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Competition Policy and State-Owned Enterprises in China

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1. Introduction

The Anti-Monopoly Law (AML)[1] of China came into effect in August 2008. In less than a decade, China has made remarkable strides to enforce this law;[2] no other jurisdiction with a competition law system – over 130 to date – comes close to matching China's accomplishments in the first decade of its competition regime.[3] However, China's progress in implementing competition policy remains uncertain.

Despite China's achievements, a considerable amount of work still lies ahead if economic performance is to be improved. Too often government action, particularly through the operation of the state-owned enterprises (SOE), displaces the market mechanism. Policies involving state ownership often subordinate the AML and the rule of law generally. China's limited success in reducing the scope of state ownership and addressing the distortions caused by SOEs has frustrated attainment of the AML's objectives and, more broadly, impeded realization of the aims of the 3rd Plenum of the 18th Party Congress, which, in November 2013, committed the nation to make 'the market play the decisive role in resource allocation' and to establish a 'unified, open, fair and orderly market'. In this framework, the market's role in organizing the economy would be *decisive*. Almost a year later, the 4th Plenum reinforced the command of the 3rd Plenum by

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1 Anti-Monopoly Law of the People's Republic of China (2007), Presidential Order No. 68, 30 August 2007.

2 On the development of China's modern competition law system, see A. Emch and S. Stallibrass (eds.), *The Chinese Anti-Monopoly Law: The First Five Years*, Kluwer, 2013; *Journal of Antitrust Enforcement: Special Supplement – Chinese Competition Law*, 15 November (2015); Y. Svetiev and L. Wang, 'Competition Law Enforcement in China: Between Technocracy and Industrial Policy', 79 *Journal of Law and Contemporary Problems* (2016) 187.

3 See W. Kovacic and M. Lopez-Galdos, 'Lifecycles of Competition Systems: Explaining Variation in the Implementation of New Systems', 79 *Journal of Law and Contemporary Problems* (2016) 85, 87–88 (discussing development of new competition systems since late 1980s); Svetiev and Wang, 'Competition Law Enforcement in China', supra note 1, at 188–90 (describing early development of China's antitrust enforcement program).

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announcing that China would enhance the rule of law – a necessary foundation for an effective, sustainable program to curb anticompetitive practices.

China today relies more heavily on market processes than it did even a decade ago, yet competition is still restricted or largely absent in many industries. China's economy encompasses two domains. In one domain, extensive state involvement is the norm, and competition is weak or seriously distorted. Government actors restrict market entry, allocate resources, and enable SOEs to dominate. Many of China's current economic problems (e.g., structural imbalances, excess capacity, and low productivity) are most severe in the heavily regulated, state-controlled, uncompetitive sub-economy. China's growth potential is under-exploited because competition is tepid in large parts of the economy. The other economic domain is robustly competitive. Here open market entry fosters intensive competition.

The 3rd Plenum and 4th Plenum decisions place China at a reform crossroads. As China's leadership recognizes, implementing decisions that will achieve the nation's aim to become a high-income economy within a few decades is critical. More intense competition is essential to the new rebalanced growth model, where sustainable growth and international competitiveness depend on more efficient resource use and rapid innovation. While implementing the decisions will take time, a faster pace would help China address domestic structural problems that have slowed growth rates in a difficult international economic environment.

Successful implementation of the 3rd Plenum decision requires special attention to competition law and policy. One priority is to upgrade the AML and the mechanisms for its enforcement.[4] A second priority, and the main focus of this paper, is to strengthen market competition using tools outside the normal scope of competition law.

Three interrelated obstacles diminish China's economic performance: 'administrative monopoly', which consists of government intervention that restricts entry or otherwise impedes the development of new private firms; a far-reaching and undisciplined conception of industrial policy; and distortions caused by the operation of SOEs. These problems afflict many economies, but they are especially serious in China. Until China overcomes these systemic and policy obstacles, enforcement of the AML and its competitive benefits will be severely limited.

This paper begins by describing possible AML reforms that would enable China to mitigate distortions caused by government intervention. The paper then turns to techniques, beyond existing notions of competition law, to mitigate problems caused by the interaction of administrative monopoly, industrial policy, and SOEs.

4 On possible improvements, see W. Kovacic, 'China's Competition Law Experience in Context', *Journal of Antitrust Enforcement* 12 (Supplement 2015).

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2. The Antimonopoly Law

The 3rd and 4th Plenum decisions represent a significant change in official thinking about the direction and pace of economic reforms in China. Experience abroad suggests that an ideal time to assess a new competition law system regime is five to ten years after it began. Therefore, reflection on China's competition regime is timely and desirable: how might expanded application of competition policy help China realize the promises of the 3rd and 4th Plenum decisions? China's AML is in many respects a state-of-the-art law. International experience and learning from the AML's implementation since 2008 suggest three revisions that could make the AML more effective – especially in dealing with SOEs.

2.1 Coherence of aims

The AML's stated aims (Article 1) should be clarified and focused. The law's aims include efficiency, consumer welfare, the interests of society, and the healthy development of the market. However, the AML neither states a hierarchy of aims nor does it discuss the provisions that could lead to potentially conflicting goals in specific cases. This gives excessive discretion to the enforcement agencies and courts and obscures what enterprises can and cannot do. The diversity of goals forces enforcement officials to make problematic decisions about how to reconcile the law's varied aims.[5] Over time, other jurisdictions have tended to focus competition law chiefly on improving economic performance. By this approach, the pursuit of non-competition aims (e.g., national security) is permitted only in a few specific circumstances.

2.2 Jurisdiction

Experience in China and elsewhere suggests reforms to extend the AML's reach. One key step is to bring all industries and all markets – including natural monopolies – under AML oversight. Some elements of a sector once deemed unreachable, such as a natural monopoly, may be susceptible to competition; for example, competition to win a franchise to run a natural monopoly network). Best-practice regulation can govern the rest.

A second valuable clarification would be to subject all enterprises, including SOEs, to the AML. Article 7 of the AML indicates that all markets and all enterprises, including SOEs, come under the AML. Yet the Article can be read to tolerate monopolies in state-owned 'lifeline' industries, where the state protects their activities and controls their prices. One interpretation is that Article 7 allows such state control to override the AML. From this point of view, SOEs may warrant different

5 See W. Kovacic and D. Hyman, 'Institutional Design, Agency Life Cycle, and the Goals of Antitrust Law', 81 *Fordham Law Review* (2013) 2163, 2169–71 (describing how competition agencies reconcile the multiple goals assigned to them by legislators).

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treatment, leading SOE managers or enforcement authorities to view the AML as having less force in such sectors.

The restrictions on entry into industries and markets that are currently reserved for SOEs, allowing some SOEs to operate as monopolies, should be significantly reduced. In view of the 13 September 2015 'Guiding Opinions of the CPC and the State Council on Deepening Reform of SOEs', which introduced a distinction between non-profit 'public service' and for-profit 'commercial' SOEs, the latter should no longer be allowed to operate as monopolies and should be subject to competition. The 8 May 2015 State Council document No. 28 on 'Made in China 2025', promoting manufacturing and innovation, states the need to 'further eliminate all forms of monopoly'. Article 7 should be revised and made consistent with these and other recent official policies.

Article 51 should also be strengthened to prohibit administrative monopoly and to authorize remedies consistent with the AML. At present, China's antitrust agencies may only refer matters back to the superior agencies for consideration of a possible administrative violation of the AML. It also would help to clarify the border between industrial policy and competition policy. Many jurisdictions expressly give competition law precedence over legislation or other instruments of industrial policy, except in a few well-defined cases.

3. The institutional structure

This section examines the institutions that implement the AML. The discussion focuses on the three-agency enforcement framework and the system's principal policy coordination mechanism (the Anti-Monopoly Commission).

3.1 The three enforcement agencies

China's three enforcement agencies have accumulated considerable experience in enforcing the AML. No other jurisdiction with a competition law has matched the intensity or extent of China's enforcement program in the first decade of operation.

The Ministry of Commerce (MOFCOM) is China's merger control agency. The AML mandates advance notification of certain mergers and imposes waiting periods. MOFCOM has reviewed over 1,000 mergers since August 2008 and has provided extensive guidance about its enforcement intentions. From its first merger ruling (which barred Coca-Cola from purchasing Huilyan) to the present, MOFCOM has issued increasingly complete and informative explanations of its decisions. Progress toward fuller disclosure is a major accomplishment for the AML regime.

The National Development and Reform Commission (NDRC) enforces the AML's prohibitions on price-related anticompetitive conduct. Its extensive enforcement program has included cartel cases involving an international scheme to set the

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prices of flat screen liquid crystal display panels, and challenges to collusion in various domestic goods and services markets; vertical restraints cases involving automobile sector distribution practices, including the recovery of a US$52 million fine from Mercedes Benz involving the company's spare parts policies; resale price maintenance cases involving two leading domestic producers of distilled spirits; and abuse of dominance cases involving leading Chinese telecommunications firms and a settlement in 2015 with Qualcomm, which produced injunctive relief and a US$975 million fine. Like MOFCOM, NDRC has showed a healthy willingness to provide detailed information about its enforcement aims and the basis for its decisions.

The State Administration for Industry and Commerce (SAIC) polices non-price anticompetitive conduct. SAIC has initiated numerous investigations into non-price monopolistic agreements, abuse of dominance, and administrative monopoly. These matters cover a wide range of manufacturing industries, public utilities (e.g., telecommunications), and services (e.g., insurance and sales of used cars). SAIC also has helped develop guidelines, for the AML's application, on intellectual property rights and has followed the internationally accepted practice of issuing drafts for public comment.

3.2 Problems of multiple enforcement agencies

The AML's division of authority across three overlapping enforcement agencies diminishes coherence in law and policy. Putting two or more enforcement agencies in the same policy domain is an inherent source of tension. Inter-agency quarrels consume enforcement resources, delay cases, and undermine respect for the AML. In recent years, other jurisdictions, which began their competition systems with multiple agencies, have unified enforcement power in one body.[6]

The AML units in MOFCOM, NDRC, and SAIC are small teams inside massive bureaucracies; the competition mandate coexists with other conflicting duties of these enforcement agencies. NDRC has extensive industrial policy functions (including price control). MOFCOM oversees domestic and foreign trade and international economic cooperation. SAIC promotes and regulates entrepreneurship through registration and administration of business enterprises. By assigning competition law duties to institutions with industrial policy, trade, regulatory, and administrative policy portfolios, the AML creates the potential for non-competition criteria to influence, or appear to influence, competition enforcement.[7]

6 See W. Kovacic, 'The Institutions of Antitrust Law: How Structure Shapes Substance', 110 *Michigan Law Review* (2012) 1019, 1043 (discussing restructuring of competition systems in Brazil, France, Portugal, Spain, and the United Kingdom).

7 NDRC's AML unit also enforces China's price law. There have been NDRC investigations where the foundations – price law or the AML – have not been clearly specified. The SAIC's AML unit also enforces China's unfair competition law, but application can clash with the AML's mandate.

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In a number of cases, one doubts that small units in immense departments can effectively perform their AML roles in challenging abuses of administrative monopoly or in applying the AML to SOEs. The minister of a large government department, the governor of a province, the mayor of a large city, or the chief executive of a powerful SOE may feel no obligation to observe the commands of the director general of a small antimonopoly bureau within MOFCOM, NDRC, or SAIC.

It is a common international precept that competition agencies should be 'independent'.[8] Definitions of independence vary, but the core idea is that a competition agency should have autonomy from political branches and other government departments when initiating or resolving cases. There also is general recognition that a competition agency should be accountable to the political process for its policy choices – e.g., by disclosing the basis for its decisions and disclosing its priorities and enforcement guidelines. The competition agency must have some connection with the political process to be an effective advocate for competition law before other public bodies.

China has no experience with fully independent regulators as the concept is defined above. The AML agencies confront two basic constraints on their autonomy. As noted above, the AML bureaus are small units in diversified policy conglomerates. Each AML unit coexists with well-established bureaus with economic interests and policy views that sometimes conflict with competition law. Second, the AML units face countervailing policy views and economic interests from other government bodies, such as ministries that oversee specific sectors or individual SOEs, or provincial- and municipal-level governments. These other bodies sometimes exercise decisive influence over AML enforcement decisions. China's competition authorities should consult, but not be governed by, other parts of the government's administration. Creation of a single and more independent Chinese competition authority would help overcome these problems.

In theory, China's Antimonopoly Commission (AMC) provides an overarching policy-making and coordination mechanism for the AML. The AMC's most visible contribution has been to draft various policy documents and guidelines. There is little transparency about the AMC's objectives, operations, and functions, or its expert advisory panels. The AMC has not published studies related to China's market structure and competitiveness, or of policies to achieve the 3rd Plenum decisions on strengthening market competition. The AMC appears to have played little part in unifying policy across the three enforcement agencies.

Achieving the 3rd Plenum objectives of making the market play the decisive role in resource allocation and in establishing a 'unified, fair, open and orderly market'

8 See W. Kovacic and M. Winerman, 'The Federal Trade Commission as an Independent Agency: Autonomy, Legitimacy, and Effectiveness', 100 *Iowa Law Review* (2015) 2085, 2087 (recounting the often-expressed view that competition agencies should be independent).

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will require a high level, authoritative, and relatively independent competition agency. In China, where competition remains weak or absent in significant parts of the economy, an agency with expanded powers, headed by a senior official, and supported by a well-resourced permanent staff, is critical to the future development of competition policy. The AMC's present configuration does not meet these requirements. Its membership (representatives from 13 powerful government departments, each with its own interests) makes it impossible for the AMC to act as an effective and relatively independent competition policy body.

A restructuring of China's AML implementation framework would strengthen competition at a level required to achieve the country's strategic economic objectives and the 3rd and 4th Plenum decisions. A new authority that integrates the three existing enforcement agencies would be a powerful, relatively independent, and properly resourced body, subject to proper checks and balances of legislation, guidance, and information disclosure, oversight of the courts, and accountable annually to either the State Council, or the National People's Congress (NPC). China's political leadership would not guide decisions by the new institution in individual cases.

By itself, improving the AML and its enforcement institutions will not increase competition to the level China needs to achieve its economic aims. Other formidable systemic and policy restraints impede competition in China. Extensive market entry barriers in China have created a competitive sub-economy, where market entry is basically open and competitive forces operate, and an uncompetitive regulated sub-economy, where market entry is restricted, monopolies predominate, and competition is either absent or weak. These entry barriers are created by administrative monopoly, industrial policy, and in the treatment of SOEs. The AML has limited impact in the regulated sub-economy. Achieving the 3rd Plenum market competition goals will require new measures, beyond the reform of the AML system. These measures are examined below.

4. Using competition policy against administrative monopoly

Administrative monopoly is the abuse of government powers to eliminate or restrict competition.[9] Its treatment is fundamentally an issue of economic governance concerning the relationship between the government and the market.

4.1 Administrative monopoly in China: economic costs

Administrative monopoly imposes high costs in terms of allocative efficiency, welfare losses, cost/price distortions, income inequality, rent seeking, and

9 See S. Xu, *Competition Law and Competition Policy – China's Perspective* (SinoMedia Holdings Ltd. 2010) 244 (calling administrative monopoly 'one of the largest obstacles to the development of China's market economy).

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corruption. It can be worse than privately imposed competitive restraints, for which there often are some competitive forces, which, in time, will overcome private abuses. In China, state actors are subject to no such discipline when they distort competition.

The most harmful economic consequence of administrative monopoly in China is the misallocation of resources arising from local protectionism and the creation of regional monopolies. This fragmentation of the national market prevents the country from exploiting the advantages of economies of scale and the opportunity to specialize in areas of comparative advantage afforded by the huge size of its internal market. Because industrial performance depends significantly on administrative action as opposed to market-driven commercial activities by the enterprises themselves, firms squander resources in rent-seeking, corruption, and the pursuit of political patronage.

4.2 Administrative monopoly in China: means

Compared to other nations, administrative monopoly is an acute problem in China because central and local governmental bodies enjoy extensive powers to directly intervene, and participate, in the economy. GDP growth is a key basis for promoting state and Party officials; this induces local governments to abuse their administrative powers to maximize locally based economic activities. A central–local fiscal revenue sharing system also encourages local governments to increase their tax revenue base, especially taxes accruing to local governments, through discriminatory measures to promote local enterprises and activities at the expense of outsiders.

Local authorities typically create administrative monopolies through local industrial policies whose scope can extend considerably beyond those of the central government. As discussed below, national industrial policy has many objectives targeted at a large number of broadly defined categories of industries. It is implemented through interventionist policy tools that distort competition by restricting market entry.

One way local authorities create administrative monopoly is to misuse the approvals process for investment – intended by the central authorities to manage national investment levels and industrial structure – to restrict local market entry. Local governments also replicate central government practices in preferential, discriminatory access to resources (e.g. funds, land, utilities), in subsidies for local SOEs, and in favoring local private over foreign-funded enterprises. Public authorities also use other extra-legal measures to stifle competition. These include the following devices.[10]

10 C. Wu and Z. Liu, 'A Tiger without teeth? Regulation of administrative monopoly under China's Anti-Monopoly Law', *Review of Industrial Organization* (March 2012).

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Discriminatory non-tariff barriers and price setting. Local governments impose higher or additional technical, quality, health, safety, and other standards in licensing non-local products and services. Frequent, repeated re-testing and re-authentication raise entry and transaction costs for non-local products and firms. These standards enable local governments to impose unjustified higher licensing and registration fees, which, along with higher, discriminatory prices on non-local goods and services, diminish their competitiveness.

Prohibition of sale of some non-local goods and services. Local businesses are restricted in selling certain goods and services provided by non-local firms. Government bodies restrict commerce by classifying some markets as monopolies and by requiring a local franchise or license before non-local enterprises can do business locally. Violators face fines and their business licenses being revocated. Some local governments set up checkpoints on highways, railway stations, ports, and airports to stop non-local products from entering the local market. This can involve outright seizure and confiscation of goods.

Government procurement and compulsory trading in favor of local enterprises. Government institutions and SOEs are instructed, by executive order, to purchase local goods and services. For example, an SOE might be required to rely entirely upon local sources to obtain materials and equipment needed for provincial engineering projects, or raw materials for local manufacturing Other consumers are compelled to purchase goods and services from designated suppliers rather than through a competitive market.

Compulsory takeover and collusive cartels. Non-local enterprises are compelled by local governments to establish enterprise groups with local partners. Local governments also force local enterprises to merged with or be acquired by other, favored local (often state-owned) enterprises. Local enterprises also are forced to enter joint restructuring, procurement, production planning, sales, and pricing agreements.

Interference in law enforcement and the judiciary. Some local governments compel local prosecutors and courts to protect local economic interests. They obstruct the investigation or prosecution of anticompetitive practices and economic crimes allegedly committed by local enterprises, while encouraging the prosecution of cases against non-local enterprises. Law, customs, and tax enforcement agencies are prevented from performing some statutory duties, such as entering and inspecting local and foreign-funded enterprises, without authorization from relevant departments of the local government. Sales of substandard and harmful products, rampant smuggling, and tax evasion have been shielded from prosecution to protect local interests.

Trade barriers, imposed by administrative monopoly within China's internal market, are formidable. For many products and services, it is easier for a Chinese producer in one province to enter foreign markets than to enter markets

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in other Chinese provinces. Beyond adverse the effects on competition and the integrity of the national market, administrative monopoly in China undermines the rule of law and national economic management and stability.

Administrative monopoly also takes the form of national sectoral monopolies created by central government bodies. They are formed through the central government's price and investment approval controls for various industries, and restrictions upon market access in strategic and other regulated industries reserved for SOE monopoly or dominance. Administratively created sector monopoly also occurs when government departments use discriminatory provisions to impose special conditions on selected enterprises, and when the conduct of an enterprise's business is subject to direction or close supervision by an administrative body.

4.3 Challenges in curbing administrative monopoly in China

The State Council issued proscriptions against administrative monopoly long before the AML's enactment allowed the competition authorities to act against monopoly. AML Article 51 was added to enable the competition authorities to block administrative monopoly created by state bodies. To date there have been few actions against administrative monopolies.[11] Several reasons explain this weak enforcement history.

First, as noted previously, the AML's powers to remedy administrative monopoly are frail. The AML agencies can only recommend that the relevant superior authority direct the offender to take corrective actions. The superior authority is not obliged to heed the guidance of AML officials, and it need not publicize its decisions.[12]

Second, enterprises that believe they are victims of the anticompetitive actions of other enterprises may face serious risks if they initiate an action against administrative monopoly. Direct confrontation with a state administrative authority – which typically can use a range of legitimate powers that will affect the enterprise's business – may damage the enterprise's future prospects. It is unsurprising that few firms would bring complaints against administrative monopoly to the competition authorities.

Third, in some cases, the senior executives of the major SOEs benefitting from administrative monopoly, and the state officials responsible for the actions at issue and the state authority to which they report, hold positions that have greater power than the senior officials of the AML enforcement units.

11 One case concerns NDRC's action (in September 2014) in Hubei province where only locally registered passenger transport companies are given a 50% discount on road toll charges while companies not locally registered receive no discounts. Another case is action taken by SAIC's Guangdong provincial branch against the Heyuan municipal government for giving one local company, the New Space-Time Navigation Technology Company (NSTNT), a monopoly in the municipality's GPS tracking and monitoring platform, forcing other GPS operators to upload their data on to the NSTNT platform at a fee.

12 AML Chapter V, Article 6, on the 'Provisions for Administrative Authorities for Industry and Commerce to Prevent Abuses of Administrative Powers to Exclude or Restrain Competition'.

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The large scale of administrative monopoly in China, and the limits to effective control, is rooted in a governance system in which public bodies play a direct, extensive role in economic activities far beyond government intervention in other modern market economies. The permitted scope, methods, and impact of public agency intervention and participation in economic activities are not rigorously defined, creating large grey areas to be exploited. For example, AML Article 8 states that administrative departments or organizations authorized by law or regulations to administer public affairs may not abuse their powers and restrict competition. Yet NDRC and the State-Owned Assets Supervision and Administration Commission (SASAC) may restrict competition by limiting market access in many industries. Together with intervention by local governments, this confuses the role of state bodies as regulators of business activity.

In 2016, NDRC's antimonopoly bureau announced the creation of a Fair Competition Review Mechanism (FCRM), which will require public bodies throughout China to ensure that new regulations take account of competition policy concerns and to review existing regulations to reconcile them with the AML's pro-competition policy objectives. In the first instance, the FCRM requires self-assessment by government bodies, with subsequent evaluation by the AML units of MOFCOM, NDRC, and SAIC. The FCRM has the potential to stimulate basic retrenchment of anticompetitive government intervention.[13]

Two additional initiatives would help address administrative monopoly more effectively in China. First, in the long-term, the relationship between the government and the market needs to be reformed, as the 3rd Plenum decisions suggest. Second, in the short to medium-term, the legal basis for prohibiting and addressing administrative monopoly should be strengthened, in the context of the 4th Plenum decision on advancing the rule of law. This includes clarifying and strengthening the AML's provisions against administrative monopoly

5. Harmonizing industrial policy and competition policy

Industrial policy encompasses varied objectives and implementation methods, which affect competition in different ways. All market economies face the challenge of devising a policy that promotes, and does not restrict, competition. Industrial policy takes two major forms. *Vertical* policies promote specific industries, regions, or enterprises through government intervention that overrides the market. In some industries, China also has encouraged the development of nationally owned rather than foreign-owned firms by restricting investment and market entry of the latter. *Horizontal* policies support selected economic activities, such

13 On the development of the FRCM mechanism, see D. Dong and Y. Meng, 'Overview of Competition Policy', in Y. Meng and H. Lee (eds.), *China–Korea IP & Competition Law Annual Report 2015*, at 35–37.

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as research and development and innovation, without discrimination regarding specific industries, regions, or enterprises, and without displacing competitive market processes.

In many advanced economies, industrial policy is regarded as part of, and subordinate to, competition policy, and is permitted only when it is shown not to undermine market competition. If the 3rd Plenum's decisions on market reform are to be implemented successfully, China's industrial policy must be made consistent with competition policy.

5.1 Industrial policy in China

China's industrial policy has diverse objectives, including the promotion of exports and the import of advanced technology, the development of state-led infrastructure and of 'strategic' and high technology industries, and the rationalization of the industrial structure by curbing excess capacity (which often is industrial policy's unintended result). Compared to other nations, China's industrial policy is unique in its exceptionally large adverse effects on competition. This arises from a number of factors.

First, China's industry policy since the late 1970s has been influenced heavily by what were seen as successful Japanese and South Korean experiences with vertical industrial policies. China has adopted and persisted with policies that are more interventionist and restrictive on market entry than those tried in Japan and South Korea, and beyond those of modern market economies.

Second, China has used interventionist vertical policies to achieve varied policy objectives in almost all targeted industries. A uniform approach appears to be applied to all industries where important development goals exist, with little consideration as to whether market competition and private enterprises should play a greater role in the industry's progress. This is most evident in national 'economic lifeline' sectors, which include network industries and natural monopolies and many industries classified as 'strategic', 'pillar', and 'new emerging technology' industries. In many economies, formerly natural monopoly industries, such as telecommunications, today have few or no natural monopoly features due to technological dynamism. International experience has shown that even these industries have numerous competitive aspects, which have greatly improved their performance.

There seems to be no rigorous economic rationale for why industries, aside from the cases involving public goods (including national defense) or clear cases of market failure, require protection from market competition. The broader reason for intervention in China today is the outdated practice, inherited from the era of comprehensive central planning, which is inconsistent with a growth model based on market allocation of resources, efficiency, innovation, and international competitiveness.

Third, China's industrial policy relies primarily on SOEs as the agents of implementation. This practice, too, is a legacy of central planning, which China still

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embraces to an exceptional degree. Industries targeted by industrial policy are overwhelmingly dominated by SOEs operating as monopolies. SASAC's statement in 2007 that China intends to create up to 50 SOEs that will be globally competitive national champions assumes that the best path to improved performance in major industries is state ownership and the suppression of competitive market forces. No modern market economy at a later stage of development has achieved global competitiveness, sustained robust long-term growth, and moved to a high-income economy through such a policy.

To the extent that the state implements industrial policy with restrictions on market entry and the preferential treatment of SOEs, the approach conflicts with the 3rd Plenum's commitment to deepen systemic market reforms. If China continues to carry out industrial policy primarily through restrictions on competition and reliance on SOEs, the SOEs will not be disciplined by stronger competition. It is also impossible to reform industrial policy without reforming SOEs.

China's vertical industrial policy has created a large, uncompetitive regulated sub-economy of sectors where market entry is restricted, competitive market forces are repressed or distorted, and monopolistic SOEs dominate. Most industries currently suffering from severe excess capacity, as well as most insolvent 'zombie' SOEs, are in the regulated industries targeted by industrial policy in China. This gives the false impression of excessive competition, but excess capacity that creates this impression arises from, and is sustained by, non-market determined interventions – by vertical policy actions, by the exercise of administrative monopoly, or preferential support for SOEs against private or foreign owned enterprises. Without these interventions, markets generally would self-correct more readily; unsuccessful enterprises would exit the market, and more efficient firms would account for a greater share of production owing to their superior ability to meet customer demand. Many of China's most successful high technology industries – such as in telecommunication equipment, mobile phones, and e-commerce – have improved through exposure to domestic and global market competition.

5.2 Measures for harmonizing industrial policy and competition policy

Following the 3rd Plenum decisions of November 2013, China has taken important steps to address sectoral monopoly and reduce market entry barriers. It has replaced a list of industries where investment is allowed with a list where investments are restricted, and has reduced the number of administrative regulations on company registration and private investments in selective industries.

Given the scale, importance, and complexity of industrial policy and its broad impact on competition, a broader program of reform would be useful. One measure would be for China to study how to rebalance and harmonize the relationship between industrial policy and competition policy. The study would propose measures to achieve the 3rd Plenum decision to establish a more competitive market to improve resource allocation, raise productivity, and promote innovation.

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The study ideally should be part of a top-level design of ways to strengthen competition in the economy. It would best be undertaken in conjunction with related studies to curb administrative monopoly and to subject SOEs more fully to market competition.

The study also should consider how to mitigate or eliminate the adverse competitive effects of China's vertical industrial policy, propose steps towards more reliance on horizontal industrial policy, and implement methods that promote competition, productivity, and innovation. If industrial policy is not to impede competition, a key criterion for any public policy intervention should be its impact on competition and the role and contribution that competitive market forces should play in its implementation. Industrial policy intervention should then only be justified when the economic benefit from the intervention exceeds its costs in terms of allocative inefficiency and adverse competitive effects. By this approach, industrial policy should be subordinate to competition policy.

6. Integrating SOEs more fully into competition policy

International experience has shown that a large state-owned sector is incompatible with economic efficiency, innovation, international competitiveness, and robust growth rates necessary for a successful transition to a high-income economy. It is difficult for China to achieve its strategic economic objectives, including the 3rd Plenum decisions on strengthening market competition, without addressing the SOE sector and the sector's impact on competition in the national economy. Because of the large number and importance of SOEs, China arguably must devote more effort to apply competition policy to SOEs than to private enterprises.

In economic theory, competition, not the type of ownership, is decisive to an enterprise's performance and efficiency. Competition is the key determinant of an SOE's performance, as it is of a privately owned enterprise. The ability of an enterprise to operate efficiently and compete depends on its corporate governance – on how ownership and control rights in an enterprise are exercised. International experience has shown that it is difficult to design governance arrangements that could effectively insulate SOEs from political interference; mitigate the dangers of regulatory capture, corruption, and anticompetitive practices; and compel them to operate efficiently and to innovate. Despite numerous, ingenious attempts in the post-war period, no country with a large state-owned sector has overcome these problems successfully in the long term. This is why no modern market economy, and no high-income economy, today has a large state-owned sector. In Western European countries, previously sizeable SOE sectors were significantly reduced when interventionist vertical industrial policy was replaced by horizontal measures that did not circumvent competitive market forces. SOEs have performed efficiently only where they have faced competition.

Given the contributions SOEs have made in the past to China's development, and the important role still attached to them, the following discussion examines

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the challenges facing SOEs – how they can be subjected more fully to competitive market forces through the more effective application of competition policy.

6.1 SOEs and market competition in China

China's state sector is estimated to have accounted for about 40% of GDP in 2007 (or about 45% of non-agricultural GDP).[14] The average in high-income industrialized economies was 8.5% in 1984 and fell to under 5% by 2000. The weighted average for 40 developing countries is estimated by the World Bank to be 10.7% of GDP. The faster growth of the non-state sector's output relative to the SOE sector will have reduced the state's share of GDP in China since then, but the figure is still large in absolute terms and compared to all modern market economies. State assets in the secondary and tertiary sectors have actually grown in recent years, increasing from 63 trillion RMB in 2008 to 103 trillion RMB (US$16.3 trillion) in 2014.[15] Assets in the non-financial 106 central SOEs controlled by SASAC, which dominate the regulated strategic and pillar industries, is reported to amount to US$5.6 trillion (around 35 trillion RMB) at the end of 2013, with US$690 billion (4.4 trillion RMB) held overseas.[16]

An important AML achievement was to provide, in Article 7, that SOEs are subject to the law. Yet the AML also states that SOEs may operate as monopolies in sectors where market entry is restricted. SOEs constitute the core of China's uncompetitive regulated sub-economy where market entry is restricted. They tend to account for a high share of output in provinces with high levels of administrative monopoly. As executors of industrial policy targeted mainly at the regulated natural monopoly, infrastructure, and strategic manufacturing industries, central SOEs controlled by SASAC monopolize and dominate the capital and technology intensive industries. One study (Zhang 2014) shows that in 2010 they accounted for 38% of total assets in manufacturing industries, with about 81% of state assets in the manufacturing industries highly concentrated in ten regulated industries that together represented 83% of total state industrial output.[17]

14 SOEs in China adversely affect resource allocation and competition in a number of ways. The AML allows them to operate as monopolies in a wide range of regulated industries regarded as strategic and which account for a significant share of manufacturing output and GDP. Consequently, competitive forces are absent in large parts of the economy.There are considerable difficulties in measuring accurately the share of the state sector in China's GDP because of various methodological issues in defining the exact scope of state ownership or control.

15 SOEs are defined as those with 100% or majority state shareholding and exclude enterprises with minority but sometimes sizeable, and even controlling, state shareholding. The total amount of state assets would therefore be greater if state shares in the mixed ownership enterprises were to be included.

16 W. Leutert, 'Challenges ahead in China's reform of state-owned enterprises', 21 *Asia Policy* 83–99 (January 2016) (National Bureau of Asian Research).

17 Z. Zhang, 'The role of state-owned enterprises in economic development: Practice in China' (2014) Unpublished presentation to the OECD Workshop on State-Owned Enterprises in the Development Process, Paris. Five industries (electric power, iron and steel, transportation equipment, coal mining and

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Vertical industrial policy in China gives most SOEs preferential treatment and access to resources (especially capital and land). This crowds out resources allocated through competition, and the lack of market discipline weakens SOEs' incentives to raise efficiency and innovate. The large central SOE conglomerates controlled by SASAC have amassed large pools of internal retained funds generated through monopoly rents and a policy of low dividend payments to the state. This feature perpetuates their access to financial resources not allocated competitively through the market and weakens competitive market discipline in their use.

Owing to the extensive administrative system of regulatory approvals that ensure the dominant role of SOEs, economic success often depends more on favorable treatment by government authorities than upon being an effective competitor. This has created significant incentives and opportunities for rent seeking and corruption. Such governmental support and corruption in turn enhances the financial returns that make such corruption possible. This distorts the equitable characteristics of free markets, with the most efficient or productive enterprises not being rewarded, but rather those with power to exercise such intervention in the market.

SOEs also have significant indirect adverse effects on allocative efficiency and market competition beyond the regulated industries they control. Their monopolistic and monopsonistic position in industries critical to the rest of the economy, together with instances where they have regulatory power to set industrial, technical, and other standards, allows them to exercise market power over suppliers and customers in upstream and downstream industries. SOEs often favor their own subsidiaries, associated enterprises, or other related parties. This undermines allocative efficiency and market competition and provides further opportunities for patronage and corruption to emerge.

6.2 *Integrating SOEs more fully into competition policy*

In theory, it is possible to subject SOEs to the same competitive pressures faced by private enterprises in markets. In practice, this has proved difficult to achieve. If state ownership confers no advantages or disadvantages – a condition known as 'competitive neutrality' – then the same benefits of competition in terms of efficiency and responsiveness to market signals can be achieved. For competitive neutrality to hold, it is necessary that SOEs receive no discriminatory state subsidies or tax benefits; preferential treatment (such as in access to land, capital assets, or finance); protection from new market entrants or in the application of regulations; and protection from bankruptcy if they are unprofitable. Few of these conditions currently apply to SOEs in China.

oil exploration) of these 10 industries alone accounted for 64% of total state industrial assets and 63% of total state industrial output.

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SOE reform has long been a major policy issue in China, and the 3rd Plenum decisions reflect its continuing importance. Chinese policymakers have not indicated how SOEs should be subjected to greater market competition, despite the 3rd Plenum's decision to make the market play the decisive role in resource allocation and to establish a unified, open, fair, and orderly market. The government should undertake a study to develop a reform framework for integrating SOEs more fully into competition policy, as a means for improving their efficiency by subjecting them to competitive market discipline. The reform framework should address three important issues.

Role and objectives of state ownership. The role and objectives of SOEs should be clarified and updated in line with the 3rd Plenum decisions, and to foster the transition to a high-income economy. A step in this direction is the 'State Council SOE Reform Guidance 2015', which distinguishes between 'public service' and 'commercial' SOEs. However, in line with the redesign of industrial policy, the proposed study should identify industries where state ownership and intervention are justified, such as in cases of market failure, national defense industries, and in certain public goods and services. Aside from these industries, all commercial SOEs – where some state ownership is retained – should be fully subjected to market competition, and opened to mixed, diversified ownership by eliminating entry barriers. Such an approach would reduce the size and scope of the uncompetitive regulated sub-economy in China and enlarge the competitive sub-economy. This would implement the 3rd Plenum's general principle that SOEs should focus on certain economic activities and that non-state firms should be allowed to compete in almost all sectors.

Ownership structure and corporate governance. A second issue is to make an explicit distinction, which economic theory and international experience show to be essential, between public ownership of capital on the one hand and government activities that interfere with the operations of enterprises and shield them from market competition on the other hand. This would require improvements to an SOE's ownership structure and corporate governance by having their assets held diversely by various state holding, asset and investment management companies, pension funds, and insurance holdings – preferably by including private ownership. This would improve governance, transparency, and accountability; diversified ownership and control would help ensure that an enterprise is operated efficiently and profitably. In this regard, the 3rd Plenum decision to establish state capital and investment operating companies could be a major step towards curbing state interference arising from state ownership. This depends critically on how these entities are configured in practice, particularly in terms of who the shareholders are and how much ownership and control rights are diversified and exercised.

China's practice of reforming SOEs through mergers and consolidation will create large enterprises with even greater market power and potential for anticompetitive practices. The process of mergers and consolidation should be subject to

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review by the competition authority. It is vital that these large SOEs are explicitly subjected to the AML, and that the competition authority receives increased powers and resources to investigate and address potentially anticompetitive practices.

Subjecting SOEs to competition. A third issue is to ensure that the reformed SOEs face competitive market forces. Unless they are compelled to operate in a competitive market environment, they will have even more powerful incentives to seek monopoly rents through greater prices and market dominance abuses. To alleviate such dangers, it is critical to introduce greater competition where SOEs operate.

Within the SOE reform policy framework described above, a number of specific SOE reform measures, based on successful international experiences in competition policy, could be taken. These include the following reforms.

One set of reforms would rationalize the structure and operations of SOEs to enable them to operate competitively.

(i) Reduce conglomerate holdings in large SOEs to prevent privileged or dominant positions in one industry from conferring market power in other potentially competitive industries.
(ii) Introduce full separation of accounting between different SOE industrial activities and include in those accounts the market-related valuations of all assets. This will permit accurate assessments of an SOE's profitability.
(iii) Remove social welfare obligations which either unduly prejudice SOEs' ability to compete, or require the government to pay subsidies to SOEs to enable them to fulfill such obligations.
(iv) Initiate measures to eliminate all ongoing SOE losses. If this does not emerge from efforts to improve efficiency and responsiveness to market pressures, the SOE should be merged, sold, or closed.

A second set of reforms seeks to preclude intervention in the market's resource allocation.

(i) Cease state subsidies to SOEs (and to any type of enterprise) except where explicitly sanctioned under a reformed industrial and SOE policy.
(ii) Reduce and eventually eliminate directives to SOEs on, and the control of, their funding or investment programs by state bodies. These should be strategic and operational market-based decisions made by a professional board of directors of commercialized SOEs upon the approval of their shareholders.
(iii) Gradually reduce the government's exercise of its power to block new entry, which threatens to weaken the market position of established SOEs. Such powers should be used only in exceptional circumstances, in a non-discriminatory way and subject to assessment by the competition authorities.
(iv) Eliminate all preferential loans or other funding, and access to resources at anything other than market-determined rates.

The third set of reforms seeks to ensure that SOEs face full competitive market discipline.

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(i) Set guidelines on a substantial minimum dividend policy, to avoid the danger that most or all funds generated are automatically reinvested in a way that may not be the most productive use of the funds (i.e. public capital) available.
(ii) Revise AML Article 7 to remove the entry restrictions in markets currently reserved for SOEs.
(iii) Adopt the practice whereby any SOE, like any other enterprise, that has a significant share of a relevant market, if combined with other concerns about competition, may trigger an investigation by the competition authorities to see whether it has a position of market dominance, and, if so, whether it is abusing its market power.

7. Conclusion

The measures proposed here seek to strengthen market competition consistent with the 3rd Plenum's decision to establish a competitive economy, and with the 4th Plenum's decision to advance the rule of law. These reforms are necessary to achieve a successful and rapid transition to a high-income economy. If adopted, the reforms would reduce the size and scope of China's uncompetitive regulated sub-economy and increase the size and scope of the competitive sub-economy. A strengthened competition law and policy regime would be more effectively enforced throughout the national economy without discrimination by ownership or industry. These outcomes would help China to realize more fully the country's economic potential, and to achieve high, robust, and sustainable growth rates based on efficiency, innovation, and international competitiveness.

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