OECD Publishing, 2009), 106.

[983] U.S. Chamber of Commerce, *China's Approval Process for Inbound Foreign Investment: Impact on Market Access, National Treatment and Transparency* (November 2012), 40.

regulations for public comment,[984] existing law allows the Standing Committee and State Council to forgo this requirement at their discretion.[985] Moreover, Chinese government agencies are not obligated to publish or solicit public comment on draft department rules, even though departmental rules – not laws or administrative regulations – may often be the most relevant legal instrument to market participants.

China has had a poor track record of publishing draft regulatory documents for public comment. Based on a recent survey, for example, the State Council published less than 18% of its economic and trade related regulatory documents for public comment during calendar year 2014.[986] Moreover, during the same period, with respect its draft economic and trade related regulatory documents, NDRC released less than 13% of such documents for public comment during calendar year 2014; MOFCOM released less than 14%; and MOF released less than 11%.[987] In addition, of the nine economic and trade related laws considered by NPC in 2014, only three were released for public comment.[988]

C. Corruption

Chinese officials have generally acknowledged that high levels of corruption are a threat to the country's economic policy process and legitimacy of the CCP. In recent years, China has taken various actions with the stated aim of combatting corruption.[989] Nonetheless, corruption remains

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[984] In 2015, NPC revised the *Law on Legislation* to include new provisions that generally require the NPC Standing Committee to make public all draft laws and amendments on the NPC's legislative agenda and require the State Council to solicit public opinions on all draft administrative regulations.

[985] Specifically, Article 37 of the *Law on Legislation* also provides that draft laws shall be released to the public for comments, except where the Chairman's Committee makes a decision to not release it. Similarly, Article 67 provides that draft administrative regulations shall be released to the public to solicit comments, except where the State Council decides not to release them.

[986] U.S. China Business Council, *China 2015 Regulatory Scorecard* (2015), 4. ("USCBC tracked 673 broad regulatory documents released by the State Council and seven priority government agencies in 2014. However, only 119 of these (17.7 percent) were open for public comment at any point on either SCLAO or the respective agency website. Though USCBC analysis shows that these numbers are an improvement from past years, these agencies still have a poor record of compliance with China's transparency commitments.")

[987] *Ibid.*, 5. This results correspond to a broad set of economic regulatory documents; USCBC tracks both "narrow regulatory documents," which are defined as documents that are clearly marked as administrative regulations and departmental rules, and "broad regulatory documents," which include "narrow regulatory documents" plus any other regulatory documents that have a broad economic impact. China's record of posting narrow regulatory documents for public comment is better than its record for broad regulatory documents. *Ibid*.

[988] *Ibid*., 4.

[989] China amended the *Criminal Law* in 2011 to criminalize the bribery of foreign public officials. The government has also issued a number of bribery-related administrative rules and judicial interpretations to complement the provisions in the Criminal Law and the *AML*. *See* Samuel R. Gintel, "Fighting Transnational Bribery: China's Gradual Approach," *Wisconsin International Law Journal* 31(1) (2013): 9.

a serious concern in China; observers note that its anticorruption laws and other measures are sporadically and selectively enforced.[990]

Instances of corrupt behavior appear particularly acute in the areas involving frequent interactions between market actors and government regulators or other public officials who are able to exert control over economic resources and their distribution.[991] For example, a 2016 study by GAN Integrity found that foreign companies operating in China continue to "experience bribery, political interference or facilitation payments when acquiring public services and dealing with the judicial system."[992] Similarly, a recent report by Charney Research found that over one-third of Chinese firms surveyed noted having to pay bribes or unofficial fees, or provide gifts to public officials.[993] A 2016 report by Freedom House notes that foreign companies continue to contend with "arbitrary regulatory obstacles, demands for bribes and other inducements."[994]

To the extent China has taken steps to address corruption, it has done so largely outside of the country's legal system. Instead, most corruption cases are handled by the by the CCP's Discipline Inspection Commission (CDI), which performs its work in secret.[995] While the CDI

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[990] *See e.g.*, Bertelsmann Stiftung, *China Country Report – Bertelsmann Stiftung's Transformation Index (BTI) 2016* (2016), 4. ("Although laws against corruption are in place, they are rarely enforced, except in the form of campaigns.")

[991] *See e.g.*, Daniel C.K. Chow, "How China's Crackdown on Corruption Has Led to Less Transparency in the Enforcement of China's Anti-Bribery Laws," *U.C. Davis Law Review* 49 (2015): 694. ("By placing its members in all-powerful positions in government and in SOEs, the Party is able to control the government and the economy. An important consequence of this pervasive control is that many corruption cases involve a member of the Party.") *See also* Yukon Huang, "The Truth about Chinese Corruption," *The Diplomat*, May 29, 2015. ("Most of the corruptive behaviors lie in the state's control over resources and financing, and the influence of local officials on their distribution […] [S]tate-owned banks have an outsized influence on economic activity through their preferential access to the huge savings of Chinese households. The pressure that these banks feel to enter into transactions that are unduly influenced by Party and local officials is a major vulnerability in the current system.") *See also* Ting Gong and Na Zhou, "Corruption and Marketization: Formal and Informal Rules in Chinese Public Procurement," *Regulation & Governance* 9(1) (2015): 63–76. ("Public procurement looms as both promise and peril: while it is expected to foster competition and thereby contain corrupt activities, it has nevertheless become an area highly contaminated with corruption…The official requirement for market competition and the formal rules regulating public procurement are regularly bent to make room for informal rules favoring special interests. As a consequence, corruption is rampant beneath the structural outlook of market competition.")

[992] GAN Integrity, *China Corruption Report* (2016).

[993] Craig Charne and Shehzad Qazi, *Corruption in China: What Companies Need to Know* (Charney Research, January 1, 2015), 1-2.

[994] Freedom House, *Freedom in the World 2016*, available at https://freedomhouse.org/report/freedom-world/2016/china, accessed September 11, 2017.

[995] *See* Daniel C.K. Chow, "How China's Crackdown on Corruption Has Led to Less Transparency in the Enforcement of China's Anti-Bribery Laws," *U.C. Davis Law Review* 49 (2015): 694. ("The Central Commission for Discipline Inspection handles all corruption cases; instead of openly referring to the cases as concerning corruption, a politically sensitive term, the CDI uses the less provocative term "discipline" as a surrogate for corruption. All of the inner working of the Central Commission for Discipline Inspection, like all Party work, is held in secrecy.") *See also* Jacque deLisle, "The Rule of Law with Xi-Characteristics: Law for Economic Reform,

disciplined dozens of high-ranking officials during China's most recent anticorruption campaign, only a "mere fraction" appeared to be referred to the court system for prosecution under China's anticorruption laws.[996] In particular, some commentators have emphasized the "highly political fashion" in which the CCP has carried out its anticorruption campaigns.[997] In many instances, commentators note that the chief criterion that appears to determine whether an individual is disciplined for corruption is not whether the individual engaged in corrupt activity, but rather his or her political status within the CCP.[998] Others have observed that the CCP has primarily focused on addressing highly visible displays of corruption that pose immediate reputational risks to the CCP,[999] while expending considerably less energy to root out more chronic and pervasive forms of corruption.[1000]

Anticorruption, and Illiberal Politics," *Asia Policy* 20 (2015): 23. ("At the same time, one of the most dramatic initiatives of Xi's early tenure—a remarkably energetic drive against corruption—has been conducted primarily through the party's extralegal discipline inspection commission under the leadership of Politburo Standing Committee member and venerable regime trouble-shooter Wang Qishan.") *See also* George Chen and Mareike Ohlberg, *A National Supervision System: the CCP's New Permanent Anti-Corruption Campaign*, European Voices on China MERICS Blog (Mercator Institute for China Studies, January 12, 2017). ("Since the 1990s, the DICs [*i.e.*, the "party's disciplinary and inspection committees"], not the procuratorates, handled the overwhelming majority of anti-corruption cases. Official statistics suggest that anti-corruption bureaus at the government level have played an insignificant role in the daily work.")

[996] Bertelsmann Stiftung, *China Country Report – Bertelsmann Stiftung's Transformation Index (BTI) 2016* (2016), 8. ("[D]ozens of high-ranking officials (above the rank of vice-minister) have been targeted, but merely a fraction of cases are submitted to the state judicial organs for prosecution.")

[997] Hualing Fu, *"China's Striking Anticorruption Adventure" in The Beijing Consensus? How China Has Changed Western Ideas of Law and Economic Development* (Cambridge: Cambridge University Press, April 2017), 266. ("The Party's disciplinary mechanism is not to enforce the criminal law but to deal with the risk party members might pose to the Party.")

[998] Jon Quah, "Hunting the Corrupt 'Tigers' and 'Flies' in China: An Evaluation of Xi Jinping's Anti-Corruption Campaign (November 2012 to March 2015)," *Maryland Series in Contemporary Asian Studies* 1(220) (2015): 68.

[999] *See* Hualing Fu, *"China's Striking Anticorruption Adventure" in The Beijing Consensus? How China Has Changed Western Ideas of Law and Economic Development* (Cambridge: Cambridge University Press, April 2017), 266.

[1000] Bertran Lang, *Engaging China in the Fight Against Transnational Bribery: "Operation Skynet" as a New Opportunity for OECD Countries*, 2017 OECD Global Anticorruption & Integrity Forum (OECD, 2017), 6. ("CCP-driven anti-corruption efforts equally remain moralistic and deliberately focused on individual responsibility, *i.e.* the punishment and public repentance of 'morally deprived' Party and government officials, rather than institutional deficiencies and the need for systemic reforms.") *See also* Jean-Pierre Cebestan, "Why Corruption Is Here to Stay in China," *The World Post*, March 15, 2017. ("This is the reason why Xi's anti-corruption campaign has been highly political, opaque and selective. It suppresses the most apparent features of corruption (like banquets and travels) and purges his rivals with the help of the party's very secretive discipline inspection commissions… Corruption has become more discreet but has continued ― the bribes have actually increased in proportion to the risks taken. In other words, party cadres' corrupt practices have been hidden, rather than really put under control and ferreted out.")

D. Assessment of Factor

China's legal system continues to function as an instrument by which the CCP and the state apparatus ultimately have the ability to secure discrete economic outcomes, channel broader economic policy, and pursue industrial policy goals. The legal system is designed and operates to be subordinate to CCP and state policy and guidance. Key legal institutions are structured to be able to respond to CCP direction. The CCP ultimately has the power to shape judicial activities on a large scale by retaining the ability to directly intervene on a case-by-case basis.[1001] The judicial system is not designed to operate as a meaningful independent check on the CCP or other state institutions and instead the courts are ultimately accountable to the CCP. In addition, firms effectively lack the ability to challenge administrative rules and procedures, and thus, have limited ability to make investment and operational decisions that fall outside the scope of government-determined outcomes. Moreover, corruption continues to be a serious concern and distorts rule-based outcomes between market actors and government regulators or other public officials who are able to exert control over economic resources and their allocation. Accordingly, China's legal system is a factor that supports the Department's assessment that China remains a NME country.

FINAL ASSESSMENT

China's economy has grown rapidly and developed significantly since the Department's last inquiry in 2006. In the intervening period, the Chinese government has taken a range of steps to modify the laws, regulations, and institutions that govern China's economy. The *Third Plenum Decision* of 2013 has been interpreted by some observers to suggest an intent by the Chinese government and the CCP to introduce a certain level of market dynamics into China's economy. The Chinese government and the CCP have recently adopted a series of coordinated policy initiatives they have called supply-side structural reform and state-owned enterprise reform.

Nonetheless, after assessing the six factors, the Department finds that the Chinese government continues to maintain and exercise broad discretion to allocate resources with the goal of achieving specific economic outcomes. China's institutional structure, and the control the Chinese government and the CCP exercise through that structure, result in fundamental economic distortions, such that non-market conditions prevail in the operation of China's economy. These non-market conditions are built upon deeply entrenched institutional and governance features of China's Party-state, and on a legal mandate to "maintain a leading role for the state sector." Accordingly, China is a NME country. It does not operate sufficiently on market principles to permit the use of Chinese prices and costs for purposes of the Department's antidumping analysis.

The government continues to exert significant ownership and control over the means of production. Land is not sufficiently allocated or priced according to market principles – all land

[1001] Ling Li, "The Chinese Communist Party and People's Courts: Judicial Dependence in China," *American Journal of Comparative Law* 64 (2016): 72-74.

is the property of the state, and the Chinese government controls rural land acquisition, monopolizes the distribution of urban land-use rights, and places restrictions on the tenure and scope of land-use rights. Labor is not sufficiently allocated or priced according to market principles – there are significant institutional constraints on the extent to which wage rates are determined through free bargaining, and the government restricts labor mobility through the *hukou* system. Capital is not sufficiently allocated or priced according to market principles – the state retains ownership and control over the largest commercial banks, while the majority of bank and interbank loans, as well as corporate bond transactions, occur between state-owned and -controlled parties. The price of energy and other key factor inputs is either set or guided by the Chinese government, resulting in distorted costs and prices throughout the economy.

In conformity with the legal mandate to "maintain a leading role for the state sector," SIEs have maintained a strong and sustained presence in China's economy. The largest enterprises in key industries, including the financial sector, are under government ownership and control. Government authorities across China, at both the national and sub-national level, own and control tens of thousands of enterprises. SIEs account for a substantial share of total credit, investment, and assets in China's economy, in spite of their generally poor performance when compared with the private sector. Studies have also shown that SIEs are far more prevalent in China's economy than in France and other large economies.

In China's economic framework, state planning through industrial policies conveys instructions regarding sector-specific economic objectives, particularly for those sectors deemed strategic and fundamental. The Chinese government employs numerous mechanisms to implement industrial policy objectives, including investment approvals, access standards, guidance catalogues, financial supports, and quantitative restrictions. Science and technology development, industrial restructuring and upgrading, and the geographic distribution of industry are three areas that demonstrate the extent to which the government uses industrial policies to influence economic outcomes.

The Chinese government also retains substantial control over the manner in which China's economy is exposed to external market forces. Although the Chinese government has made market-oriented modifications to its capital account and exchange rate system, and has taken steps to develop its FOREX market, it still maintains significant restrictions on capital account transactions and intervenes considerably in onshore and offshore FOREX markets. It remains unclear to what extent market forces affect the exchange rate. With respect to foreign investment, administrative costs and hurdles remain significant enough to ensure that the Chinese government can channel foreign investment to the producers, products, technologies and industries it seeks to bolster. At the same time, these administrative instruments provide the government with discretion to limit foreign investment from reaching industries that the Chinese government finds strategically important to maintain under its control alone.

The Department also finds that China's legal system continues to function as an instrument by which the Chinese government and the CCP can secure discrete economic outcomes, channel broader economic policy, and pursue industrial policy goals. Key legal institutions, such as the courts, respond as necessary to their direction in broad policy or case-specific ways. Individuals and firms are constrained in their ability to have meaningful independent input into administrative rulemaking or to challenge administrative decisions.

China's economy continues to be significantly tied to the institutional structures established by the Chinese government and the CCP for the purpose of achieving a "socialist market economy." In this system, the Chinese government must "maintain a leading role for the state sector" and market forces are to be contained within that framework. Policy signals from the Chinese government on the direction and pace of relevant proposals to modify the relationship between the state, the CCP, and the economy have been unclear, uncertain, and inconsistent. Accordingly, the Department has determined that China remains an NME country under the U.S. antidumping and countervailing duty laws.

10/26/2017

X

Signed by: GARY TAVERMAN

Gary Taverman
Deputy Assistant Secretary
for Antidumping and Countervailing Duty Operations,
performing the non-exclusive functions and duties of the
Assistant Secretary for Enforcement and Compliance

APPENDIX

Appendix Table 1: Sample of Planning Documents for the *13th FYP* Period, 2016-2020

Measure	Agency	Date Issued
Energy		
Shale Gas Development Plan	MIIT	9/14/2016
13th Five-Year Development Plan for Natural Gas	NDRC	12/24/2016
13th Five-Year Development Plan for Oil	MIIT	12/24/2016
Renewable Energy Development Plan	NDRC	12/10/2016
Solar Energy Development Plan	NEA	12/8/2016
Electric Power Development Plan	NDRC/NEA	11/7/2016
Wind Power Development Plan	NEA	11/16/2016
Energy Development Plan	NEA	12/2016
Energy Technology Innovation Plan	NEA	12/2016
Coal Industry Development Plan	NDRC, NEA	12/2016
Geothermal Energy Exploration and Usage Plan	NEA	1/23/2017
Science and Technology		
National Strategic and Emerging Industries Development Plan	State Council	11/29/2016
National Science and Technology Innovation Plan	State Council	7/28/2016
National Informatization Plan	State Council	12/15/2016
Smart Manufacturing Development Plan	MIIT, MOF	12/8/2016
Made in China 2025 Agricultural Machinery	MIIT	11/28/2016
Made in China 2025 Key Area Technology Roadmap	MIIT	10/2015
Sector-Level Plans		
Information Industry Development Guide	MIIT, NDRC	12/30/2016
Civil Aviation Development Plan	CAAC, NDRC, MOT	2/17/2017
Software and Information Technology Services Development Plan	MIIT	12/18/2016
Information and Telecommunications Industry Development Plan (2016-2020)	MIIT	12/18/2016
Steel Adjustment and Upgrading Plan	MIIT	10/28/2017
Textile Industry Development Plan	MIIT	9/20/2016
Building Material Industry Development Plan	MIIT	9/28/2016
Petrochemical and Chemical Industry Development Plan	MIIT	9/29/2016
Pharmaceutical Industry Development Guide	MIIT, NDRC, MOST, MOFCom, NHFPC, CFDA	10/26/2016
Civil Explosive Products Industry Development Plan	MIIT	10/12/2016
Non-Ferrous Metal Industry Development Plan	MIIT	9/28/2016
Shipping Industry Structure Adjustment and Transformation and Upgrade Action Plan	MIIT, NDRC, MOF, PBOC, CBRC, State Administration of Science, Technology and Industry for National Defense	1/12/2017
Chemical Fiber Industry Development Guide	MIIT, NDRC	11/25/2016
Other Sector-Level Plans		
Industry Green Development Plan	MIIT	6/30/2016
Big Data Industry Development Plan	MIIT	12/18/2016
State Radio Management Plan	MIIT	8/2016
Rare Earth Industry Development Plan	MIIT	9/29/2016
Robotics Industry Development Plan	MIIT, NDRC, MOF	3/21/2016

Industrial Technology Innovation Plan	MIIT	10/21/2016
Information and Industry Integration Plan	MIIT	10/12/2016
Promoting the Development of Small and Medium-Sized Enterprises Plan	MIIT	6/28/2016
Five-Year Action Plan to Promote the Internationalization of Small and Medium-Sized Enterprises	MIIT	8/1/2016
New Materials Industry Development Guide	MIIT, NDRC, MOST, MOF	12/30/2016
National Standard System Building Development Plan	State Council	12/17/2015
Smart Health Elderly Caring Industrial Development Action Plan	MIIT, MCA, National Health and Family Planning Commission	2/6/2017
Agricultural Machinery Equipment Development Action Plan	MIIT, MOA, NDRC	11/28/2016
Project Implementation Guides and Action Plans		
Smart Manufacturing Project Implementation Guide	MIIT, NDRC, MOST, MOF	4/12/2016
Green Manufacturing Project Implementation Guide	MIIT, NDRC, MOST, MOF	4/12/2016
Manufacturing Industry Innovation Center Construction Project Implementation Guide	MIIT, NDRC, MOST, MOF	4/12/2016
High-End Equipment Innovation Project Implementation Guide	MIIT, NDRC, MOST, MOF	4/12/2016
Strong Industrial Base Project Implementation Guide	MIIT, NDRC, MOST, MOF	4/12/2016
Manufacturing Industry Talents Development Guide	MOE, MIIT, MOHRSS	12/27/2016
Promoting Auto Battery Industrial Development Action Plan	MIIT, NDRC, MOST, MOF	2/20/2017
Industries Using Textile Products Development Guide	MIIT, NDRC	12/30/2016
Developing Service-Oriented Manufacturing Action Guide	MIIT, NDRC, CAE	7/12/2016
Promoting Upgrading of the Brand and Quality of the Equipment Manufacturing Industry Action Guide	MIIT, AQSIQ, SASTIND	8/15/2016

Sources: Government documents including *S&T MLP*, *SEI Decision*, *12th Five-Year SEI Plan*, *13th Five-Year SEI Plan*, and documents pertaining to MiC2025.

Appendix Table 2: Key Technologies and Sectors Targeted in Science and Technology Plans

2006-2020 MEDIUM AND LONG-TERM PLAN FOR SCIENCE AND TECHNOLOGY
Key Areas (11):
agriculture
energy
environment
IT and modern services
manufacturing
national defense
population and health
public securities
transportation
urbanization and urban development
water and mineral resources
Frontier Technologies (8):
advanced energy
advanced manufacturing
aerospace and aeronautics
biotechnology
information
laser
new materials
ocean
Engineering Megaprojects (16):
advanced numeric-controlled machinery and basic manufacturing technology
control and treatment of AIDS, hepatitis, and other major diseases
core electronic components, high-end generic chips, and basic software
drug innovation and development
extra-large-scale integrated circuit manufacturing and technique
genetically-modified new-organism variety breeding
high-definition Earth observation systems
large advanced nuclear reactors
large aircraft
large-scale oil and gas exploration
manned aerospace and moon exploration
new-generation broadband wireless mobile telecommunications
water pollution control and treatment
(#14-16) undisclosed military programs
Science Megaprojects (4):
development and reproductive biology

nanotechnology	
protein science	
quantum research	
STRATEGIC AND EMERGING INDUSTRIES	
energy efficient and environmental technologies	
next generation information technology	
biotechnology	
high-end equipment manufacturing	
new energy	
new materials	
new-energy vehicles (NEVs)	
MADE IN CHINA 2025	
Major Breakthrough Fields:	
1. IT Industry	
	integrated circuits and special equipment
	information and communication equipment
	operating system and industrial software
2. high-grade computer numerical control (CNC) machine tools and robots	
3. aerospace	
	aviation equipment
	aerospace equipment
4. marine engineering equipment and high-tech ships	
5. advanced rail transportation equipment	
6. energy-saving and new-energy vehicles	
7. electricity equipment	
8. agricultural machinery and equipment	
9. new materials	
	special metal functional materials
	high-performance structural materials
	functional polymers
	special inorganic nonmetals
	advanced composite materials
	superconducting materials
	nanomaterials
	graphene
	bio-based materials
10. biomedical and high-performance medical equipment	

Sources: Government documents including *S&T MLP*, *SEI Decision*, *12th Five-Year SEI Plan*, *13th Five-Year SEI Plan*, and documents pertaining to MiC2025.

LIST OF ABBREVIATIONS

ABC	Agricultural Bank of China
ACFTU	All-China Federation of Trade Unions
ADBC	Agricultural Development Bank of China
ADBI	Asian Development Bank Institute
AD/CVD	Antidumping/Countervailing Duties
ALL	Administrative Litigation Law of the People's Republic of China
AmCham	American Chamber of Commerce
AML	Anti-Monopoly Law of the People's Republic of China
ARL	Administrative Reconsideration Law of the People's Republic of China
BA	Banker's Acceptance
BCM	Bank of Communications
BIS	Bank for International Settlements
BoC	Bank of China
BRIICS	Brazil, Russia, India, Indonesia, China, and South Africa
CBRC	China Banking Regulatory Commission
CCBC	China Construction Bank Corporation
CCP	Chinese Communist Party
CCPCC	Chinese Communist Party Central Committee
CDI	Central Commission for Discipline Inspection
CFETS	China Foreign Exchange Trade System
CGDC	China Guodian Corporation
CIRC	China Insurance Regulation Commission
CJV	Contractual Joint Venture
CNH	Offshore Chinese Renminbi
CNY	Onshore Chinese Renminbi
COMAC	Commercial Aircraft Corporation of China, Ltd.
CPLC	Central Political and Legal Affairs Committee
CSRC	China Securities Regulatory Commission
DAMP	Directed Asset Management Plan
EBIT	Liabilities-to-Earnings Ratio
EBL	Enterprise Bankruptcy Law of the People's Republic of China
EJV	Equity Joint Venture
EU	European Union
FAI	Fixed Asset Investment
FDI	Foreign Direct Investment
FDIC	Federal Deposit Insurance Corporation
FIE	Foreign-Invested Enterprise
FOREX	Foreign Exchange
FYP	Five-Year Plan for Economic and Social Development
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GERD	Gross Expenditure on Research & Development
GNI	Gross National Income

ICBC	Industrial and Commercial Bank of China
ICR	Interest Coverage Ratio
ILO	International Labour Organization
IMF	International Monetary Fund
JSB	Joint-Stock Commercial Bank
LGFV	Local Government-Owned Financing Vehicle
LTC	Land Transfer Center
MiC 2025	Made in China 2025 Initiative
MIIT	Ministry of Industry and Information Technology, People's Republic of China
MLR	Ministry of Land and Resources, People's Republic of China
MMT	Million Metric Tons
MOA	Ministry of Agriculture, People's Republic of China
MOF	Ministry of Finance, People's Republic of China
MOFCOM	Ministry of Commerce, People's Republic of China
MOFTEC	Ministry of Foreign Trade and Economic Cooperation, People's Republic of China
MOHRSS	Ministry of Human Resources and Social Security, People's Republic of China
MOST	Ministry of Science and Technology, People's Republic of China
NBFI	Non-Bank Financial Institution
NBS	National Bureau of Statistics, People's Republic of China
NDRC	National Development and Reform Commission, People's Republic of China
NEV	New Energy Vehicle
NFTTC	National Fund for Technology Transfer and Commercialization, People's Republic of China
NGO	Non-Governmental Organization
NME	Non-Market Economy
NMSAC	National Manufacturing Strategy Advisory Committee
NOC	National Oil Company
NPC	National People's Congress
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
OTC	Over-The-Counter
PBOC	People's Bank of China
PICC	People's Insurance Company of China
PLC	Political and Legal Affairs Committee
PRC	People's Republic of China
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
R&D	Research & Development
RLCL	Rural Land Contracting Law of the People's Republic of China
RMB	Renminbi
S&T	Science & Technology
S&T MLP	Medium- and Long-Term Plan for Science and Technology

SAFE	State Administration of Foreign Exchange
SAIC	State Administration of Industry and Commerce
SASAC	State-Owned Assets Supervision and Administration Commission
SCIO	State Capital Investment and/or Operations Company
SDPC	State Development Planning Commission
SDR	Special Drawing Right
SEG	State Enterprise Group
SEI	Strategic and Emerging Industry
SERC	State Electricity Regulatory Commission
SEZ	Special Economic Zone
SIE	State-Invested Enterprise
SME	Small- and Medium-Sized Enterprise
SML	Special-Mention Loan
SOCB	State-Owned Commercial Bank
SOE	State-Owned Enterprise
SPC	Supreme People's Court, People's Republic of China
SSSR	Supply-Side Structural Reform
State Council DRC	Development Research Center of the State Council, People's Republic of China
STE	State-Trading Enterprise
SWIFT	Society for Worldwide Interbank Financial Telecommunications
TBR	Trade Beneficiary Right
TRIMS	Trade-Related Investment Measures
TVE	Township and Village Enterprise
TWh	Terawatt Hours
USD	U.S. Dollar
VAT	Value-Added Tax
WB	World Bank
WFOE	Wholly Foreign-Owned Enterprise
WMP	Wealth Management Product
WTO	World Trade Organization

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